
COMMISSION ON THE REGULATION OF
U.S. CAPITAL MARKETS IN THE 21ST CENTURY

Report and Recommendations

AN INDEPENDENT, BIPARTISAN COMMISSION
ESTABLISHED BY THE U.S. CHAMBER OF COMMERCE

MARCH 2007



regulators, venture capitalists, investment bankers, labor leaders, exchange officials, and entrepreneurs.

The Commission also met formally and informally with current and former regulators and executive branch and Congressional officials. The Commission received a broad range of informal views and thoughtful concerns.

The Commission has agreed on recommendations to further the competitiveness of U.S. capital markets, the development of capital sources for business expansion and job creation, and the protection of the investors whose savings contribute so importantly to capital formation.

Our most fundamental recommendation is that policy-makers and thought-leaders address these problems now before a crisis arises. We have it within our power to take sensible, effective steps to ensure that U.S. markets are the most fair, efficient, transparent, and attractive in the world. **The question is, can we find the political will to take them.**

COMMISSION ON THE REGULATION OF
U.S. CAPITAL MARKETS IN THE 21ST CENTURY



CONTENTS

Overview 4

U.S. Capital Markets in the Global Marketplace 13

Accumulated Savings and Investor Education 49

Challenges Confronting Issuers and Auditors 70

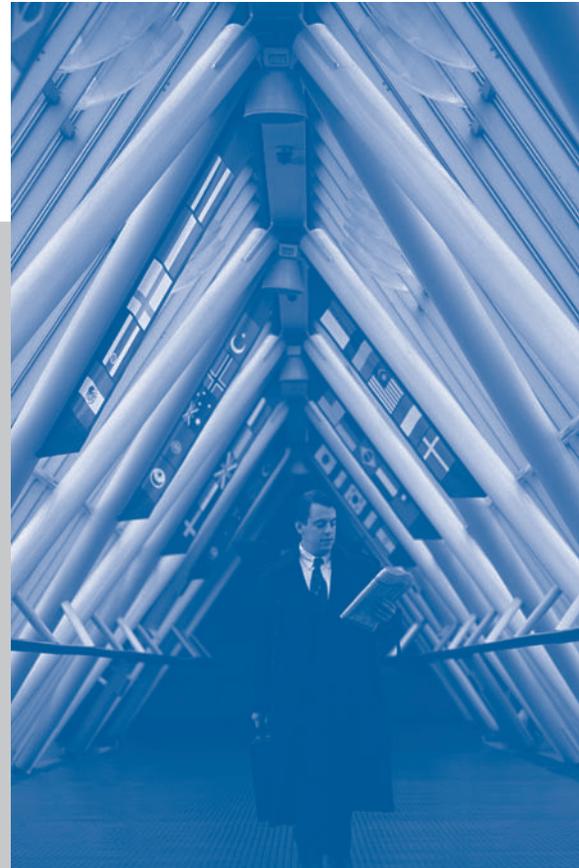
Challenges Facing the Financial Services Industry 115

Report Conclusion 146

Appendix 1: Commissioner Biographies 147

Appendix 2: Acknowledgments 162

Appendix 3: Summary of Full Recommendations 164





OVERVIEW

The U.S. capital markets have long provided tremendous advantages to our economy. They have provided growing companies with much-needed access to capital—and have given millions of investors the opportunity to share in the wealth created by these companies. More than half of all U.S. households—57 million according to a recent survey—participate in our markets through either stocks or mutual funds, and the health and competitiveness of these markets has an immediate and direct effect on the broader economy, as well as on the wealth and prosperity of the American people.

Unfortunately, the competitive position of our capital markets is under strain—from increasingly competitive international markets and the need to modernize our legal and regulatory frameworks. Over the last two decades, markets have truly become global—corporations, accounting firms, investment banking firms, law firms, and now stock exchanges—all have internationalized. Yet, the U.S. regulatory structure is deeply rooted in the reforms put in place in the 1930s, a period that was closer in time to the Civil War than it is to today.



The Commission Co-Chairs A.B. Culvahouse (left) and Bill Daley discuss the strategic direction of the Commission's recommendations.

The Commission believes that with quick and decisive adjustments in the U.S. legal and regulatory framework, U.S. government regulators and market participants will be better positioned to ensure that U.S. investor and business interests are best served in the global marketplace. To better protect investors and promote capital formation, the Commission is setting forth a series of recommendations that would significantly improve the U.S. position in the global markets. These recommendations can be implemented quickly and without overly burdensome costs.

Principal Recommendations

- **Reform and modernize the federal government's regulatory approach to financial markets and market participants.**
- **Give the Securities and Exchange Commission (SEC) the flexibility to address issues relating to the implementation of the Sarbanes-Oxley Act of 2002 (SOX) by making it part of the Securities Exchange Act of 1934.**

Commission Co-Chairs

A.B. Culvahouse
Chairman
O'Melveny & Myers LLP

William M. Daley
Vice Chairman
JPMorgan Chase and
former Secretary of Commerce

Commissioners

John Bachmann
Senior Partner
Edward Jones

John Bohn
Chairman
GlobalNet Venture Partners

Jim Copeland
Former Chief Executive Officer
Deloitte & Touche

Christine Edwards
Partner
Winston & Strawn

Peter Gilbert
Chief Investment Officer
Pennsylvania State Employees'
Retirement System

Melody Hobson
President
Ariel Mutual Funds

- **Convince public companies to stop issuing earnings guidance or, alternatively, move away from quarterly guidance with one earnings per share (EPS) number to annual guidance with a range of EPS numbers.**
- **Call on domestic and international policy-makers to seriously consider proposals by others to address the significant risks faced by the public audit profession from catastrophic litigation, as well as the Commission's suggestion that national audit firms be allowed to raise capital from private shareholders other than audit partners.**
- **Increase retirement savings plans by connecting all employers of 21 or more employees without any retirement plan to a financial institution that will offer a retirement arrangement to those employees.**
- **Encourage employers to sponsor retirement plans and enhance the portability of retirement accounts through the introduction of a simpler, consolidated 401(k)-type program.**

Other groups have already commented extensively on other important areas such as litigation reform. Generally, this Commission sought to add to the discussion rather than revisit the ground covered by others. This Commission does, however, make a number of specific litigation reform-related recommendations designed to enhance the effectiveness of the U.S. legal system. We also call upon policy-makers to carefully consider the work of all responsible commentators on these critically important issues.

Commissioners

Jim Johnson
Vice Chairman
Perseus LLC

Mickey Kantor
Partner
Mayer, Brown,
Rowe & Maw LLP

Eric Mindich
Chief Executive Officer
Eton Park Capital

Rick Murray
Managing Director &
Chief Claims Strategist
Swiss Re

Don Nickles
Chairman and
Chief Executive Officer
The Nickles Group

Bob Pozen
Chairman
MFS Investment Management

Michael Ryan
Executive Director
Commission on the Regulation of
U.S. Capital Markets in the
21st Century



PRINCIPAL RECOMMENDATIONS

We highlight six recommendations that the Commission believes would provide significant improvements to the functioning of America's capital markets. These recommendations have not been the focus of other groups examining global competitiveness. We believe that these six recommendations by and large can, and should, be implemented in 2007 by Congress, the regulatory agencies, and market participants.

1. Reform and modernize the federal government's regulatory approach to financial markets and market participants.

The Commission recommends four primary operational and organizational changes to the U.S. financial services regulatory structure:

- *The SEC should realign its organizational structure to improve its efficiency and mirror the contours of the current capital markets, including, for example, by folding the Office of Compliance Inspections and Examinations (OCIE) back into the operating divisions to facilitate consistent interpretations of applicable rules.*
- *The SEC should place greater emphasis on ensuring consistent and uniform compliance with the Administrative Procedures Act (APA) when adopting new or significant changes in policy, particularly the Office of Chief Accountant in connection with significant changes in accounting policy.*
- *The SEC should implement, and Congress should support with targeted legislation (e.g., an SEC examination privilege), an enhanced "prudential" regulatory role over the financial intermediaries it regulates.*
- *Congress should enact legislation to establish an optional federal insurance charter.*

As capital markets change rapidly and new products are developed, it is critical for the SEC to provide clear and consistent guidance to the financial community. To promote consistency of interpretation in the application of SEC rules, SEC examiners should work for the divisions responsible for establishing and interpreting the rules for regulated entities, such as broker-dealers and investment advisers. Although the Commission supports and encourages the SEC to provide informal interpretative guidance, the Commission believes that to alert investors and market participants to significant potential changes in regulatory policy, all parts of the SEC—including the Office of Chief Accountant—should adhere to the notice and comment procedures of the Administrative Procedures Act for significant changes in policy.

The Commission believes that the protection of investors and promotion of capital formation is best achieved by addressing and resolving issues before

they become real problems. One of the most effective and efficient ways for the SEC to achieve this goal is by providing informal guidance to market participants as new issues emerge that are important but do not require rulemaking. A more prudential supervisory approach by the SEC should enhance its effectiveness in this area by fostering open communication between the SEC and the institutions it regulates while improving the SEC's understanding of current market practices and issues.

Finally, the Commission believes that the proposed optional federal insurance charter will enable large insurance companies to engage more efficiently on a national or international scale, thus increasing competitiveness and reducing costs for consumers.

2. Give the SEC the flexibility to address issues relating to the implementation of SOX by making SOX part of the Securities Exchange Act of 1934.

The Commission recommends that Congress enact legislation that expressly incorporates the Sarbanes-Oxley Act of 2002 into the Securities Exchange Act of 1934.

SOX is perhaps the only part of the federal securities laws that is not fully subject to the SEC's general powers to issue rules and exemptions for the implementation of these laws. This has led to questions about the nature and extent of the SEC's authority in the complex process of implementing SOX and has limited the flexibility of the SEC in addressing issues related to SOX implementation.

The Commission believes that taking this step would provide greater certainty to the marketplace by ensuring that the SEC has the clear authority to issue rules on important aspects of SOX that will need to be fine-tuned from time to time to the realities of the capital markets. For example, the SEC could issue rules applying Section 404 of SOX on internal controls with appropriate variations for public companies of different sizes, and the SEC could issue partial exemptions for foreign registrants subject to comparable home-country requirements.

3. Convince public companies to stop issuing earnings guidance or, alternatively, move away from quarterly guidance with one earnings per share (EPS) number to annual guidance with a range of EPS numbers.

The Commission recommends that all public companies seriously consider the permanent elimination of quarterly guidance on EPS. Alternatively, the Commission recommends that public companies move from quarterly guidance with one EPS number to annual guidance with a range of EPS numbers. In either case, the Commission recommends that public companies promulgate additional information on their long-term business strategies as

well as on any material developments between quarterly announcements of actual earnings.

The Commission believes that there is too much focus on the short-term performance of U.S. companies. The pressure for businesses to “hit” their targets can be overwhelming and creates adverse incentives to forgo value-added investments in long-term projects. Although a few high-performing companies have stopped making quarterly earnings projections, many companies have stopped doing so only after they have missed their earnings targets. As a result, an announcement that a company will stop making quarterly earnings projections is often interpreted as a “negative signal” by the securities markets.

The Commission believes that implementation of this recommendation by all public companies will reduce emphasis on short-term results and avoid the “negative signal.” This, in turn, will benefit investors by placing greater emphasis on long-term value creation and will further the interests of the U.S. economy by encouraging innovation based on long-term thinking.

4. Call on domestic and international policy-makers to seriously consider proposals by others to address the significant risks faced by the public audit profession from catastrophic litigation, as well as the Commission’s suggestion that national audit firms be allowed to raise capital from private shareholders other than audit partners.

The Commission recommends that Congress, government agencies, and market participants engage in serious discussion about proposals made by others—including safe harbors or damage limits in specified circumstances—to address the risk of losing another large audit firm. At the same time, to facilitate interstate audit practices, the Commission recommends that Congress create the option of a federal charter for a limited number of large national audit firms. These national audit firms would be allowed to raise capital from shareholders other than audit partners (subject to resolving independence issues), which might allow more capital to flow into the major audit firms and may incent investors like private equity funds to create a new fifth global audit firm.

The independent auditing firms play a critical role in our capital markets by providing reasonable assurance on the financial statements of public companies. Thus, the Commission believes that sustaining a strong, economically viable public company audit profession is vital to domestic and global capital markets.

The viability of the audit function is threatened by a variety of factors, including (i) unrealistic expectations about the precision of financial statements, as well as the inherent limits on an auditor’s ability to detect collusive frauds;

(ii) criminal indictment of audit firms (rather than responsible audit partners);
(iii) catastrophic litigation claims in a market in which commercial insurance simply is not available to the firms in adequate amounts to cover such claims; and (iv) multijurisdictional regulation and enforcement activities that pose a barrier to interstate and global service.

Thus, the Commission believes that it is critical that domestic and foreign policy-makers immediately engage in proactive discussions to consider a wide range of proposals to address serious issues concerning the viability of the public company auditing profession.

5. Increase retirement savings plans by connecting all employers of 21 or more employees without any retirement plan to a financial institution that will offer a retirement arrangement to those employees.

The Commission recommends that Congress enact legislation establishing tax-favored savings accounts for employees of companies with 21 or more employees that do not sponsor a retirement savings plan of any type.

The Commission believes that the use of automatic payroll deductions will encourage greater retirement savings by employees of companies that do not offer any type of retirement plan. Millions of full-time employees work for companies with 21 or more employees that do not offer any type of employer-sponsored retirement plan. Under this proposed legislation, employers with 21 or more employees would choose a qualifying financial institution to offer retirement accounts to their employees. Such employers would collect employee contributions through payroll deductions and transmit those contributions to that financial institution. Employees would be permitted to opt out of these arrangements at any time.

Furthermore, under these arrangements, employers would be allowed, but not required, to make employer contributions or to match employee contributions. Employer costs and ongoing responsibilities would be minimal; for example, employer responsibilities would be limited to choosing the financial institutions, monitoring the continued soundness of that institution, and transmitting employee contributions in a timely manner. The recipient financial institution would have the remaining fiduciary obligations.

The Commission believes that implementing this recommendation will both increase retirement savings and strengthen U.S. capital markets by growing the size and diversity of investment funds flowing into these markets.

6. Encourage employers to sponsor retirement plans and enhance the portability of retirement accounts through the introduction of a simpler, consolidated 401(k)-type program.

The Commission recommends that Congress consolidate the various types of defined contribution (DC) plans into one 401(x) program.

While retirement savings as a whole have grown significantly in recent years, current retirement savings are inadequate for many future retirees. A significant number of American families will not have sufficient wealth in retirement to maintain their current standard of living. In particular, several types of DC plans—401(k), 403(b), and 457(b) plans—have identical annual employee contribution levels, but they differ to a greater or lesser degree in many other ways.

The Commission believes that implementing this recommendation will reduce the administrative and systems costs involved by maintaining separate plan designs by retirement providers. By reducing the costs associated with the administration and design of various types of DC plans, the 401(x) program will encourage employers to sponsor DC plans. Moreover, the 401(x) program would enhance the portability of retirement plans for any employee who changes jobs.

The Commission further believes that implementing this recommendation will, over time, increase the investments retained in DC plans as well as the participation of plan participants in the U.S. capital markets. Larger pools of retirement savings should enhance the attraction of the U.S. capital markets to all issuers of securities.

In addition, others have examined the issue of America's capital market competitiveness and made recommendations in the areas that they believed presented the most significant challenges and the greatest opportunities for improvement. This Commission does not take a position on their specific findings or recommendations, but it does support their efforts to identify challenges and propose possible solutions. Most important, however, we believe that the increased focus in recent months on these issues by a wide range of interested parties provides further evidence that fundamental challenges face our capital markets and that these challenges are of critical importance to others in our country besides those who make their living on Wall Street.

There will be some overlap with the findings and recommendations of other groups, but this Commission attempted to reduce as much as practical the duplication of the examination of issue areas. For example, although the Commission would support efforts to reform America's litigation system to reduce frivolous lawsuits, substantial work has already been done by others in this area, including the U.S. Chamber Institute for Legal Reform, which has begun its own initiative to comprehensively examine the securities class action litigation system. The Commission does make one important recommendation in this area. Given that the Private Securities Litigation Reform Act (PSLRA) has been in effect for more than 11 years, the Commission recommends that Congress call upon the SEC to undertake a comprehensive study of the state and federal civil, regulatory, and criminal enforcement mechanisms to assess whether they are enhancing the goals of investor protection and capital formation, including whether the PSLRA is meeting the objectives set forth by Congress.

CONCLUSION

The challenges to our capital markets are multifaceted, as are answers to those challenges. The Commission believes that the time has come to seriously reconsider some of the systems and institutions built over the past 70 years to protect investors and foster capital formation. Historically, most reform in this area took place only after the country faced a crisis. We can—and should—do better. Thus, the Commission's most fundamental recommendation is that policy-makers and thought-leaders address these problems now, before a crisis arises.



U.S. CAPITAL MARKETS IN THE GLOBAL MARKETPLACE

I. Introduction	14
II. Observations and Views	15
III. Data Collection and Statistical Survey	18
IV. Survey of Drivers.....	21
A. Quality and Effectiveness of Foreign Markets.....	21
B. Socioeconomic Growth and Technological Advancements.....	23
C. Cost of Capital.....	24
1. Direct Costs of Issuing Equity	25
2. Indirect Costs of Issuing Equity.....	25
3. Timing to Complete Equity Offerings.....	26
4. Cost of Capital for Small Businesses.....	27
D. Securities Litigation	28
E. U.S. Regulatory Standards and Environment.....	31
1. Sarbanes-Oxley	32
2. Securities Offering Reform Package.....	34
3. Rule 144A and Regulation S.....	34
F. Substituted Compliance—Foreign Brokers and Exchanges	36
1. Current U.S. Regulatory Environment for Foreign Entities.....	38
2. Benefit of Improved Access Between U.S. and Foreign Capital Markets.....	39
3. Key Concepts to Inform an SEC International Strategy.....	40
G. Convergence of Accounting Principles and Audit Standards.....	40
1. Current Requirements for Foreign Private Issuers Listed in the United States	42
2. Development of IFRS—Convergence of National Accounting Standards	43
3. Tangible Steps Made Toward Convergence of IFRS and U.S. GAAP.....	44
4. Auditing Convergence	46
5. Prospects for Convergence of Accounting Principles and Audit Standards.....	47
6. Commission Recommendations.....	47



I. INTRODUCTION

As the Commission progressed through its review and analysis of the challenges confronting the United States capital markets, it became clear that the relevant issues are more complicated, complex, and interrelated than suggested by the news headlines on the relative decline in global initial public offerings (IPOs) in the United States. The challenge for the Commission was to gain a sufficient understanding of global marketplace dynamics so that the vital interests of the U.S. capital markets and its market participants could be best advanced.

Through discussions with third parties and review of various studies, news reports, and other sources of commentary, the Commission identified a broad spectrum of drivers that it views as potentially causing—or at least influencing—the trends in global capital markets. The Commission reviewed such drivers over a period long enough not to be misled by short-term or cyclical trends, but short enough to capture recent structural shifts in global capital markets that are both relevant today and will remain key drivers in the near future.



Rick Murray leverages his experience in international business to lead the Global Marketplace Working Group.

The Commission believes that the United States faces a dual and somewhat conflicting challenge: to craft a policy that fosters collaboration between U.S. and foreign capital markets institutions and, at the same time, enables the United States to retain a leadership position in the trading and distribution of global capital. To address this challenge, the Commission examined recent trends in global capital markets and how such trends affect the competitiveness of the U.S. capital markets. In particular, the Commission sought to understand why foreign companies, seeking to raise capital outside their own country, are increasingly choosing to raise capital in venues outside of the United States.

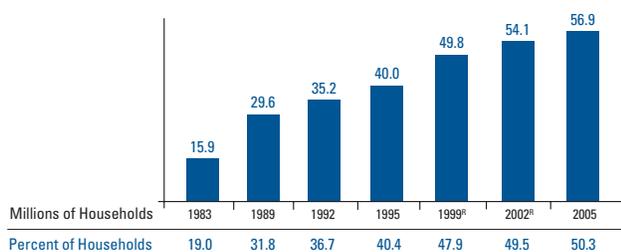
The Commission believes that the United States faces a dual and somewhat conflicting challenge: to craft a policy that fosters collaboration between U.S. and foreign capital markets institutions and, at the same time, enables the United States to retain a leadership position in the trading and distribution of global capital.

II. OBSERVATIONS AND VIEWS

For more than 70 years, the United States has been home to the most fair, efficient, and well-functioning capital markets in the world. The presence of such markets has brought prosperity to our nation and has been a positive force in many other parts of the world. Efficient capital markets channel needed investment at competitive prices to entrepreneurial companies, creating jobs and providing lucrative opportunities for investors. Today, more than half of all U.S. households—57 million according to a recent survey—participate in equity markets through investments either directly in securities or indirectly in mutual funds.¹ See *Figures A and B*.

Figure A
Growth in Equity Ownership

Number and percent of U.S. households owning equities, 1983-2005



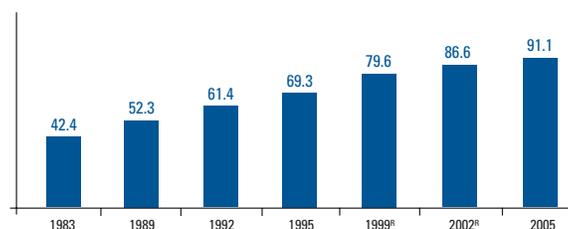
R=Revised

Note: The number of households owning equities in 1999 and 2002 was revised to reflect updated U.S. Census Bureau estimates of the number of U.S. households in those years.

Sources: ICI/SIA Equity Ownership Surveys; Federal Reserve Board, Survey of Consumer Finances; and U.S. Census Bureau

Figure B
One in Three Individuals Owns Equities in 2005

Millions of individual U.S. investors owning equities, 1983-2005



R=Revised

Note: The number of households owning equities in 1999 and 2002 was revised to reflect updated U.S. Census Bureau estimates of the number of U.S. households in those years.

Sources: ICI/SIA Equity Ownership Surveys, New York Stock Exchange, and U.S. Census Bureau

By many measures, the U.S. capital markets remain the most liquid and trustworthy in the world. Since the 1990s, however, the United States has experienced a steady decline in the share of global capital markets activity in a number of important areas. The Commission believes that the daily headlines generally oversimplify these trends: either exaggerating the extent of this decline, or understating the challenges facing the U.S. capital markets. Nevertheless, reviewing the data trends over the past decade and listening to the range of commentators on this subject, we believe that the future competitiveness of the U.S. capital markets is a serious issue that transcends Wall Street.

Of course, the factors impacting the trends in capital markets activity are varied, shifting, and complex. Chief among these factors is the cost of capital. The direct

¹ *Equity Ownership in America*. Investment Company Institute and the Securities Industry Association, 2005

costs of raising capital in the United States remain significantly higher when compared to foreign markets. These include underwriting spreads (which are the highest in the world), as well as professional costs and listing fees. Nevertheless, some of the indirect costs in the United States, such as trading costs, remain lower than in Europe and Asia. Indirect costs include the discount when shares are sold at an offer price below the market price that the shares subsequently realize. For IPOs in both the United States and other countries, these indirect costs—related to underpricing discounts—can be as high as the direct costs.

Historically, regulatory policies, the friendly corporate environment, and the strength of the legal institutions in the United States have been critical factors contributing to the leading position of U.S. capital markets. Higher governance standards improve corporate oversight, in turn leading to greater investor confidence and higher shareholder value. Greater transparency and these increased standards encourage corporate executives to act in the best interests of the company and

its shareholders. Further, through the recent Securities Offering Reform Package and other U.S. Securities and Exchanges Commission (SEC) accommodations for non-U.S. issuers, U.S. regulators are attempting to provide an increasingly friendly environment for foreign companies to access the U.S. capital markets. The U.S. markets remain highly liquid; the trading of securities in the United States takes place at well-established exchanges operating in a carefully supervised environment.



Commissioners John Bohn, Mickey Kantor, and Don Nickles (left to right) discuss the cost of raising capital in U.S. markets.

The U.S. regulatory environment, however, increasingly is coming under criticism. Many commentators observe that the implementation of the Sarbanes-Oxley Act of 2002 (SOX) and other regulatory

requirements have increased the cost of raising capital in the United States. Others expressed concern that the lack of convergence in accounting systems between U.S. and foreign markets presents an obstacle for foreign investors and companies. Finally, many have observed that the level of civil litigation related to the capital markets remains much higher and more expensive in the United States than in Europe or Asia.

Another important factor increasing the competitiveness of foreign capital markets comes from the technological, economic, and regulatory advancements these foreign markets and related economies have made over the past decade. Foreign market centers are becoming more liquid and are developing the technological infrastructure comparable to that found in the United States. Such market centers are reliable

and trusted listing venues that enable businesses to obtain capital at relatively low costs. Foreign exchanges are marketing their lower listing standards and smaller capitalization requirements in an effort to capture the flight of activity away from the United States. Further, although beyond the scope of this Commission's work, the Commission believes that nationalistic and noneconomic factors also play a meaningful role. For example, IPOs of Chinese state-owned enterprises may prefer to be centered in the Hong Kong markets. Even if these Chinese entities are listing in regional markets, the fact that they are not listing in the United States deprives American investors of opportunity.

The fact that European and Asian markets are developing so rapidly and successfully should be viewed as a positive development for the United States. As has been the case for many decades, the outcome of our successful integration with these economic regions will be impacted by many factors, including U.S. tax and trade policies, foreign policy, as well as economic and political changes occurring within and outside the United States. Many of these factors are beyond the control of the U.S. policy-makers. By contrast, they have more ability to change the legal and regulatory framework surrounding the capital markets and financial services industry.

The challenge in this regard is two-fold:

- To strike the right balance between two statutorily mandated goals: protecting investors and promoting capital formation. If there is too much or too little emphasis on either, then both are undermined, while getting one right works to support the other.
- To make adjustments to this balance over time in response to the inevitable fluctuations in the many variables that are at play—*e.g.*, technological advances, the introduction of new financial products, the changing demands of end users (investors and issuers), the increased competitiveness of foreign markets, as well as certain noneconomic factors like geopolitical developments.

III. DATA COLLECTION AND STATISTICAL SURVEY

The Commission engaged in a general survey of published data to identify the current trends in the global capital markets. The sources included the World Federation of Exchanges, Thomson Financial, Dealogic, the U.S. Department of the Treasury, the World Bank, the International Monetary Fund, the Securities Industry and Financial Markets Association, and the Investment Company Institute. At the broadest level of this analysis, the Commission sought to determine whether the trends indicated something as simple as a sharp reaction to recent events in the marketplace, or rather long-term, fundamental shifts in the capital market centers. The Commission's observation is that we are experiencing both: some dramatic but probably self-correcting responses to specific events, as well as gradual, but meaningful longer-term trends reflecting a series of interconnected and evolving changes in domestic and foreign markets.

The Commission's review of the data begins with the trends in global IPOs that dominated the headlines in 2006. There has been a substantial decrease in the number of IPOs occurring in the U.S. markets, from 507 in 1999 to 235 in 2006.² Similarly, data from Thomson Financial indicates that the U.S. market share of IPOs has declined from 57% in 2001 to 16% last year. It is notable, however, that the decreasing number of IPOs is partially attributed to the tech bubble bursting. Despite this loss in IPO activity, the total proceeds in the United States has remained strong (see Figure C), indicating that growth in foreign markets is a significant driver behind this trend. While the majority of total global IPOs occur in their home market, this number has declined 8% since 2002, indicating that companies are increasingly looking outside their domicile country to raise capital. See Figure D. Indeed, there was something of a resurgence of foreign IPOs in the U.S. capital markets during 2006. See Figures E and F.

Since 1996, the United States has also experienced a decrease in its participation rate (in the listing of the securities on U.S. exchanges) with the top 25 global

Figure C
Total U.S. IPOs and Proceeds

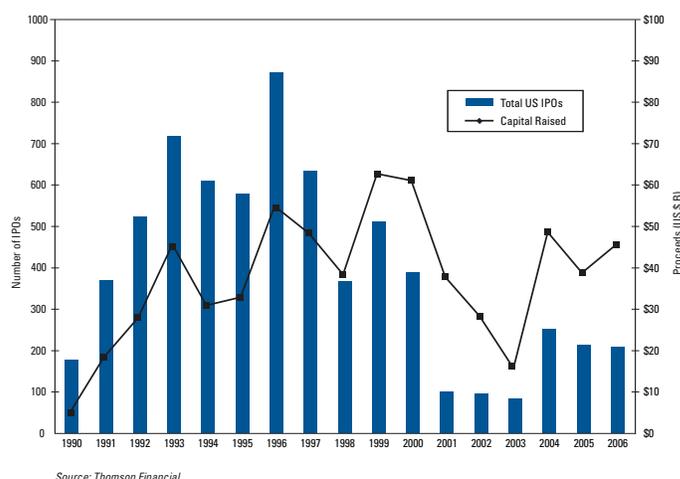
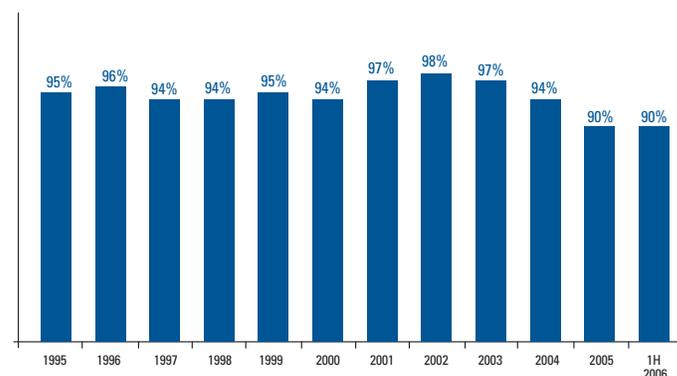


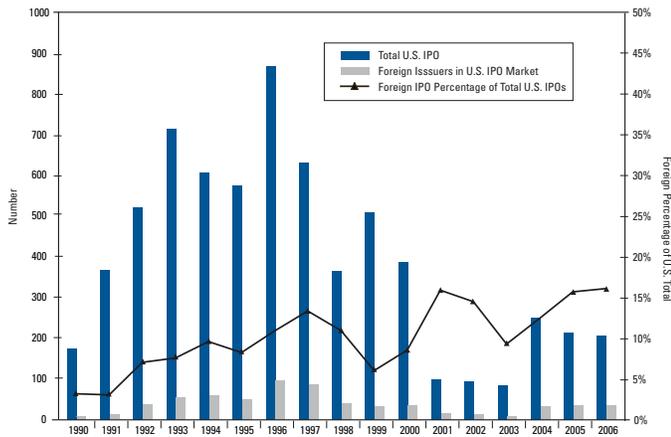
Figure D
The Majority of Companies List in Their Home Market

Percentage of Global IPOs with Domestic Primary Listings



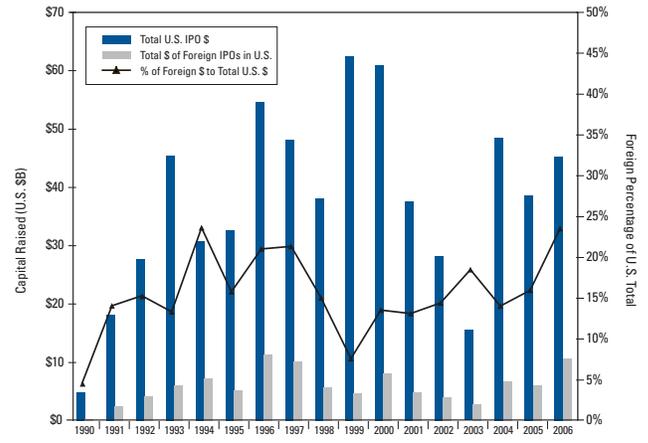
² Gopinath, Deepak, "IPOs Shun U.S. Exchanges While Wall Street Collects Record Fees," *Bloomberg*, February 20, 2007, http://www.bloomberg.com/apps/news?pid=20601109&sid=aF07N_Ngeuzc&refer=home.

Figure E
Foreign Issuers in the U.S.: Number of IPOs



Source: Thomson Financial

Figure F
Foreign Issuers in the U.S.



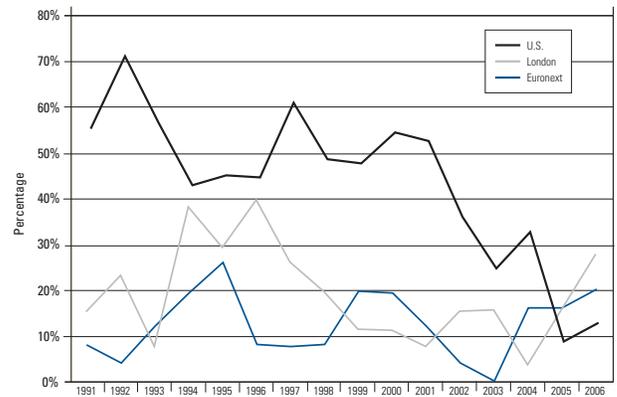
Source: Thomson Financial

IPOs, as well as a movement away from multiple listing. See Figure G. During the boom years in the late 1990s, the technology sector was an engine of growth for the U.S. economy and produced a large number of IPOs, but IPOs in that sector have declined sharply since 1999. In contrast, nontechnology IPOs in the United States experienced a steady decline beginning in 1996, with a modest increase since 2003. While many of the recent large global IPOs have been Chinese companies, the fact that these companies have chosen to list in London and not the United States is a cause for concern.

Similarly, since 1996, there has been a steady decrease in the number of companies that are opting to list on U.S. exchanges. Not only has the total number of companies listing on U.S. exchanges declined, the U.S. market share for worldwide listings has dropped 19% since 1997. Foreign exchanges have seen an increase in their listings over the same period. The data strongly suggest that both Europe and Asia are capturing a substantial portion of the shift away from U.S. markets and exchanges. See Figure H.

This shift in capital markets activity away from the United States is driven partly by the dramatic increase in capital outside the United States (e.g., from oil producing countries) as well as the market improvements in foreign capital markets mentioned above. Other studies have attempted to analyze the composition of the IPOs that

Figure G
Distribution of Top 25 Global IPOs by Year



Source: Thomson Financial

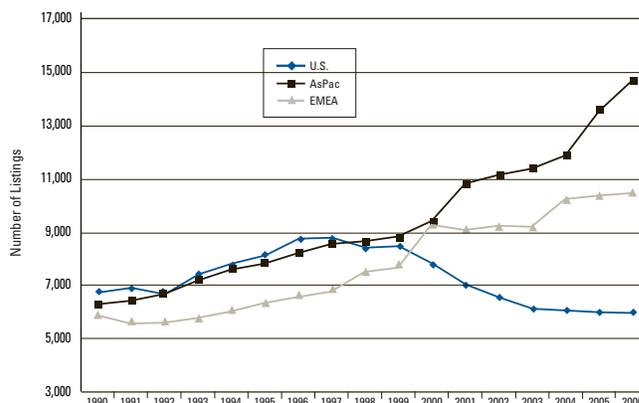
Since 1996, the United States has experienced a steady decline in its participation rate in the top 25 largest global IPOs each year.

have experienced global shifts. One study from Ernst & Young notes that, during the first half of 2006, there were 77 IPOs that listed outside their domicile country, yet only 17 of these actually represented “in-play” IPOs, or those presenting competitive opportunity for U.S. markets.³ Of those 17, 11 did list on a U.S. exchange. This suggests that the competitive position of the United States for in-play IPOs has not dramatically deteriorated, despite the larger shifts in capital market dynamics.

Another notable trend has been the change in the composition of the companies raising equity capital. In the 1990s, as mentioned above, technology companies were the major issues of equity. *See Figure I.* This helped the U.S. markets as a large number of technology companies are located in this country. In recent years, the technology section has raised much less equity, and privatizations of state-owned enterprises have become more important to the equity-raising process. The shift to such privatizations has helped markets in Europe and Asia, which are closer to the headquarters of these state enterprises.

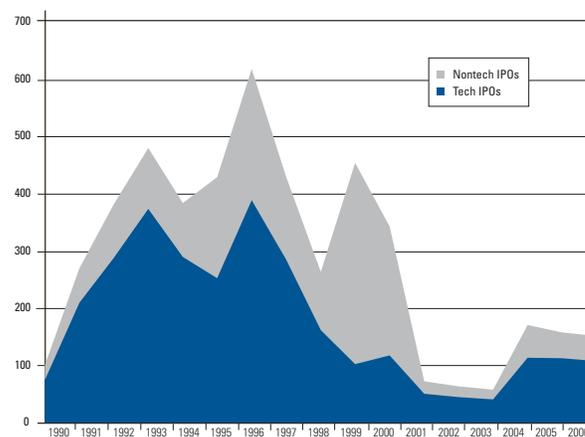
In particular, the IPOs of Chinese banks in Hong Kong have boosted Hong Kong’s capital-raising activity relative to New York. Five years ago the big concern in Hong Kong was that Shanghai would take over as the main financial center in Asia outside of Japan. And it should also be noted that Tokyo has had a decline in market share in the 16 years since the Japanese bubble peaked. Many American companies that once had a joint listing in Tokyo have dropped the Tokyo listings.

Figure H
Total Exchange Listings



Since 1996, the United States has experienced a decline in market share of total worldwide listings of public companies. Source: World Federation of Exchanges; figures based on total listings excluding closed-end funds and exchange traded funds (ETFs)

Figure I
Tech IPOs VS Nontech IPOs, 1990-2006



Source: Thomson Financial

3 Maria Pinelli and Joseph A. Muscat. *Global Capital Market Trends*. Ernst & Young. January 2007.

IV. SURVEY OF DRIVERS

After surveying the data on global trends in the capital markets and reviewing the inputs from market participants, the Commission has identified four broad themes:

- The capacity and efficiency of foreign capital markets to meet needs of a wide range of issuers and investors has markedly improved over the past decade.
- Like many business trends, the shift in global markets is influenced in varying degrees by noneconomic factors, such as geopolitical developments and local cultural dynamics.
- The attractiveness of different capital markets depends ultimately on the actual and perceived costs of capital, including both direct and indirect costs.
- The legal and regulatory requirements in the United States relative to Europe and Asia play an influential role in corporate decisions about where to access capital markets.

A. Quality and Effectiveness of Foreign Markets

During the late 1990s and early 2000s, the capital markets of many developing countries opened their doors to the rest of the world while experiencing reductions in inflation, sounder fiscal policies, and privatization trends. In time, this movement toward market reforms created a more stable investing environment. Over time there has been a significant increase in the demand for capital in these centers as well as in the ability of companies to raise capital domestically through citizens and foreign investors.⁴

More recently, there have been considerable advancements in foreign capital centers that have sharply increased their competitive position in relation to the traditionally dominant U.S. markets. The United States now faces stiff competition from capital markets in Europe and Asia. General economic growth throughout these foreign markets has driven advancements in technology, communication, and information management systems. Concurrently, lawmakers and regulatory bodies have collaborated in modernizing their internal legal frameworks while working to harmonize securities regulations on both regional and global levels to improve cross-border capital flows. These newly developed foreign infrastructures support secondary trading markets and provide the requisite liquidity sought by issuers and investors.

Whereas investors were traditionally limited to their local markets, the development and integration of clearance and settlement systems has increased the ability of global

⁴ Remarks by Peter Henry, Global Marketplace Town Hall Meeting, San Francisco, October 12, 2006.

investors to enter these markets directly.⁵ Higher liquidity creates a more attractive environment for companies seeking to raise capital. The posttrade processes are a key part of an efficient capital market system. Increased demand from a growing investor base can be processed through more efficient communications technology coupled with streamlined clearance and settlement systems.

Traditionally, the high costs for cross-border clearing and settlement in the European Union (EU) could be attributed to differences in laws, practices, and communications standards.⁶ There have been several initiatives over the past few years aimed at harmonizing the clearance and settlement systems in Europe with a view toward promoting economic growth and enlarging the variety and quality of financial services offered to investors.⁷

When comparing the systems of the United States and the EU, several distinctions between clearance and settlement cost components have been identified. The United States is able to take advantage of the significantly larger volume of trading activity by realizing lower net basis costs of settlement.⁸ Automated trading coupled with lower settlement costs and exchange competition have been cited as factors contributing to the stronger growth in U.S. equity trading.⁹ However, where the United States has separate settlement systems for corporate securities and government bonds, the majority of European countries have integrated these into a single system.¹⁰ Additionally, the U.S. derivative market system remains fragmented when compared to European markets.¹¹ In November 2006, the European Commission welcomed the clearance and settlement industry's new Code of Conduct, which will continue to improve the transparency, access, and interoperability of these systems.¹²

5 Ip, Greg; Scannell, Kara; and Solomon, Deborah, "Trade Winds: In Call to Deregulate Business, a Global Twist—Onerous Rules Hurt U.S. Stock Markets, But So Do New Rivals," *Wall Street Journal*, January, 25, 2007, Page A1.

6 de Carvalho, Cynthia Hirata, "Cross-Border Securities Clearing and Settlement Infrastructure in the European Union as a Prerequisite to Financial Markets Integration: Challenges and Perspectives" (July 2004). *HWWA Discussion Paper No. 287*. Available at SSRN: <http://ssrn.com/abstract=575981>.

7 *Id.*

8 Cox, Peter; Simpson, Hugh; Jones, Lynton, "The Future of Clearance and Settlement in Europe, Corporation of London," *City Research Series Number Seven*, http://213.86.34.248/NR/rdonlyres/B5FC6EE2637242148DE61683363911B7/0/BC_RS_Fulllengthversionforweb.pdf.

9 *Id.*

10 *Id.*

11 *Id.*

12 European Commission website, *Clearance and Settlement*, http://ec.europa.eu/internal_market/financial-markets/clearing/index_en.htm.

B. Socioeconomic Growth and Technological Advancements

There are several economic trends that have been driving the global economic surge over the past few decades. One of the most prominent relates to the sheer size of the global capital market. The world's financial assets total more than \$136 trillion and are forecasted to exceed \$228 trillion by 2010.¹³ This trend has even exceeded gross domestic product (GDP) growth, which indicates that financial markets are expanding in breadth and depth, providing increased liquidity for investors.¹⁴ Although the United States historically dominated the market share of financial assets, the new environment has seen a flux in the dominant positions of larger newly competitive markets.¹⁵

Another area of growth relates to privatization programs that have infused foreign markets with capital streams that were traditionally harbored in government-managed companies.¹⁶ During the 1990s, foreign governments sought the increased operating efficiencies characteristic of public companies and incorporated a wave of privatization programs into their reform processes.¹⁷ For example, these programs raised \$157.5 billion in 1997, up from \$33.3 billion only seven years earlier.¹⁸

Although the major investment banking firms have traditionally maintained a foreign presence, these institutions are increasingly becoming more global in their strategies and operations.¹⁹ Statistics show that between one-quarter and one-third of the revenue stream for large global securities firms now flows from foreign markets.²⁰ One industry leader has noted that goals for his institution were to target a balance of securities sales at 60% international and 40% domestic within the next three years.²¹ Likewise, smaller firms now have access to foreign capital markets through both intermediaries and direct links.²²

13 McKinsey Global Institute, *Mapping the Global Capital Market 2006*, available at: <http://www.mckinsey.com/mgi/publications/gcmAnnualReport.asp>.

14 *Id.*

15 *Id.*

16 Securities Industry Association (SIA), *The Rise of International Equity Financing*, http://www.sia.com/capitol_hill/html/international_equity_.html.

17 *Id.*

18 *Id.*

19 Tafara, Ethiopis and Peterson, Robert J., "A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework," *Harvard International Law Journal*, Vol. 48, Num.1, (Winter 2007).

20 *Id.*

21 Remark by Christine Edwards, Global Marketplace Town Hall Meeting, San Francisco, October 12, 2006 (quoting Chuck Prince, Chairman of Citigroup).

22 Tafara, Ethiopis and Peterson, Robert J., "A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework," *Harvard International Law Journal*, Vol. 48, Num.1, (Winter 2007).

Undoubtedly, technological innovation is one of the primary factors facilitating the growth and leveling of the global playing field. This has allowed foreign markets to realize the benefits of automated systems and real-time communications and reporting technology. The Internet is spreading across the globe at an exponential rate, stretching in breadth to reach developing markets and disseminating in depth to increase penetration in established areas.

In Asia, for example, which has more than half of the world's population, there are about 394 million Internet users, representing only 10.8% of the population.²³ Internet usage growth in Asia surged a staggering 245% from 2000 to 2006, and there is still significant room to expand.²⁴ Europe maintains similar potential, with connectivity penetration still hovering around 38%.²⁵ This sharply contrasts with North America, where Internet penetration has already reached 69%, and the growth rate since 2000 has been less than half the Asian rate.²⁶ This illustrates both the recent explosion that has facilitated the globalization phenomenon and the growth potential that will manifest itself in the years to come.

This rapid flow of information has resulted in quantitative and qualitative changes in the information available to market participants and has driven investor interests in looking outside their home markets for opportunities.²⁷ The formerly complex process of conducting a cross-border transaction has been replaced with a system that allows entire exchanges to be accessed through trading screens in broker-dealers' offices.²⁸ These trends will most likely persist and strengthen as communication capabilities and technological innovation continue to develop.

C. Cost of Capital

All companies, from the small start-up to very large multinationals, in every industry and profession, depend on capital to grow, develop, and meet constantly evolving competitive challenges. By investing needed capital in new products, technology, production facilities, and jobs, these companies drive economic activity in the United States. Thus, efficiently priced capital is absolutely essential for continued economic development in the United States.

The "cost of capital" refers to what companies have to pay for the use of capital. Factors that drive up the cost of capital reduce the incentives for businesses to invest

²³ Internet World Statistics, <http://www.internetworldstats.com/st>.

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

²⁷ Tafara, Ethiopis and Peterson, Robert J., "A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework," *Harvard International Law Journal*, Vol. 48, Num.1, (Winter 2007).

²⁸ *Id.* at 34

and, likewise, factors that lower the cost of capital generally promote investment and, in turn, productivity and employment growth. Because every sector of our economy is highly dependent on the use of capital, the higher the cost of capital, the more we all pay for goods and services and the greater the incentive to take economic activity—including jobs and innovation—out of the United States.

There are many factors that affect the total cost of capital for a particular company. These include both the direct payments made by companies to the suppliers of capital and financial intermediaries, as well as the indirect costs incurred by the company as a result of accessing the capital markets.

1. Direct Costs of Issuing Equity

The fees involved in raising capital account for a portion of the direct costs of raising such capital. These fees include investment banking fees, legal and accounting charges, exchange listing fees, and printing costs. These fees tend to be higher in the United States than in other jurisdictions. For example, gross spreads, or the percentage of the issue price that the syndicate receives, are commonly the largest cost component of an IPO. Torstilla (2003) finds median gross spreads in equity IPOs of 7.0% in the United States compared with 4.0% in Europe.²⁹

2. Indirect Costs of Issuing Equity

The direct costs for raising capital represent only a portion of the total costs. Underpricing of IPOs is also an important component of the total cost. This occurs when a new stock issue is priced below the price that prevails in the market once the stock starts trading. Underpricing costs are roughly comparable between the United States and Europe, although they vary considerably from company to company and from time period to time period. Ritter (2003) found that average underpricing was similar in the United Kingdom and highest in the United States. Using more recent data, covering the low-volume time period from January 2003 to June 2005, Oxera (2006) found underpricing lowest on Euronext and highest on the United Kingdom (UK) Alternative Investment Market (AIM) with the U.S. markets in between.³⁰

On the other hand, there is evidence that the United States still has a cost of capital advantage over other countries. Foreign firms cross-listed in the United States

²⁹ For example, see: Oxera Consulting Limited (2006), *The Cost of Capital: An International Comparison*; Torstilla, Sami (2003). The clustering of IPO gross spreads: International evidence, *Journal of Financial and Quantitative Analysis*, 38, 673-694; Ritter, Jay (2003), "Differences between European and American IPO Markets." *European Financial Management*, 9 (4), 421-434

³⁰ See Oxera (2006), op. cit, and Ritter (2003) op cit.

continue to command a premium over firms that are not cross-listed, although the premium has declined over the last decade.³¹ Studies summarized in the *Interim Report of the Committee on Capital Markets Regulation* show that, after the passage of the SOX, the premium for cross-listed companies declined further by an average of 0.19%, although there was considerable variation from country to country.³²

In addition, there is evidence that the increasing costs of being a public company are a factor contributing to the decline in the number of public companies listed in the United States. This number declined from 8,823 to 6,005 between 1997 and 2006.³³ After conducting a cross-country comparison, Kamar et al. (2005) found that small U.S. issuers are more likely than their foreign counterparts to exit the public markets since the passage of SOX in 2002.³⁴ Piotroski and Srinivasan (2007) also provide evidence that the flow of listings into the United States has declined subsequent to SOX.³⁵

3. Timing to Complete Equity Offerings

Another important indirect cost of capital is the time needed to complete an offering. The IPO offering process in the United States is quite complex and time consuming. As top management often spends significant time on the details of the IPO process, a longer process takes more management time away from actually running the business. Lengthy regulatory reviews add not only legal expenses, but also add to the risk that a company may miss an important market window.

Although directly comparable statistics are not available, anecdotal evidence indicates that securities offerings take much more time to complete in the United States than in London. Little has changed since the Government Accountability Office (GAO) reported in 2002 that SEC reviews of IPOs “can be lengthy.” According to the GAO, industry officials reported that it takes four to seven weeks for the SEC to review an IPO, there was no reason the review should take so long, and these delays hurt the international competitiveness of the U.S. capital markets.³⁶

31 See *Interim Report of the Committee on Capital Markets Regulation* at 38, 47 (Discussing Doidge et al. study analyzing the premium of cross-listed firms and Hail et al. study on changes in the cost of capital).

32 See *Interim Report of the Committee on Capital Markets Regulation* at 47 (Discussing Doidge et al. study analyzing changes in cross-listing premiums after passage of SOX).

33 World Federation of Exchanges.

34 E. Kamar, P. Karaca-Mandic, E. Talley. *University of California, Berkeley Law and Economics Paper*, 2005: <http://law.bepress.com/cgi/viewcontent.cgi?article=1051&context=usclwps>.

35 Piotroski, Joseph D. and Srinivasan, Suraj, “The Sarbanes-Oxley Act and the Flow of International Listings” (January 2007). Available at SSRN: <http://ssrn.com/abstract=956987>.

36 See U.S. Government Accountability Office (2002), *SEC Operations: Increased workload creates challenges*. GAO 02-302. <http://www.gao.gov/new.items/d02302.pdf>.

Indeed, financial regulatory processes in the United States are generally slow. The SEC itself in its 2005 annual report indicates that it believes its 30-day target for review of initial filings is “aggressive.”³⁷ The SEC also reports performance measures for self-regulatory organization (SRO) rule filings closed in less than 60 days and “no-action” letters issued within six months.³⁸ However, many of these rule filings and no-action letters are generally unnecessary in overseas markets. This and other problems lead to a perception among financial executives that the United States has a less attractive regulatory climate than the UK, as documented by McKinsey.³⁹

4. Cost of Capital for Small Businesses

Small business drives much of the economic activity, innovation, and job creation in the United States. For example, small businesses have generated 60% to 80% of net jobs annually over the last decade.⁴⁰ These businesses made up 97% of exporters and produced 28.6% of the known export value in FY 2005.⁴¹ Small businesses employ 41% of high-tech workers and produce 13 to 14 times more patents per employee than large patenting businesses.⁴²

The direct cost of capital for small business is often a significant obstacle to development, growth, and capital formation. Businesses too small for the public capital markets have fewer choices for raising both debt and equity capital and thus end up paying much more for capital. Likewise, indirect cost increases disproportionately affect smaller firms. Linck, Netter, and Yang (2006) report that director fees for small public firms increased approximately 61% from 1998 to 2004, amounting to \$3.19 per \$1,000 of sales. For large firms, the director fees rose to \$0.32 per \$1,000 in net sales.⁴³

37 U.S. Securities and Exchange Commission, 2005, *2005 Performance and Accountability Report*. <http://www.sec.gov/about/secpar/secpar2005.pdf>.

38 Some complex rule filings stretch out for several years. It took six years for NASDAQ to get approval by the SEC to operate as a national stock exchange rather than as a national securities association under the umbrella of the NASD.

39 The McKinsey survey is found in Bloomberg, Michael R., and Charles E. Schumer, 2007, *Sustaining New York's and the U.S. Global Financial Services Leadership*. January 2007.

40 Small Business Administration website, <http://app1.sba.gov/faqs/faqindex.cfm?areaid=24>.

41 *Id.*

42 *Id.*

43 See Linck, James S., Netter, Jeffrey M. and Yang, Tina, “Effects and Unintended Consequences of the Sarbanes-Oxley Act on Corporate Boards” (May 16, 2006). *AFA 2006 Boston Meetings Paper* Available at SSRN: <http://ssrn.com/abstract=902665>; see also Ettredge, Michael L., Li, Chan and Scholz, Susan W., “Audit Fees and Auditor Realignments in the Sarbanes-Oxley Era” (July 2006). Available at SSRN: <http://ssrn.com/abstract=929486>; GAO, *Report to the Committee on Small Business and Entrepreneurship in the United States, Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies*. <http://enzi.senate.gov/gaosox.pdf>.

Statistical evidence indicates that regulatory changes resulting from the passage of SOX have had a disproportionate impact on the cost of capital for small businesses. For example, a \$1 million to \$2 million compliance price tag is an enormous burden on a company that has \$3 million in net income.⁴⁴ A study released by the GAO in April 2006 stated that public companies with market capitalization of \$75 million or less paid a median \$1.14 in audit fees for every \$100 of revenues. This compares with \$0.13 in audit fees for public companies with market capitalization greater than \$1 billion.⁴⁵

Fortunately, these costs associated with small business capital formation have come to the forefront of the agenda for financial markets' regulators. To address these issues, the SEC formed the Advisory Committee for Smaller Public Companies, which released its findings in April 2006.⁴⁶ These findings laid the foundation for the SEC's extension of time for smaller businesses to comply with the provisions of SOX.⁴⁷ In connection with the December 2006 small business proposals, SEC Commissioner Roel Campos noted, "It is impossible for companies and their auditors to efficiently comply with a one-size-fits-all requirement when the companies themselves vary tremendously in complexity and size."⁴⁸ The Public Company Accounting Oversight Board (PCAOB) has also proposed a new principles-based approach to internal controls, which allows management to identify those areas that present a reasonable risk of having a material impact on financial statements.⁴⁹

D. Securities Litigation

Investor protection is a cornerstone of all strong and successful capital markets and is the hallmark of the U.S. capital markets. A unique aspect of the U.S. capital markets is the broad availability through private lawsuits for individuals to recover damages attributable to a wide range of conduct that violates the federal securities laws. Although many countries authorize private parties to institute lawsuits to recover damages relating to capital markets activities, the United States is unique in terms of the size and scale of claims permitted.

44 Comment by Clay Corbus, Town Hall Meeting, San Francisco, October 12, 2006.

45 U.S. Government Accountability Office, Report to the Committee on Small Business and Entrepreneurship, *U.S. Senate, Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies*, at 17. (April 2006) (GAO Report) available at: <http://www.gao.gov/new.items/d06361.pdf>.

46 Final Report of the Advisory Committee for Smaller Public Companies to the U.S. Securities and Exchange Commission, April 23, 2006.

47 SEC Release 2006-210, Further Relief from the Section 404 Requirements for Smaller Companies and Newly Public Companies. December 15, 2006.

48 *Id.*

49 Board Proposes Revised Auditing Standard on Internal Control over Financial Reporting Washington, DC, December 19, 2006. Available at: http://www.pcaobus.org/Rules/Docket_021/2006-12-19_Release_No._2006-007.pdf.

One of the most dominant criticisms of U.S. capital markets is that the heavily litigious environment imposes significant costs disproportionate to its benefits. For example, civil penalties amounted to \$4.74 billion in the United States during 2004 compared to the \$40.48 million in penalties imposed in the UK.⁵⁰ In addition to administrative enforcement penalties, private class action in the United States created \$3.5 billion of liability for issuers.⁵¹ While a few European nations do have “group actions,” U.S. class action litigation is tremendously more costly and voluminous.⁵² The class action vehicle is the primary contributor to the high U.S. D&O insurance costs, which are six times greater when compared to the same costs in Europe.⁵³ Overall, the stringent enforcement framework in the United States plays a crucial role in maintaining the integrity of our markets. However, overenforcement can upset the intended balance between investor protection and judicial economy by creating exorbitant costs and an unpredictable business environment.

The call for litigation reform has been directed toward several major areas, including the private enforcement system, criminal prosecutions of corporations, auditor liability, and liability of outside directors. For example, Professor John Coffee of Columbia Law School has pointed out that the costs of private litigation are borne primarily by long-term shareholders of companies, while the damages primarily go to short-term holders who can meet the purchaser-seller requirement for standing to bring private claims under SEC Rule 10b-5.⁵⁴ The compensatory role of class actions is also debatable in light of the fact that the average suit settles for a mere 3% of the investors’ loss.⁵⁵ As the costs of operating in such a litigious environment increase, the importance that this factor will have upon a company’s decision of where to seek capital will concurrently rise.

In addition to private litigation to redress violations of the federal securities laws, there are many state and federal governmental bodies as well as SROs⁵⁶ with regulatory oversight and enforcement authority over the financial services industry. The broad availability of private rights of actions—combined with the enforcement mechanisms of the various governmental agencies and SROs—is an advantage of the U.S. system because it provides shareholders greater assurance that their interests will be protected and that they can receive redress for a broad range of potential injuries.

50 See *Interim Report of the Committee on Capital Markets Regulation* at 71, November 30, 2006.

51 *Id.*

52 See, e.g., “If you can’t beat them, join them.” *The Economist*, February 15, 2007.

53 See *Interim Report of the Committee on Capital Markets Regulation* at 71, November 30, 2006.

54 Coffee, John C., “Reforming the Securities Class Action: An Essay on Deterrence and its Implementation” (October 2006). *Columbia Law and Economics Working Paper No. 293*. Available at SSRN: <http://ssrn.com/abstract=893833>.

55 *Id.* at 78.

56 e.g., the NASD and New York Stock Exchange Regulation.

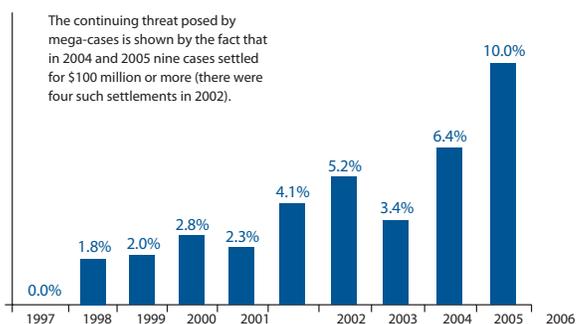
As with other forms of regulation, however, a periodic and thorough assessment of the costs and benefits of the U.S. litigation system is appropriate, especially in light of changes to the global capital markets and the expansion of the SEC's enforcement authority by SOX (*e.g.*, Fair Funds). Indeed, international observers increasingly cite the U.S. legal and regulatory environment as a critical factor discouraging companies and other market participants from accessing the U.S. markets.⁵⁷

In 1995, Congress enacted the Private Securities Litigation Reform Act (PSLRA) to address concerns over frivolous securities litigation. Mindful that meritorious private litigation serves to deter wrongdoing and compensate investors, Congress focused on tightening up the securities litigation process so that courts could more easily separate out the nonmeritorious claims. With the enactment of the PSLRA, the SEC was charged with assessing its impact on the “effectiveness of the securities laws and on investor protection.”⁵⁸ In 1997, relying on a “limited” data set, the SEC issued a report canvassing the litigation environment but could make no “firm conclusions” as to the PSLRA's impact.

Today, almost a dozen years after the passage of the PSLRA, that data set that was limited in size in 1997 is no longer so limited. Since 1996, according to the Securities Class Action Clearinghouse at Stanford Law School, 2,465 issuers have been named as defendants in class actions for federal securities fraud. When compared with the approximately 6,000 listed companies on the New York Stock Exchange, NASDAQ Stock Market, and American Stock Exchange combined, this suggests that public companies have a relatively high risk of facing securities litigation. Since 1997, the number of mega-settlements (those more than \$100 million) has increased from 0% of all cases to 10% of all cases in 2006. *See Figure J.* And the average settlement remains high, even in the face of the declining number of class actions for securities fraud filed in 2006.⁵⁹ *See Figure K.*

The Commission recognizes that striking the proper balance between reliance on the federal, state, and SRO enforcement authorities and permission for private

Figure J
Mega-Settlements, Period: 1997-2006



Note: Mega-Settlements are defined as settlements over \$100 million.
Source: Recent Trends in Shareholder Class Action Litigation: Filings Plummet, Settlements Soar, NERA Economic Consulting, p.1 and p.6.

57 See *Sustaining New York's and the U.S. Global Financial Services Leadership*, pages 74-78 and *The Unintended Economic Consequences of Securities Class Actions*, Anjan V. Thakor.

58 Report To The President And The Congress On The First Year Of Practice Under The Private Securities Litigation Reform Act Of 1995, Office of the General Counsel, U.S. Securities and Exchange Commission (April 1997), available at <http://sec.gov/news/studies/lreform.txt>

59 “Classier Actions,” *The Economist*, February 15, 2007.

litigants to independently enforce the securities laws is a complex and controversial issue. Nevertheless, there is a correspondingly strong need to investigate the accuracy of the widely held global perception that the U.S. securities litigation and regulatory environment makes it dangerous to participate in our capital markets. Furthermore, the Commission believes that for an analysis of this nature to gain widespread acceptance, it must be conducted by an independent body with a deep knowledge and understanding of the role of the securities laws and access to the relevant data.

This Commission, therefore, recommends that Congress call upon the SEC⁶⁰ to undertake a comprehensive study of state and federal securities enforcement mechanisms to assess whether they are enhancing the goals of investor protection and capital formation and whether the PSLRA is achieving the objectives set forth by Congress. In particular, the Commission recommends that this study include an analysis of the:

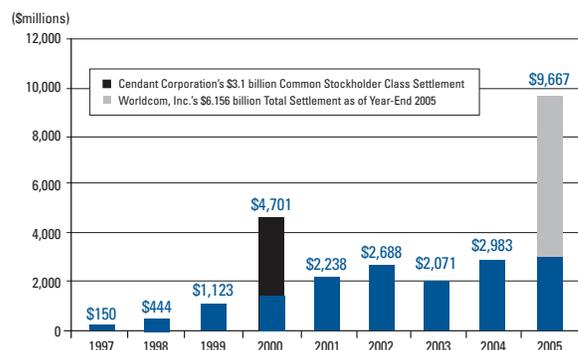
- **civil and criminal cases brought by governmental agencies and regulatory actions brought by SROs**
- **PSLRA's impact on the effectiveness of the federal securities laws; and**
- **impact of post-PSLRA litigation on the dual objectives of protecting investors and promoting capital formation.**

The Commission believes that time is of the essence for this study, since its subject is so important to the global competitiveness of our capital markets as well as the continued viability of the public company auditing profession.

E. U.S. Regulatory Standards and Environment

It has long been the American view that adherence to the financial reporting, corporate governance, auditing, and disclosure requirements in the United States

**Figure K
Total Settlement Dollars, Period: 1997-2005**



Note: "The designated settlement year corresponds to the year in which the hearing to approve the settlement was held. Cases that include multiple settlements are reflected in the year of the latest partial settlement."

Source: Post-Reform Act Securities Settlements, 2005 Review and Analysis, Cornerstone Research

⁶⁰ The Commission also recommends that Congress give consideration to whether the SEC has all the requisite tools and resources to conduct a thorough and comprehensive study and, for example, whether the SEC should be joined by another agency or governmental body in conducting the study.

creates a higher level of credibility for companies when compared to those listed in other markets.⁶¹ Shareholders also generally realize increased valuation in stocks that are listed on U.S. exchanges versus foreign exchanges, which is often attributed to the greater visibility and transparency of U.S. listings.⁶²

Over the past several years, however, there has been increasing commentary—both domestically and internationally—that the U.S. regulatory framework is too rules-based and increasingly difficult to apply to the rapidly changing face of the global marketplace.⁶³ The recent SOX legislation, which substantially increased compliance costs through requirements such as the controversial Section 404, has become a rallying cry in this debate.⁶⁴ Despite the positive effects of the SOX legislation and that it has been or is being adopted in substantial part by many jurisdictions around the world, it is evident that certain regulatory requirements have increased both the direct and indirect costs associated with public capital markets activity in the United States.

Nevertheless, there are also clear examples going back many years that U.S. regulators—principally the SEC with regard to capital markets activity—have recognized and acted to reduce the adverse effects of the U.S. rules and regulations on international capital markets activity.

1. Sarbanes-Oxley

For several years now, there has been much discussion about and debate over the costs and benefits of SOX. As this Commission began its deliberations, it was clear that the most significant concerns with SOX were being raised and addressed by the SEC, PCAOB, issuers, and many others interested parties. This Commission, therefore, determined to focus on other pressing issues impacting the competitiveness of the U.S. capital markets, particularly in areas that the Commission believed were not receiving adequate attention. Nevertheless, this report would not be complete unless it provided a general outline of this Commission's view on SOX.

Many argue that the higher standards set by the Sarbanes-Oxley legislation have had, and will continue to have, a positive effect on the competitiveness of U.S. markets. Those espousing the virtues of SOX often cite evidence suggesting that compliance

61 *The Cost of Capital: An International Comparison*, report prepared for the City of London Corporation and the London Stock Exchange, June 2006, available at www.oxera.com.

62 Neeraj Bhargava, "Good Governance Is Good Business," *Wall Street Journal*, August 28, 2006; Page A12.

63 See Jeremy Grant, Francesco Guerrera and Krishna Guha, "The Cost of Compliance", *Wall Street Journal*, November 19, 2006.

64 "Letter to the Editor from NYSE CEO, John A. Thain: Sarbanes-Oxley: Is the Price Too High?" *Wall Street Journal*, May 28, 2004.

with SOX optimizes business processes and could lead to smoother follow-on financing and greater flexibility in mergers and acquisitions (M&A) activity.⁶⁵ They also point out that companies that are not required to comply with SOX have faced pressure from lenders and customers to implement voluntary shifts toward the higher compliance standards.⁶⁶ And finally, those who support SOX note there is a clear trend of other countries adopting many of the provisions of SOX.⁶⁷

Others, however, would argue that accompanying the benefits of SOX are significant direct and indirect costs. The direct costs are generally well known and well documented; they include, principally, the implementation and maintenance costs imposed on public companies, most notably in connection with Section 404.⁶⁸ With greater experience and the recent proposals made by the SEC and the PCAOB, there is general agreement that these costs will become more manageable, although the Commission believes that ongoing attention will be needed in this regard. As a result of the recent proposals, the indirect costs may prove to be the greatest challenge.

There are two indirect costs that raise concern. The first is the impact SOX has on the relationship and communication between issuers and their independent auditors. While this Commission did not study the nature and extent of this concern, it does believe that the policy-makers should take steps to help avoid the relationship between company executives and their auditors becoming adversarial.

The second indirect cost falls more within the scope of the Commission's work and deliberations: namely, the marketing benefits that foreign market centers and other market participants have been able to derive from SOX. These markets—apparently with some success—have stressed both the actual costs and burdens imposed on U.S.-registered companies as well as the process by which SOX was adopted. Regarding the latter point, the Commission has heard concerns voiced by some outside the United States that the speed with which SOX was adopted, and the perception that it was a “knee-jerk” reaction to two well-publicized bankruptcies, raises questions about the American response to future problems.

In the past year, the SEC and PCAOB have taken steps to address some of the

65 Neeraj Bhargava, “Good Governance Is Good Business,” *Wall Street Journal*, August 28, 2006; Page A12.

66 “Sarbanes-Oxley Gains Adherents, Closely Held Companies Embrace Internal Controls As Incentives, Pressure Rise,” *Wall Street Journal*, Jaclyne Badal and Phred Dvorak, August 14, 2006; Page B3.

67 Ethiopis Tafara and Robert J. Peterson “A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework,” *Harvard International Law Journal*, Volume 48, Number 1, Winter 2007.

68 For example, Hartman, Thomas E., *The Cost of Being Public in the Era of Sarbanes-Oxley*, Foley & Lardner LLP, June 2006.

concerns about the burdens SOX places on domestic and foreign companies. In May 2006 they held a joint roundtable on internal control reporting requirements and announced a roadmap for addressing some of the problems associated with Section 404. In December 2006, they released proposed guidance that seeks to reduce Section 404 compliance time and costs.

While the Commission recognizes that work still needs to be done on these proposals, the Commission applauds the SEC, PCAOB, and other parties interested in working in a constructive manner to resolve these implementation problems. The Commission encourages all policy-makers to continue to refine SOX rules to ensure the best practical balance of costs and benefits.⁶⁹

2. Securities Offering Reform Package

Another recent example of the SEC's efforts to improve and minimize the burden of the registration process is its Securities Offering Reform Package. These rules became effective on December 1, 2005, and represent a meaningful step toward modernizing the offerings rules. Although the reforms do not distinguish between U.S. and non-U.S. issuers, they should make the U.S. offering process more attractive to foreign issuers.

The reforms can be grouped into three categories:

- Issuer segmentation, which allows companies to realize more lenient procedures upon achieving well-known seasoned issuer (WKSI) status
- Improved shelf registration, which allows WSIs to preregister a range of offerings so that they are ready for issuance as soon as the issuer/market is ready
- A liberalized communications environment that attempts to reverse much of the restrictive stigma that looms around the U.S. IPO process

The Commission understands that experience with these rules has generally been quite positive and commends the SEC for undertaking initiatives such as this to streamline and simplify the U.S. regulatory process.

3. Rule 144A and Regulation S

The SEC has taken other important steps over the years to alleviate impediments

⁶⁹ For further discussion of SOX, see page 122 of this report.

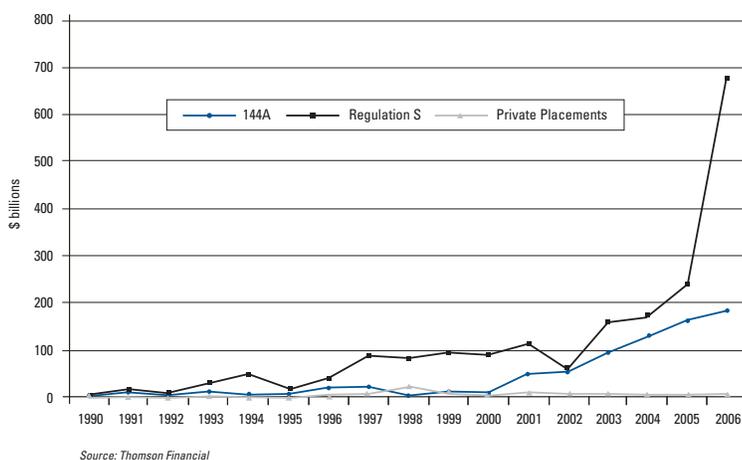
to capital formation in the global marketplace without adversely affecting investor protection. One of the best examples of this was SEC’s adoption of Rule 144A and Regulation S in 1990. Both of these rules were designed by the SEC to lower the cost and regulatory burden of capital formation by eliminating the registration requirements for offerings made to certain classes of investors under specified circumstances, where the protection of the registration provision of the Securities Act of 1933 was considered unnecessary.

The critical importance of these rules is two fold. First, they provide an identifiable set of “safe harbor” factors on which an issuer can rely to ensure itself that an offering is exempt from the registration requirements of the Securities Act. Before the adoption of these safe harbors, issuers were forced to rely either on the general language of Section 4(2) of the Securities Act for a private placement or the “General Requirement” affecting foreign issuance. These other provisions are far more general and do not provide the benefit of a clearly defined safe harbor from registration. Traditional private placements often required opinions of counsel and other certifications from issuers, which impeded marketability. Rule 144A, under certain circumstances, eases these restrictions.

The second critical element to both rules is that they provide liquidity to the purchaser of the securities sold pursuant to Rule 144A or Regulation S by permitting resales in a manner less restrictive than for resales of securities issued in a traditional private placement or offshore sale. The ability of the initial purchaser to resell to even a restricted group of buyers has made the use of Rule 144A and Regulation S very popular and presumably has lowered the cost of issuance and added resale liquidity. Importantly, they encourage the globalization of the market for the offered securities, whether by domestic or non-U.S. issuers, and the active participation by financial institutions in these capital formation activities.

There has also been broad market acceptance of Rule 144A and Regulation S offerings even with the limitations on access to this market by retail investors. *Figure L* shows the growth of Rule 144A, Regulation S, and private placement transactions (excluding Rule 144A transactions) since the enactment of Rule 144A and Regulation S in 1990. This chart demonstrates the broad market acceptance of Rule 144A and Regulation S, as growth in the amount of proceeds from these types of transactions has increased dramatically during this period, especially the growth in offshore capital formation under Regulation S in

Figure L
Foreign Issuers Accessing the U.S. Private Equity Markets



the past four years. The SEC's activities in promulgating Rule 144A and Regulation S and the refinements over the years demonstrate the SEC's encouragement of responsible capital formation in the global market.

Despite its benefits, growing reliance on Rule 144A by foreign issuers does raise potentially serious concerns for U.S. investors. Namely, when foreign issuers do IPOs abroad and access the U.S. markets by Rule 144A, they are offering securities only to U.S. institutions and not to individual investors in the United States. Thus, increasingly, individual U.S. investors are being denied the opportunity to purchase IPOs of foreign issuers, including some large, multinational companies that, at least in the past, would have registered and listed their securities in the United States.

F. Substituted Compliance—Foreign Brokers and Exchanges

Until the 1990s, most securities regulations in foreign countries fell far below the level found in the United States. In many countries, for example, there were no statutes governing M&As, and even insider trading was not prohibited until after 1990.⁷⁰ As foreign markets continue to align their securities regulations closer to U.S. standards, investors become more confident in allocating capital to these areas. Not only have large, developed foreign markets refined their regulatory schemes, smaller emerging markets have given extensive treatment to areas governing takeovers, duties of directors, prospectus requirements, and market regulation.⁷¹

As foreign economies develop and strengthen, groups such as the International Organization of Securities Commissions (IOSCO) work to promote the integrity and growth of capital markets around the world. IOSCO's membership includes securities regulators in 108 jurisdictions, representing more than 90% of the world's securities markets.⁷² IOSCO has prescribed 30 foundational principles that encompass the responsibilities of national market regulators, issuers, SROs, investment companies,

70 DeLaMater, Robert G., "Recent Trends in SEC Regulation of Foreign Issuers: How the U.S. Regulatory Regime is Affecting the United States' Historic Position as the World's Principal Capital Market," *39 Cornell Int'l L.J.* 109, (Winter 2006) (citing Thomas C. Newkirk, Assoc. Dir., Div. of Enforcement, & Melissa A. Robertson, Senior Counsel, Div. of Enforcement, Sec. and Exch. Comm'n, Insider Trading: A U.S. Perspective, Remarks at the 16th International Symposium on Economic Crime (Sept. 19, 1998) <http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm>).

71 *Id.*

72 Speech by Jane Diplock, AO, Chairman, IOSCO Executive Committee, Chairman Securities Commission of New Zealand, *Securities Regulation – An International Perspective*, International Council of Securities Associations, Tokyo, October, 20 2006.

73 Speech by Jane Diplock, AO, Chairman, IOSCO Executive Committee, Chairman, Securities Commission of New Zealand, *IOSCO Challenges in a Dynamic Global Market*, Mumbai, April 24, 2006, p. 4.

and the functions of secondary markets.⁷³ The IOSCO multilateral memorandum of understanding (MOU) facilitates oversight and enforcement through the collection and exchange of information across borders.⁷⁴ All IOSCO members are required to become full signatories to the MOU by January 1, 2010. Furthermore, IOSCO's standing in the global financial community allows it to collaborate with the Basel Committee on Banking Supervision and International Association of Insurance Supervisors through a joint forum.⁷⁵

On a broader level, a reliable capital markets system requires a well-defined system of property, contract, securities, trust, bankruptcy, and tax laws that permits relatively speedy access to both courts and arbitration systems, produces final judgments, and provides a relatively convenient mechanism to enforce them. Large funds such as the California Public Employees' Retirement System (CalPERS) study these emerging markets carefully through a transparent grading process.⁷⁶ Five years ago, one-third of these markets failed to meet the minimum standards for justice systems and other standards such as collective bargaining.⁷⁷ Since then, there has been a consistent improvement in all of these market and country standards. As a result, CalPERS is currently investing in 93% of emerging countries.⁷⁸

Given significant advances in recent years in the quality of many foreign markets, the Commission recommends that the SEC give serious consideration to new approaches for improving cross-border capital markets activity. The Commission believes that significant participation by U.S. investors and issuers in foreign markets is inevitable, and therefore it is in our interest for U.S. regulators to actively engage in new and innovative ways to participate and provide leadership in the increasingly global dialogue regarding market and regulatory structure and approach. Thus, the Commission believes that the SEC should consider new approaches to providing U.S. investors to foreign securities and U.S. issuers to foreign capital.

To achieve these goals—providing greater access in return for greater opportunities to engage in a mutual dialogue between and among foreign regulators to ensure high regulatory standards and consistency—the Commission recommends that the SEC give serious consideration to an approach of substituted compliance.

As an example, the Commission recommends consideration of approaches recently

⁷⁴ *Id.* at 6.

⁷⁵ *Id.* at 2.

⁷⁶ Remarks by Christie Wood, Global Marketplace Town Hall Meeting, San Francisco, October 12, 2006.

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ Director, Office of International Affairs, SEC.

⁸⁰ Senior Counsel, Office of International Affairs, SEC.

put forth by Ethiopis Tafara⁷⁹ and Robert J. Peterson⁸⁰ in their recently published article, “A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework” (the Tafara-Peterson proposal).⁸¹ Under the Tafara-Peterson proposal, the SEC would exempt foreign exchanges and foreign broker-dealers from U.S. securities regulation if the SEC determines they are subject to comparable home-country regulation, provided that the SEC has entered into a bilateral information-sharing agreement with the foreign regulator. The bilateral agreement would be predicated upon a reciprocal treatment by the foreign regulator of U.S. exchanges and U.S. broker-dealers.

This system of substituted compliance would enhance access by U.S. investors and issuers to global markets and would promote the development of robust and efficient regulation of the international capital markets.

1. Current U.S. Regulatory Environment for Foreign Entities

The current system of SEC regulation recognizes few distinctions between foreign-based broker-dealers and exchanges and U.S. broker-dealers and exchanges when it comes to their U.S. securities activities. As a general matter, to conduct securities activities in the United States, foreign broker-dealers and exchanges must register with the SEC and comply with the SEC’s extensive regulations just as domestic broker-dealers and exchanges are required to do. For example, foreign stock exchanges cannot place trading screens in the United States without registering with the SEC as a national securities exchange. Foreign broker-dealers may not solicit U.S. retail investors directly or follow up requests by U.S. investors with additional services.⁸² For U.S. retail investors who wish to invest in foreign securities, the process is cumbersome (although it is becoming easier).⁸³ These investors generally make requests through U.S. broker-dealers, who in turn funnel the investment through a foreign broker (which may or may not be an affiliate), adding extra layers of cost to the investor in comparison to a transaction directly between the investor and a foreign broker.⁸⁴ It is difficult for investors to obtain information about foreign securities because the foreign service providers and issuers cannot solicit investors or provide information directly to them.⁸⁵

81 Ethiopis Tafara and Robert J. Peterson, “A Blueprint for Cross-Border to U.S. Investors: A New International Framework,” *Harvard International Law Journal*, Vol. 48, No. 1 (Winter 2007).

82 *Id.* at 47-8.

83 The limitations described, apply only to retail investors as institutional investors may be approached by foreign brokers selling 144A securities, and additionally large institutional investors often establish overseas offices (*see* Howell E. Jackson, “A System of Selective Substitute Compliance,” *Harvard International Law Journal* 105, 108 (2007).

84 In addition, SEC rules permit a U.S. retail investor to make direct contact (provided that it is unsolicited) with a foreign broker-dealer for the purpose of acquiring securities listed on a foreign exchange.

85 Tafara at 48.

The SEC has valid policy concerns for limiting U.S. access to foreign markets. For example, it would be difficult for the SEC or investors to detect market fraud or prudential risks if the foreign entity were not subject to adequate disclosure requirements. Allowing foreign exchanges and issuers to access U.S. investors without registering with the SEC may give an advantage to foreign entities that may not be reciprocated abroad for U.S. entities. In addition, the SEC would face political risk if a major financial scandal at a foreign, unregistered issuer resulted in losses to U.S. retail investors.⁸⁶ While these concerns are valid, the approach to address and manage them suggested by the Tafari-Peterson proposal warrants serious consideration. Additionally, the many benefits to be garnered by improving the access of U.S. investors to foreign securities and (through reciprocity) the access of foreign investors to U.S. securities are substantial.

2. Benefits of Improved Access Between U.S. and Foreign Capital Markets

Allowing foreign exchanges and foreign broker-dealers to access U.S. investors, and the reciprocal access of U.S. market participants to foreign investors, will strengthen the U.S. and global capital markets.

Providing U.S. investors with the widest array of high-quality investment choices strengthens the U.S. economy.⁸⁷ U.S. investors need and want access to foreign markets for two main reasons. One reason is that many of the world's fastest growing and most profitable companies are in foreign countries. Another is that modern portfolio theory encourages diversification, and investing in foreign securities allows another dimension of such diversification, including a degree of hedging against exchange rate fluctuations.⁸⁸ A system of substituted compliance would expand U.S. investor access to foreign securities, allowing them to invest in potentially lucrative companies and diversify their portfolios, while decreasing the current cross-border transaction costs.⁸⁹ It would also improve the quality and quantity of the information available to investors, who must currently research these foreign securities without the benefit of a regulatory filter. Not only would the investor be able to become better and more easily informed about the securities, but U.S. investors would be able to choose foreign securities subject to regulatory systems that have met the "substantial compliance" requirements of the SEC, ensuring a requisite level of investor protection.

⁸⁶ *Id.* at 49.

⁸⁷ *Id.* at 47.

⁸⁸ *Id.* at 41.

⁸⁹ *Id.* at 33.

U.S. issuers would benefit from a system of substituted compliance such as that proposed by Tafara and Peterson because of its reciprocal nature.⁹⁰ U.S. issuers would be able to access foreign investors with more ease and lower costs, and, like all issuers, they would have lower administrative costs when they operate in multiple jurisdictions under substituted compliance agreements. The system would promote blindness to national origin and enlarge the pool of potential investors for all issuers.⁹¹

3. Key Concepts to Inform an SEC International Strategy

The Commission supports three underlying concepts that Tafara and Peterson say should guide the SEC's international strategy.⁹² The first is that U.S. securities regulations should remain nationality neutral, because the U.S. interest is not served by protectionist policies. The second is that U.S. securities regulation should remain flexible so as to allow regulators to adapt quickly to new information and new problems. The third underlying concept is that regulatory competition can be beneficial. Regulatory arbitrage and a "race-to-the-bottom" should be protected against, but a "one-size-fits-all" approach can also be problematic in that, for example, it can lock in bad ideas and discourage innovation.

The Commission recommends that the SEC improve the cross-border access of (i) U.S. investors to foreign securities, and (ii) U.S. issuers to foreign capital. To achieve these goals, the Commission recommends that the SEC give serious consideration to a form of "substantial compliance" that would provide access to U.S. markets to foreign exchanges and foreign broker-dealers with home-country regulation comparable to U.S. securities regulation, provided that the foreign jurisdiction provides reciprocal treatment for U.S. exchanges and broker-dealers.

G. Convergence of Accounting Principles and Audit Standards

There is long-standing consensus among market participants that enhanced comparability of financial reporting among issuers from different countries would provide significant benefits to global capital markets. Efforts to achieve enhanced comparability have been generally pursued by seeking convergence among international accounting and audit standards.

⁹⁰ The Commission notes that the SEC would need to work closely with the U.S. Trade Representative and the Department of Treasury to ensure that any discussions, negotiations, and agreements between the SEC and foreign regulators comply with U.S. obligations under international treaties, such as the General Agreement on Trade in Services (GATS).

⁹¹ Tafara at 46.

⁹² *Id.* at 51-52.

Convergence of accounting principles and audit standards will bring many benefits:

- Facilitating comparability of financial results of companies operating in different jurisdictions for investors, thus providing greater opportunity for investment and diversification
- Removing the risk that investors may not fully understand the nuances of different national accounting regimes and thus draw improper and potentially misleading conclusions from comparative analyses
- Enabling international audit firms to standardize training and better assure the quality of their work on a global basis
- Allowing audit firms and their clients to develop consistent global practices to address accounting problems and thus further enhancing consistency and efficiency
- Reducing the confusion associated with needing to understand various reporting regimes

International Standards Setting Bodies

The International Accounting Standards Board (IASB) is an independent, privately funded accounting standard setter based in London. The IASB is committed to developing, in the public interest, a single set of high-quality, understandable, and enforceable global accounting standards, namely, the **International Financial Reporting Standards (IFRS)**. In addition, the IASB cooperates with national accounting standard setters to achieve convergence in accounting standards around the world.

The International Financial Reporting Interpretations Committee (IFRIC) is the IASB's interpretative body. The IFRIC reviews, on a timely basis within the context of the current IFRS and the IASB framework, accounting issues that are likely to receive divergent or unacceptable treatment in the absence of authoritative guidance, with a view to reaching consensus on the appropriate accounting treatment.

The International Organization of Securities Commissions (IOSCO). The 108 members of the IOSCO consist principally of national securities commissions. The member agencies of IOSCO have resolved to cooperate to promote high standards of regulation to maintain just, efficient, and sound markets; to exchange information on their respective experiences to promote the development of domestic markets; to unite their efforts to establish standards and an effective surveillance of international securities transactions; and to provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses.

The Financial Accounting Standards Board (FASB) is the designated organization in the private sector for establishing and improving U.S. standards of financial accounting and reporting (U.S. GAAP). It is part of a structure that is independent of all other business and professional organizations. FASB was created in 1973 and traces its history back to a predecessor body created in 1936. The SEC has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. The standards promulgated by FASB are officially recognized as authoritative by the SEC (Financial Reporting Release No. 1, Section 101, and reaffirmed in its April 2003 Policy Statement) and the American Institute of Certified Public Accountants Rule 203, Rules of Professional Conduct, as amended May 1973 and May 1979.

Together, these benefits should reduce the cost of capital and open new opportunities for diversification and improved investment returns.⁹³

The first tangible step forward in the global project of converging national accounting standards was the development and acceptance of International Financial Reporting Standards (IFRS). Currently, IFRS have been adopted by every major country in the world except the United States, which continues to rely on U.S. standards of financial accounting and reporting (U.S. GAAP). Nevertheless, IFRS and U.S. GAAP are similar in many respects. They do differ, however, in several significant areas, including accounting for derivatives, leases, and pension obligations.⁹⁴

The next step in the global project for accounting standards harmonization is the process of converging IFRS and U.S. GAAP. The final key step will be convergence of U.S. and various foreign audit standards.

1. Current Requirements for Foreign Private Issuers Listed in the United States

Under current SEC rules, foreign private issuers who are subject to SEC reporting requirements must include in offering prospectuses and annual reports filed with the SEC either (i) financial statements prepared in accordance with U.S. GAAP, or (ii) financial statements prepared in accordance with home-country accounting principles, with a reconciliation of net income and shareholders' equity to U.S. GAAP. This requirement was adopted in 1982 as part of an overhaul of foreign private issuer registration and reporting requirements. In adopting the requirement, the SEC acknowledged that it was seeking to balance the competing policy goals of requiring foreign private issuers to provide U.S. investors with information that was comparable to information provided by domestic issuers while not unduly discouraging foreign private issuers from accessing the U.S. capital market.

This U.S. GAAP reconciliation requirement provides benefits to U.S. investors by allowing direct comparisons of certain financial statement items reported under U.S. GAAP among domestic and foreign private issuers. However, it also imposes significant compliance costs on foreign private issuers, as preparation of the reconciliation does not merely require a mathematical recalculation of certain financial data, but rather, frequently requires the maintenance of double accounting records and an obligation to stay abreast of developments in more than one body of

93 Drawn from remarks of Sir David Tweedie, Chairman, IASB, to the Economic and Monetary Affairs Committee of the European Parliament, January 31, 2006.

94 See, e.g., Similarities and Differences: A comparison of IFRS and U.S. GAAP, PricewaterhouseCoopers (October 2006), available at http://www.pwc.com/gx/eng/about/svcs/corporatereporting/SandD_06.pdf; see also "Some Key Differences Between IFRSs and U.S. GAAP as of August 2005," IAS Plus, Deloitte (August 2005), available at <http://www.iasplus.com/usa/ifrsus.htm>.

accounting standards. External costs are also significant due to the costs of auditing (i) the IFRS set of financial statements in accordance with home country auditing standards, (ii) the U.S. GAAP set of financial statements in accordance with U.S. auditing standards, and (iii) the reconciled data.

In addition to the general benefits accruing to investors and market participants globally, convergence presents an opportunity for enhancing the competitiveness of the U.S. capital markets by removing a significant ongoing cost for foreign private issuers. To the extent IFRS can provide high-quality, comparable financial information to U.S. investors, this regulatory burden becomes redundant and ripe for elimination.

2. Development of IFRS—Convergence of National Accounting Standards

Convergence of accounting standards commenced in earnest in 1973, with the agreement of the professional accountancy bodies of Australia, Canada, France, Germany, Japan, Mexico, Netherlands, the United Kingdom/Ireland, and the United States to create the International Accounting Standards Committee (IASC). The first International Accounting Standards were published in 1975. Over the next two decades, membership in the IASC and related organizations grew to encompass accountancy bodies of more than 100 countries, and the core standards were considered completed with the publication of IAS 39 in 1998.

At the turn of the century, the IASC underwent a restructuring process that resulted in the creation of the International Accounting Standards Board (IASB), which assumed the standard-setting responsibilities of the IASC and formally adopted existing International Accounting Standards and standing interpretations. Henceforth, new standards would be labeled IFRS. The first IFRS was published in June 2003.

Although this convergence effort had received encouragement and support from a significant array of national and international bodies (including, for example, the European Commission, the SEC, the G7, and the International Monetary Fund), it was not until June 2002 that the global implementation of IFRS took a major step forward with the approval by the European Council of Foreign Ministers of a regulation requiring all EU companies listed on a regulated market to prepare financial statements in accordance with IFRS for periods beginning on or after January 1, 2005. With that step, the number of companies required to report under IFRS leapt from a relatively negligible number to more than 7,000. The number of foreign private issuers filing IFRS financial statements with the SEC increased from approximately 40 in 2005 to approximately 350 in 2006.

It is worth emphasizing that the process of convergence is more than a technical exercise and can involve significant debate, as changes in accounting rules have

a direct impact on companies' bottom lines.⁹⁵ These types of divergent standards undermine the uniformity of IFRS as a true single international standard.

3. Tangible Steps Made Toward Convergence of IFRS and U.S. GAAP

a. The Norwalk Agreement

A significant formal step toward convergence of IFRS and U.S. GAAP occurred in October 2002, when the IASB and the Financial Accounting Standards Board (FASB) signed a memorandum of understanding known as the Norwalk Agreement, in which each board acknowledged its commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. The boards pledged to use their best efforts to make their existing financial reporting standards fully compatible as soon as is practicable, and to coordinate their future work programs to ensure that once achieved, compatibility is maintained. The specific steps the boards agreed to make included the following:

- Undertaking a short-term project aimed at removing a variety of individual differences between U.S. GAAP and IFRS
- Removing other differences between IFRS and U.S. GAAP through coordination of future work programs
- Continuing progress on ongoing joint projects
- Encouraging their respective interpretative bodies (the U.S. Emerging Issues Task Force and IFRIC) to coordinate their activities

⁹⁵ A salient example of the potential for disagreement is the process whereby the EU adopted IFRS and the carve-out it took for derivative accounting. For a given IAS or IFRS to become binding on a listed EU company, it must be endorsed by the European Commission after a consultative process. When the European Commission endorsed IAS in September 2003, it endorsed all standards except IAS 32 and 39, which relate to accounting for derivatives, due to significant opposition from the European banking industry and others. Although IAS 32 was ultimately endorsed in December 2004, the controversy surrounding IAS 39 continues. In November 2004, the Commission endorsed IAS 39, with the exception of certain provisions on the use of the full fair value option and on hedge accounting. This latter provision was particularly criticized by European banks, which argued that implementation would be unduly expensive and would generate unwarranted income statement volatility. IASB responded to the criticism on the full fair value option issue by revising the standard, producing a result that was endorsed by all affected parties, including the European Commission in November 2005. The hedge accounting controversy remains open, however, leaving a mishmash of standards. Companies reporting under "standard" IFRS must comply with IAS 39 in full, while companies reporting under IFRS as endorsed by the European Commission ("EU GAAP") may, but are not required to, comply with IAS 39 in full.

In their joint press release announcing the agreement, the boards noted that convergence would be pursued in accordance with their respective “due process procedures,” which include open decision-making meetings, exposure of proposed standards, and an opportunity for interested parties to be heard.

b. The SEC Roadmap

The SEC has long expressed its support for convergence and in recent years has taken an increasingly active role in moving toward common, high-quality standards. In 2005, SEC Chief Accountant Donald Nicolaisen, in an article reviewing the status of convergence, laid out a “roadmap” toward eliminating the U.S. GAAP reconciliation requirement for foreign IFRS filers.⁹⁶ Although as a matter of policy the SEC disclaims responsibility for such private publications by SEC employees, the roadmap provided significant impetus to the convergence process. The process proposed was an extensive review conducted by SEC staff of the faithfulness and consistency of IFRS financial statements filed in 2006 and their accompanying U.S. GAAP reconciliations, designed to identify principal areas of concern. Through 2007 the SEC would discuss the implications of its review with the financial community and standard setters and would monitor the status of convergence efforts of the IASB and the FASB. IFRS financial statement reviews would continue in subsequent years to update initial findings, and by 2009 the SEC staff would decide whether to recommend to the Commission the elimination of the requirement to reconcile IFRS to U.S. GAAP.

c. The 2006 FASB/IASB Memorandum of Understanding (MOU)

In response to the chief accountant’s proposal, the IASB and the FASB renewed their commitment to convergence and laid out a short-term path to achieving it in a new memorandum of understanding entered into in February 2006. The boards endorsed the 2009 goal for the elimination by the SEC of the U.S. GAAP reconciliation requirement and recognized that their contribution to achieving the roadmap was continued and measurable progress on the convergence program. The MOU set forth their agreement to work toward the following goals by 2008:

- **Short-term convergence** – The MOU identified a limited number of focused areas where major differences between U.S. GAAP and IFRS should be eliminated through short-term standard-setting projects. The topics include fair value option, impairment, income tax, investment properties, research and development, subsequent events, borrowing costs, government grants, joint ventures, and segment reporting.

⁹⁶ Donald T. Nicolaisen, “Statement by SEC Staff: A Securities Regulator Looks at Convergence,” *Northwestern University Journal of International Law and Business*, April 2005.

- **Medium-term convergence** – The MOU identified 11 further topics where substantial progress toward convergence should be made by 2008, although completion would not be possible in light of timing constraints from their respective due process procedures and the need to attain short-term convergence on the priority differences.

4. Auditing Convergence

Although the major benefits of convergence and the principal costs of disparate standards relate to financial reporting standards, convergence of international and U.S. auditing standards also merits consideration in discussing opportunities for reducing overlapping regulatory requirements that increase costs for foreign private issuers subject to SEC reporting requirements. Convergence of audit standards would also be expected to improve audit quality on a global basis, as audit firms and companies would be able to streamline internal and external audit procedures and focus compliance on a single standard.

Similar in nature to the international efforts for the convergence of financial reporting standards, a coordinated effort toward global convergence of auditing standards is ongoing under the auspices of the International Auditing and Assurance Standards Board (IAASB). The IAASB is a standard-setting body designated by, and operating under the auspices of, the International Federation of Accountants (IFAC) and subject to the oversight of the international Public Interest Oversight Board (PIOB) for the accountancy profession. The IAASB is currently undertaking a major project to complete its international auditing standards. A significant advance in global acceptance of IAASB standards is likely to come from the same source that did so much to advance the spread of IFRS—the EU, which is expected to adopt a Statutory Audit Directive, incorporating most or all of the IAASB standards. The timing and details of the directive, however, currently remain unsettled.

The PCAOB is an official observer at IAASB meetings and provides observer status to the IAASB at PCAOB Standing Advisory Group meetings. Some have criticized the PCAOB for not taking into account international standards in the promulgation of its auditing standards.⁹⁷ A more fundamental issue is the fact that IAASB standards aim to be principles-based, while the PCAOB tends to be more prescriptive in its approach.⁹⁸

⁹⁷ See, e.g., Jill P. Giles, Elizabeth K. Venuti and Richard C. Jones, “The PCAOB and Convergence of the Global Auditing and Accounting Profession,” *The CPA Journal Online*, September 2004.

⁹⁸ See, e.g., David Devlin’s Remarks to Fee Conference “Contribution of Financial Reporting to Financial Stability and Transparency,” Brussels, December 7, 2006.

5. Prospects for Convergence of Accounting Principles and Audit Standards

In light of the strong institutional support from the SEC, European Commission, IASB, FASB, and others, it seems likely that significant progress toward convergence of accounting standards will be made. In particular, prospects are encouraging that a sufficient level of progress will be made to permit foreign private issuers registered with the SEC to cease preparing U.S. GAAP reconciliations, which would provide a significant step forward in reducing costs for foreign private issuers accessing U.S. public capital markets.

Attaining full convergence, however, is less certain. As illustrated by the derivative accounting dispute that has dogged the full adoption of IFRS in Europe, certain differences between the two sets of standards may be very difficult, or impossible, to overcome. Nevertheless, the reduction of differences between IFRS and U.S. GAAP to a relatively small number of widely understood points would provide many of the benefits of comparability that convergence is designed to attain. As John White, director of the SEC Division of Corporate Finance, stated recently “It is not an important step, in fact not a step at all, that IFRS be exactly the same as U.S. GAAP.”⁹⁹

In comparison, prospects for convergence of international and U.S. auditing standards is even more uncertain. The weaker institutional support, particularly at the level of the PCAOB as compared to the movement toward accounting convergence, makes reaching convergence of auditing standards more challenging.

6. Commission Recommendations

1. Continued Convergence—Accounting

The Commission supports and encourages the efforts currently underway by the IASB and the U.S. FASB to converge IFRS and U.S. GAAP. Recognizing that IFRS are principles-based standards, the Commission recommends that foreign regulators give full consideration to the positions of their international counterparts regarding application and enforcement of IFRS, and seriously endeavor to avoid conflicting conclusions, such as the divergent standards applicable to derivatives.

At the same time, the Commission acknowledges and respects the authority of IFRS countries to sort out amongst themselves the agreeable method for interpreting IFRS principles. The SEC should not involve itself unnecessarily in this process. In this regard, the Commission applauds recent public statements by the SEC director

⁹⁹ John W. White, Speech by SEC Staff: Remarks before the Practicing Law Institute Sixth Annual Institute on Securities Regulation in Europe, January 15, 2007.

of Corporate Finance that the SEC does not intend to become the arbiter of IFRS, and encourages the SEC to apply faithfully IFRIC interpretations of IFRS and to defer to home-country regulators where appropriate in reviewing financial statements filed by foreign private issuers under IFRS.

In addition, the Commission would further encourage the SEC to continue and redouble its efforts to work within the IOSCO toward the convergence of international disclosure standards, particularly with respect to financial disclosure. Modifying home-country disclosure to comply with similar but different SEC standards merely adds costs for foreign private issuers.

2. Continued Convergence—Auditing

The Commission also recommends that the SEC and PCAOB work with their international counterparts and the ISAAB toward global convergence of U.S. and international auditing standards. The Commission strongly believes that it is imperative that international convergence of accounting standards be accompanied by convergence of audit standards.

The Commission believes that U.S. and international regulators and standards-setting bodies should accomplish accounting and auditing convergence within five years.

3. Elimination of the Reconciliation Requirement

The Commission also recommends that the SEC immediately consider an alternative approach for eliminating the reconciliation requirement. Specifically, the Commission proposes that the SEC establish a process by which it could, on a case-by-case basis, determine that a foreign country's accounting standards are sufficiently equivalent to U.S. GAAP that foreign companies from that jurisdiction would not be required to reconcile their financial statements to U.S. GAAP for SEC financial reporting purposes. The foreign country would be required to provide reciprocity for U.S. companies. As a potential model, the Commission suggests consideration of an approach similar to that set forth above in the subsection "Substituted Compliance—Foreign Brokers and Exchanges."¹⁰⁰

¹⁰⁰ The Commission notes that the SEC would need to work closely with the U.S. Trade Representative and the Department of Treasury to ensure that any discussions, negotiations, and agreements between the SEC and foreign regulators comply with U.S. obligations under international treaties, such as the General Agreement on Trade in Services (GATS).



ACCUMULATED SAVINGS AND INVESTOR EDUCATION

I. Introduction	50
II. Background	51
III. Commission Recommendations.....	56
A. Encourage Employment-Based Plan Sponsorship	56
B. Maximize the Positive Use of Inertia	58
C. Encourage Retirement Savings Through Automatic Payroll Deduction	62
D. Promote Investor Education, Advice, and Reporting.....	64
E. Encourage Sustainable Payment Streams in Retirement	67



I. INTRODUCTION

Current retirement savings are inadequate for many future retirees.¹⁰¹ The Commission believes that increasing retirement savings is critical to the U.S. capital markets, to American workers and their families, and to American social policy. U.S. capital markets fuel the nation's business economy. Throughout its discussions with various individuals and groups, the Commission has been told, time after time, how important retirement savings are to the capital markets. Discussing the need for additional retirement savings on the floor of the United States Senate recently, Senator Jeff Sessions (R-AL) agreed:



By increasing household savings we will be providing the investment capital our nation needs to ensure long-term economic growth and create more and better jobs. Increasing savings will allow the United States to depend less on foreign capital. America's current account deficit, the amount of domestic investment financed by borrowing from abroad, hit a record high of over 6% of GDP in 2005.¹⁰²

The Commission believes that providing tools to encourage increased retirement savings will benefit individuals, their families, and society at large; that with increased resources, individuals and their families should be better able to cope with the costs of retirement; and that increased retirement savings will help supply the capital needed to make the U.S. competitive in the global marketplace.

As chief investment officer of the Pennsylvania State Employees' Retirement System, Peter Gilbert provides insight on retirement savings and investor education.

101 Although investments in tax-favored retirement savings vehicles as a whole have grown significantly in recent years to more than \$14.5 trillion, they remain inadequate for many retirees. Investment Company Institute, "Appendix: Additional Data on the U.S. Retirement Market." *Research Fundamentals*. Vol. 15, no. 5A (Investment Company Institute, July 2006) www.ici.org/issues/ret/fm-v15n5_appendix.pdf. For example, Jack VanDerhei and Craig Copeland, "Can America Afford Tomorrow's Retirees?" *EBRI Issue Brief*, no. 263 (Employee Benefit Research Institute, November 2003) shows many retirees would have to increase their savings to be able to maintain their standard of living in retirement.

102 *Congressional Record*, January 23, 2007, p. S894.

II. BACKGROUND

Currently, the main tax-favored retirement savings vehicles for employees are employment-based defined contribution and defined benefit plans and individual retirement accounts (IRAs).¹⁰³ For example, the level of assets held in private sector plans and IRAs has grown significantly since 2002, with assets held in both defined contribution plans and IRAs surpassing the level in defined benefit plans. IRAs have the highest level of assets in 2005 with \$3.67 trillion, compared with \$2.97 trillion in defined contribution plans and \$2.15 trillion in defined benefit plans.¹⁰⁴ Growth in IRAs is being driven by rollovers from both defined contribution and defined benefit plans, not by individual IRA contributions. In 2002, the latest year that official Internal Revenue Service data are available, \$204.4 billion was rolled over to IRAs, compared with IRA contributions of \$42.3 billion.¹⁰⁵

This increase in overall savings for retirement in tax-favored retirement savings vehicles is encouraging. However, current retirement savings are inadequate for many future retirees. Significant reasons exist for inadequate retirement savings. Those reasons relate to the amount saved, the way those savings are invested, and the preservation of those savings for and through retirement.

Regarding, the amount of money saved, many private sector employees do not have access to employment-based retirement plans because their employers do not sponsor plans. In 2005, only 52.6% of private sector employees ages 21 to 64 worked for an employer that sponsored a plan.¹⁰⁶ This percentage was substantially lower for employees of small employers, as only 29% of individuals employed by employers with 10 to 24 employees worked for an employer that sponsored a plan.¹⁰⁷

Furthermore, many employees who are eligible for employer-sponsored defined contribution plans do not participate.¹⁰⁸ Of those who were eligible to participate in an employer-sponsored defined contribution plan, only 75.7% participated in the

103 The Commission has not addressed Social Security reform.

104 See Craig Copeland, "IRA Assets, Contributions, and Market Share." *EBRI Notes* Vol. 28, no.1 (Employee Benefit Research Institute, January 2007): 8-14.

105 Victoria L. Bryant and Peter J. Sailer, "Accumulation and Distribution of Individual Retirement Arrangements, 2001-2002" *SOI Bulletin* (Spring 2006): 233-254.

106 See Craig Copeland, "Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2005." *EBRI Issue Brief*, no. 299 (Employee Benefit Research Institute, November 2006).

107 See Copeland (November 2006) op cit.

108 Participation in most defined benefit plans is automatic, once the employee meets the eligibility criteria.

plan in 2004.¹⁰⁹ Failure of eligible individuals to participate in available retirement savings vehicles is even more pronounced in IRAs. Only about 10% of those who were eligible to contribute to an IRA did so in 2002.¹¹⁰

Finally, many employees who participate in an employer-sponsored plan do not make sufficient contributions to the plan. Twenty-five percent of non-highly compensated 401(k) plan participants contributed 5% or less of their salary into their 401(k) plan, when the most common maximum level eligible for a company match was 6% of salary.¹¹¹ The same is true of employees who contribute to IRAs. The average IRA contribution in 2002 was \$2,894, which was less than the then-maximum individual contribution of \$3,000 for those under age 50 and \$3,500 for those ages 50 or older.¹¹²



Andy Stern, president of the Service Employees' International Union, discusses trends in U.S. individual retirement savings.

Regarding how that money is invested, it must be noted at the outset that defined contribution plans and IRAs shift all responsibility for investment and longevity risks to individuals throughout the life of the arrangement. Defined benefit plans with lump-sum distributions also shift those risks to employees when a lump-sum distribution is made. This risk shifting currently means that many individuals must make numerous financial decisions that together have a huge impact on their retirement savings.

In addition to failing to participate and contributing too little to available tax-preferred retirement savings vehicles as described above, individuals often err in handling their retirement savings in one or more of the following ways.

Many individuals fail to balance their portfolios with respect to asset classes, for example, equity funds and bond funds, and they often invest too conservatively or too aggressively. For example, 43% of 401(k) plan participants in

109 See Craig Copeland, "Individual Account Retirement Plans: An Analysis of the 2004 Survey of Consumer Finances." *EBRI Issue Brief*, no. 293 (Employee Benefit Research Institute, May 2006). However, studies from 401(k) plan administrators found much lower participation rates. For example, Fidelity found about 65% of those eligible to participate in the 401(k) plans they administer actually participated in 2005. Vanguard reported that the average plan participation rate for Vanguard-administered defined contribution plans with an employee-contributory feature was 74% in 2005. The composite participation rate for all eligible participants across all Vanguard employee contributory defined contribution plans was 64%.

110 Bryant and Sailer (2006) *op cit.*

111 See Sarah Holden and Jack VanDerhei, "Contribution Behavior of 401(k) Plan Participants." *EBRI Issue Brief* no. 238 (Employee Benefit Research Institute, October 2001).

112 Bryant and Sailer (2006) *op cit.*

their 20s have none of their plan's assets in equity funds and 13% of those in their 60s have 100% in equity funds.¹¹³

In addition, individuals often fail to diversify their assets sufficiently. Of 401(k) plan participants in their 60s with company stock as an option, 12.6% have more than 90% of their assets in company stock.¹¹⁴ For those in their 50s, almost 10% have an allocation of more than 90% in company stock.¹¹⁵ Overall, almost 30% of participants with company stock as an option have 30% or more of their assets in company stock.¹¹⁶ This amount invested in a single stock is considerably higher than would be prescribed by optimal diversification.

Allocations that are too aggressive, too conservative, or insufficiently diversified are at least partially driven by the fact that most employees do not rebalance their portfolios. In a study of 1,500 401(k) plans over a two-year period, 80% of the participants initiated no changes and 11% initiated only one trade.¹¹⁷ Furthermore, from 1986 through 1996, approximately 47% of Teachers Insurance and Annuity Association, College Retirement Equities Fund (TIAA-CREF) participants made no changes in their account allocation.¹¹⁸ An additional 21% made only one change in that same time period.¹¹⁹

These errors are not surprising given that many individuals have low levels of financial literacy. Individuals often do not understand the various financial products or how to use them effectively, and many do not understand the basics of economic principles and personal finance. In a survey for the National Council of Economic Education, 28% of adults received an F for their knowledge of economics, including personal finance.¹²⁰ The younger the individual was, the more likely it was that he or she received a failing score on the survey exam, with 18- to 34-year-old respondents receiving a failure rate of 35%. In the Financial Literacy 2000 project, individuals

113 See Sarah Holden and Jack VanDerhei, "Appendix: Additional Figures for the EBRI/ICI Participant-Directed Retirement Plan Data Collection Project for Year-End 2005." *ICI Research Perspective*. Vol. 12, no. 1A (Investment Company Institute, August 2006). www.ici.org/stats/res/per12-01_appendix.pdf. In 2007, the maximum tax-deductible contribution to an IRA is \$4,000, and the maximum tax-deductible catch-up contribution for those age 50 and over is \$1,000.

114 Holden and VanDerhei (2006) op cit.

115 *Id.*

116 *Id.*

117 See Olivia S. Mitchell, Gary R. Mottola, Stephen P. Utkus, and Takeshi Yamaguchi, 2006. "The Inattentive Participant: Portfolio Trading Behavior in 401(k) Plans." *Pension Research Council WP 2006-5*.

118 See John Ameriks and Stephen Zeldes, 2001. "How Do Household Portfolio Shares Vary With Age?" *TIAA-CREF Working Paper*.

119 Ameriks and Zeldes (2001) op cit.

120 "What American Teens and Adults Know About Economics," The National Council of Economic Education, www.ncee.net/cel/WhatAmericansKnowAboutEconomics_051105-ExecSummary.pdf.

were also found to score low on knowledge of financial products for retirement.¹²¹ Financial education programs can help, but the results of various programs vary widely.¹²²

Participants in 401(k) plans may further reduce their retirement savings by taking loans. Approximately half of all 401(k) plans allow loans, and more than 90% of plans with more than 5,000 participants allow loans.¹²³ Of those eligible for a loan, 19% held a loan balance in 2005.¹²⁴ This number reached 22% for those in their 40s and 27% for those with an account balance between \$20,000 and \$30,000.¹²⁵

Individual decisions upon retirement or job change can also reduce savings for retirement. Generally, when individuals terminate employment they can leave their tax-favored account balance in an employer-sponsored defined contribution plan, roll over their account balance to another tax-favored savings vehicle such as an IRA, or simply take a cash distribution. The same is generally true for benefits in defined benefit plans with lump-sum distribution options. By the mid-1990s, 82% of pension plan participants were in plans that offered lump-sum distributions and more than half of those participants took their distributions in that form.¹²⁶ Approximately 50% of those taking a lump-sum distribution rolled over some portion of their most recent distribution to a tax-favored savings vehicle.¹²⁷ After a significant increase in this percentage in the late 1980s to the early 1990s, this percentage has leveled off at approximately 50%.¹²⁸ Younger individuals are less likely to roll over their assets, as only one-third of those ages 21 to 30 rolled over their entire lump-sum distribution, compared with 55.5% of those ages 51 to 60.¹²⁹ The higher the amount of the lump-sum distribution, the more likely the distribution is to be rolled over. For individuals with their most recent distribution amounting to \$1,000 to \$2,499,

121 See Neal E. Cutler and S. J. Devlin. 1996. "Financial Literacy 2000," *Journal of the American Society of CLU & ChFC* for results from this project.

122 See Lois Vitt, Gwen M. Reichbach, Jamie L. Kent, Jurg K. Siegenthaler. "Goodbye to Complacency: Financial Literacy Education in the U.S. 2000-2005 Research Report." http://assets.aarp.org/www.aarp.org/_articles/GAP/GoodbyetoComplacency.pdf for an evaluation of various financial literacy programs.

123 Holden and VanDerhei (2006) op cit.

124 *Id.*

125 *Id.*

126 Patrick J. Purcell, "Lump-Sum Distributions and Retirement Income Security." *Journal of Pension Planning and Compliance*, Fall 2000, pp. 27-60. Michael D. Hurd, Lee Lillard, and Constantijn Panis. "An Analysis of the Choice to Cash-Out, Maintain, or Annuitize Pension Rights at Job Change or Retirement." *Rand Working Paper DRU-1979-DOL* October 1998.

127 Craig Copeland, "Lump-sum Distributions," *EBRI Notes*. Vol. 26, no. 12 (Employee Benefit Research Institute, December 2005): 7-17.

128 Copeland (2005) op. cit.

129 Copeland (2005) op. cit.

30.4% rolled over the distribution, compared with 73.4% of those with a distribution of \$50,000 or more.¹³⁰

Individuals who have successfully preserved savings for retirement must, after retirement, determine what amount they can withdraw while still having a high probability of not outliving their savings. The withdrawal rate from tax-preferred retirement accounts is just now becoming an issue, because the individuals beginning to retire are the first ones who have had a sufficient period of time to have accumulated retirement savings in these individual account arrangements. Of those reaching age 65 in the last 10 years, 29% have had a decline in their total wealth from 1992 to 2004.¹³¹ Among those with a decline in total wealth, the decline was significant: the median average annual decline from 1992 to 2004 was greater than 5% and, among those with a decline in financial wealth (housing assets and debt excluded), the median average annual decline approached 10%.¹³² Declines of this magnitude create a substantial risk that individuals will outlive their retirement savings.¹³³

130 Copeland (2005) op. cit.

131 See Craig Copeland, "How Are New Retirees Doing Financially in Retirement?" *EBRI Issue Brief* no. 302 (Employee Benefit Research Institute, February 2007).

132 In Copeland (2007) op. cit., average annual decline in wealth is a proxy for a withdrawal rate of retirement assets, as the study was not able to distinguish capital losses from assets spent when examining the changes in the wealth over the period studied.

133 Annuitization could reduce this risk but only 10% of individuals with defined contribution plans annuitized their account balances when terminating employment at ages 60 to 64 and ages 65 to 69. William G. Gale and Michael Dworky, "Effects of Public Policies on the Disposition of Lump-Sum Distributions: Rational and Behavioral Influences." Center for Retirement Research at Boston College, CRR WP 2006-15, August 2006. http://www.bc.edu/centers/crr/papers/wp_2006-15.pdf.



III. COMMISSION RECOMMENDATIONS

These patterns of behavior reveal significant impending problems for individuals and society at large that can be reduced by promoting employer-sponsored plans and increasing IRAs. In general, the Commission recommends removing as many barriers to retirement savings and retirement plans as possible.¹³⁴ Specifically, the Commission recommends the actions described below to encourage employment-based plan sponsorship; to maximize the positive use of employee inertia; to encourage retirement savings through automatic payroll deduction; to promote investor education, advice, and reporting; and to encourage sustainable payment streams in retirement.¹³⁵ With respect to each of its recommendations, the Commission endorses further study to develop specific, detailed proposals.

A. Encourage Employment-Based Plan Sponsorship

Recommendation: Encourage employment-based plan sponsorship by encouraging simplification in plan design and administration.

As discussed, one serious shortcoming of the current tax-favored retirement savings system is that many employees are not eligible to participate in any type of employer-

¹³⁴ While the Commission's report focuses on increasing retirement savings inside of tax-favored vehicles, the Commission believes that increasing savings outside of such vehicles also would have a significant positive effect on the capital markets. In the course of its work, the Commission has encountered many ideas designed to increase such savings. One idea, for example, is to encourage investment in mutual funds by eliminating the current requirement that fund shareholders pay tax every year on capital gains realized by their funds. The proposed legislation would defer taxes on capital gains automatically reinvested by fund shareholders until they decided to sell their fund shares. Although the Commission has not studied this proposal, it notes that the proposed legislation, introduced in the last Congress as the Generate Retirement Ownership Through Long-Term Holding Act of 2005 (Growth Act), had strong bipartisan support in the U.S. Senate and House of Representatives in the last Congressional term.

¹³⁵ Some of the issues with respect to which the Commission is making recommendations were touched upon in the Pension Protection Act of 2006 (PPA). In every such case, however, the Commission's recommendations go significantly further than the PPA or deal with issues not covered by the PPA. In addition, a number of the Commission's recommendations are similar to recommendations currently being made by other groups and individuals. *See, e.g.*, the proposal advanced in Congressional testimony by Brookings Institution Nonresident Senior Fellow J. Mark Iwry and Heritage Foundation Senior Fellow David C. John, "Pursuing Universal Retirement Security Through Automatic IRAs," Testimony before Long-Term Growth and Debt Reduction Subcommittee of the Committee on Finance, United States Senate (June 29, 2006), and the Iwry-John working paper draft dated February 12, 2006, available at www.retirementsecurityproject.org; Samuel Estreicher and Laurence Gold, "The Shift from Defined Benefit to Defined Contribution Plans," *Labor & Employment Law*, Vol. 35, Number 2, Winter 2007; Amendment to H.R.2 (federal minimum wage law) introduced by Sen. Sessions to express the sense of the Senate that increasing personal savings is a necessary step toward ensuring the economic security of all the people of the United States upon retirement, adopted by U.S. Senate January 23, 2007. The Commission is adding its thoughts to this mix with the hope that the best parts of each will move forward and result in positive change.

sponsored retirement savings plan. The Commission believes that one reason many employers do not sponsor a retirement savings plan is the bewildering array of plans from which to choose, each with its own set of lengthy and complicated rules that must be sorted out before a choice can be made. For example, in the private sector, available defined contribution plans include profit sharing plans, 401(k) plans, 401(k) plans with Roth accounts, Savings Incentive Match Plans for Employees (SIMPLE), Simplified Employee Pensions (SEPs), and money purchase plans.

Although the Commission understands that the current array of plans reflects historical responses to employee and employer needs, the Commission would encourage Congress to consider simplifying plan design and administration. For example, Congress should consider whether the array of defined contribution plans currently available to private sector employers could be reduced to a single defined contribution plan design that minimizes barriers to implementation, administration, and participation.¹³⁶ Congress also should consider whether this single defined contribution plan design could incorporate the defined contribution plan designs currently available to not-for-profit and government entities (*e.g.*, 403(b) and 457(b) plans).¹³⁷ The goal should be to eliminate administrative differences while not eliminating the range of features available to employers and employees. Within reason, employees should be better off, not worse off, after the plan designs are consolidated.

136 Individual IRAs, including Roth IRAs, are not among the arrangements that the Commission is suggesting be consolidated.

137 Code § 401(k), 403(b), and 457(b) plans are identical in their annual employee contribution limit (\$15,500 for 2007), but they are different to a greater or lesser degree in many other ways. For example, in addition to employee contributions, both 401(k) and 403(b) plans allow employer contributions up to an annual employee-employer combined total of \$45,000 (2007). Code § 457(b) plans, on the other hand, also allow employer contributions, but those contributions reduce the employee's ability to contribute because the annual employee-employer combined total contribution is limited to \$15,500 (2007). Both 401(k) and 403(b) plans may permit in-service distributions at age 59 1/2, but a 457(b) plan may not. Code § 401(k), 403(b) and governmental 457(b) plans may offer participant loans, but nongovernmental 457(b) plans may not. Further, while there is both an IRS approval program and an IRS correction program for 401(k) plans, there is no approval program for 403(b) or for 457(b) plans, and no correction program for 457(b) plans. IRS Publication 4406 (10-2004); <http://www.irs.gov/pub/irs-pdf/p4406.pdf>. The Commission believes that these differences unduly burden plan administrators and plan sponsors.



Peter Orszag, former senior fellow at The Brookings Institution, discusses ways to facilitate retirement savings at a town hall meeting in New York City.

Recommendation: Encourage multiple employer plans, such as association plans.

A multiple employer plan is a single plan in which a number of unrelated employers participate.¹³⁸ For example, a trade association could sponsor a multiple employer plan for its participating employer members.

The Commission believes that multiple employer plans may be a particularly desirable option for small and midsize employers. These plans should have lower administrative costs for each participating employer than would an individually sponsored plan as a result of back-office efficiencies.¹³⁹ In addition, multiple employer defined benefit plans could provide increased benefit portability within the sponsoring employer group to employees of any member of the group.¹⁴⁰ Moreover, the Commission believes that multiple employer defined benefit plans would allow aggregation and professional management of investments and, as a result, permit such plans to gain access to higher return asset classes, more diverse investments, and reduced investment costs. In making this recommendation, the Commission recognizes that problems identified with current multiple

employer arrangements will need to be addressed (*e.g.*, the issue of liability for underfunding by another employer). The Commission encourages consideration of legislation that would facilitate such multiple employer defined benefit and defined contribution plans, including reducing the cross-liability problems currently associated with such arrangements.

B. Maximize the Positive Use of Inertia

Recommendation: Require automatic participation of eligible employees, use of appropriate default investment alternatives, automatic escalation of employee

138 A multiple employer plan is not to be confused with a multiemployer plan. A multiemployer plan is a plan to which more than one employer is required to contribute and which is maintained pursuant to one or more collective bargaining agreements. A multiple employer plan, on the other hand, is a voluntary arrangement and is not maintained pursuant to collective bargaining agreements.

139 Teresa Ghilarducci and Kevin Terry, "Scale Economies in Union Pension Plan Administration: 1981-1993." *Industrial Relations* 38(1) January 1999: 11-17.

140 John Turner. *Pension Policy for a Mobile Labor Force* Kalamazoo, MI: Upjohn Institute for Employment Research, 1993.

contributions over time, and automatic transfers of lump-sum distributions to IRAs upon a job change or retirement, absent employee opt-out.

Presumptive rules and default investment alternatives, because of employee inertia, can have a significant positive effect on tax-favored retirement savings.¹⁴¹ The Commission recommends presumptive enrollment, contribution, distribution rules, and default investment alternatives, which maximize the use of employee inertia to increase retirement savings, with all such presumptions and defaults subject to the employee's ability to opt-out.

As discussed, in 2004, almost 25% of those eligible to participate in employer-sponsored defined contribution plans did not take advantage of their ability to do so. Automatic participation successfully raises the percentage of employees who participate in existing tax-favored retirement savings plans.¹⁴² The Commission recommends a presumptive rule requiring automatic participation of newly hired eligible employees in every existing employer-sponsored plan. The Commission also recommends a presumptive rule requiring a one-time automatic enrollment of existing employees who are eligible but who have not participated in an existing plan in the past.

Retirement savings are inadequate for many future retirees. For example, a study published in 2003 showed that, depending on family status, year of birth, and income, between 15% and 65% of American families reaching Social Security normal retirement age over the next 15 years would not have sufficient wealth to maintain their preretirement standard of living, even if their retirement savings increased by an additional 5% of compensation each year.¹⁴³ Automatic escalation of employee contribution rates in tax-favored retirement savings vehicles is an effective way to increase employee retirement savings.¹⁴⁴ Typically, the initial default contribution rate associated with automatic enrollment is set low so that the reduction in the employee's take-home pay will not be too difficult for the employee to manage.¹⁴⁵

141 Sarah Holden and Jack VanDerhei. "The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement." *EBRI Issue Brief* no. 283 (Employee Benefit Research Institute, July 2005). See also Peter R. Orszag, J. Mark Iwry, and William G. Gale (editors). *Aging Gracefully: Ideas to Improve Retirement Security in America*. (New York: The Century Foundation Press, 2006).

142 The Vanguard Center for Retirement Research. "Automatic Enrollment: Vanguard Client Experience." Valley Forge, PA: The Vanguard Group, July 2001.

143 See Jack VanDerhei and Craig Copeland, "Can America Afford Tomorrow's Retirees?" *EBRI Issue Brief* no. 263 (Employee Benefit Research Institute, November 2003).

144 Stephen P. Utkus. "A Recent Successful Test of the SMarT Program." Valley Forge, PA: The Vanguard Center for Retirement Research and the Vanguard Group, November 2002.

145 Profit Sharing/401(k) Council of America. *47th Annual Survey of Profit Sharing and 401(k) Plans: Reflecting 2003 Plan Year Experience*. Chicago, IL: Profit Sharing/401(k) Council of America, 2004.

This rate, however, is below the average contribution for all 401(k) participants and inevitably will be too low to result in adequate savings for retirement over the course of the employee's working life.¹⁴⁶ Automatic escalation, which can be structured to occur annually or with every pay raise, gradually increases the employee's contribution rate to an appropriate level.¹⁴⁷ The Commission recommends a presumptive rule requiring automatic escalation of employee contributions to appropriate levels, subject to the employee's ability to opt-out at any automatic level increase.

The importance of proper asset allocation to investment growth, and by extension, to adequate retirement savings, is well-documented.¹⁴⁸ Studies indicate, however, that many employees who are automatically enrolled in tax-favored retirement savings vehicles remain in the default investment option for a substantial period of time. For example, one study found that after one year more than half of automatically enrolled participants remained in the default investment option and that after two years 40% were still in that option.¹⁴⁹ Another study of several plans found that after six months 48% to 73% of those automatically enrolled were still in the default option, after two years 37% to 50% were still in that option, and after three years 29% to 48% remained in that option.¹⁵⁰ In the past, the most common default investment was a money market fund, which typically provided very low investment returns.¹⁵¹ In addition, as discussed, many employees do not adjust their portfolios as they age and many employees' investments are not sufficiently diversified. Finally, high administrative costs can significantly decrease savings available for retirement.¹⁵²

In recent years, investment fund products that help to address investor uncertainty, timidity, and inertia have been developed. Life-cycle funds automatically adjust the

146 Holden and VanDerhei, (2005) op. cit.

147 Utkus (2002) op. cit. For example, provisions similar to those enacted as part of the new 401(k) non-discrimination safe harbor in the PPA could apply, and automatic escalation could begin at 3%, increase 1% a year, and escalate to no less than 6% and no more than 10%.

148 Stephen P. Utkus. "Selecting a Default Fund for a Defined Contribution Pension Plan." Valley Forge, PA: The Vanguard Center for Retirement Research and the Vanguard Group, June 2005. See also SEC. "Beginners' Guide to Asset Allocation, Diversification, and Rebalancing." <http://www.sec.gov/investor/pubs/assetallocation.htm>.

149 Madrian, Brigitte C. and Shea, Dennis F., "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior." *Quarterly Journal of Economics* 116 (4) (November 2001): 1149-1187.

150 Choi, James J.; Laibson, David; Madrian, Brigitte; and Metrick, Andrew. "Saving for Retirement on the Path of Least Resistance." In *Behavioral Public Finance Toward a New Agenda*, edited by Ed McCaffrey and Joel Slemrod. New York, N.Y.: Russell Sage Foundation, 2006, 304-351.

151 Ameriks and Zeldes (2001) op. cit. and Utkus (2005) op. cit.

152 SEC. "Final Report: Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies." May 10, 2004. <http://www.sec.gov/rules/final/33-8393.htm>.

mix of stocks and bonds as employees age.¹⁵³ Target retirement funds are life-cycle funds that reference a specific expected retirement date.¹⁵⁴ Asset allocation funds enable employees to obtain a diversified portfolio, including both stocks and bonds by purchasing a single mutual fund, with the fund changing the proportion of stocks to bonds based on its expectation for future returns.¹⁵⁵ Balanced funds invest in equities and fixed income investments providing the opportunity for broad diversification across asset classes within a single mutual fund, while maintaining a fixed proportion of the fund in different asset classes.¹⁵⁶ The Commission recommends that all default investments before retirement be required to be in life-cycle, target retirement, asset allocation, or balanced funds, which all have low administrative costs.

As explained, employees changing jobs or reaching retirement often request lump-sum distributions.¹⁵⁷ Employees with benefits valued at \$5,000 or less at termination of employment can be forced to take a lump-sum distribution.¹⁵⁸ If these mandatory distributions are more than \$1,000, they must be distributed to an individual retirement plan, such as an IRA, unless the participant elects otherwise.¹⁵⁹ In contrast, if the mandatory distribution is \$1,000 or less, it is not required to be distributed to an individual retirement plan, even if the employee provides no other direction. As noted, only approximately half of individuals taking lump-sum distributions roll over some or all of the distribution received. Even small lump-sum distributions, if invested rather than spent, can assist in providing adequate retirement savings.¹⁶⁰ The Commission recommends a presumptive rule requiring automatic transfer of all mandatory or requested lump-sum distributions to IRAs upon a job change or retirement.

The Commission believes in preserving employee free choice and in providing employees the information necessary to make informed decisions. The Commission recommends that employees receive sufficient notice of the presumptive rules and default investment alternatives to make informed decisions. The Commission also recommends that employees should be allowed to opt-out of any or all of these presumptive rules and default investment alternatives at any time.

153 Joseph C. Nagengast, John Bucci and William J. Coaker II. "Popping the Hood: An Analysis of Major Life-Cycle Fund Families." Turnstone Advisory Group, LLC. 2006. <http://turnstoneag.com/downloads/PoppingTheHood2005.pdf>.

154 SEC. "Beginners' Guide to Asset Allocation, Diversification, and Rebalancing." <http://www.sec.gov/investor/pubs/assetallocation.htm>.

155 John Waggoner. "Are asset allocation or balanced funds for you?" *USA Today*, June 21, 2001, <http://www.usatoday.com/money/perfi/columnist/netgains/2001-06-20-net.htm>.

156 Ibid.

157 Copeland (2005) op. cit.

158 Internal Revenue Code § 411(a)(11)(A).

159 Internal Revenue Code § 401(a)(31)(B).

160 Copeland (2005) op. cit.

C. Encourage Retirement Savings Through Automatic Payroll Deduction

Recommendation: Require employers with 21 or more employees who do not sponsor a retirement savings plan of any type to provide for automatic employee payroll deductions and to transmit those contributions to financial institutions that establish and administer these arrangements.

Administration of a retirement savings plan can be time-consuming and burdensome, particularly for small and midsize employers.¹⁶¹ In addition, sponsoring such a plan generally requires an employer to shoulder all the fiduciary responsibilities and liabilities related to the proper management of the plan and its assets.¹⁶² Fulfilling these plan fiduciary responsibilities can be particularly demanding because pension law is complex and changes regularly as new legislation and administrative rules are enacted or adopted.¹⁶³ Many employers do not sponsor any type of retirement savings plan because they cannot, or do not want to, assume these plan-related burdens.¹⁶⁴

The Commission recommends that Congress adopt a presumptive rule ensuring that, if an employer with 21 or more employees does not sponsor a tax-favored defined benefit or defined contribution plan, employees who work for such an employer will have access to tax-favored retirement savings through an automatic payroll deduction arrangement. Under the Commission's proposal, Congress is encouraged to require employers to transmit automatic employee payroll deduction contributions directly to financial institutions that establish and administer such arrangements. Such transmissions should be made using automated payroll systems if at all possible. Because many employees end up in default investment alternatives, the default investment alternatives should be life-cycle, retirement target, asset allocation, or balanced funds with low administrative costs. Because employees of different ages have different investment needs, different default investment funds may be appropriate for employees of different ages. Employees faced with a large number

161 Paul Jakoboski, Pamela Ostuw, and Bill Pierron. "The 1999 Small Employer Retirement Survey: Building a Better Mousetrap is not Enough." *EBRI Issue Brief* (Employee Benefit Research Institute, August 1999). <http://www.ebri.org/pdf/briefspdf/0899ib.pdf>.

162 See, e.g., ERISA § 402.

163 A recently published list names 71 benefits-related laws passed since ERISA was enacted in 1974. "Major Post-ERISA Benefits Legislation." Hewitt LLC, January 2007.

164 Jakoboski et al. (1999) op. cit.

of investment choices often make no active investment choice at all.¹⁶⁵ To encourage employees to make such choices, the number of investment options available under the arrangement should be limited, while still offering a range of diversified options that vary as to level of risk and type of investment.

Employers would specifically not be responsible for administration of the arrangement. Employers would not be responsible for selecting the investment alternatives, managing the investments, keeping records of account balances, or handling any other administrative functions, all of which would be done by the financial institution.

Employers would, however, be responsible for choosing a sound financial institution, monitoring the continued soundness of that financial institution, and transmitting all employee contributions in a timely manner. The recipient financial institution would assume all remaining fiduciary obligations.

The Commission believes that costs should be minimized under the arrangement, although financial institutions should be able to charge reasonable fees for providing record keeping, investment management, and other services. The Commission recommends allowing, but not requiring, employer contributions to the arrangement. Furthermore, antidiscrimination testing would not be required and participant loans from plans would not be permitted.

Based on employer-provided payroll information, employees would be automatically enrolled in the arrangement by the qualifying financial institution selected by the employer, but they would be allowed to opt-out of the arrangement at any time. All lump-sum distributions would be automatically transferred to an IRA. Employees would be provided sufficient notice to make informed choices about opting out.

Specific design features should encourage employers with existing plans to continue those plans, rather than terminating existing plans and electing this arrangement. For example, this arrangement should have lower annual contribution limits than traditional defined benefit or defined contribution plans. These lower limits would provide an incentive for employers to sponsor the traditional plans because the higher contribution limits would allow employers to contribute more to their own savings.

¹⁶⁵ Sheena S. Iyengar, Wei Jiang, and Gur Huberman. (2004). "How Much Choice is too Much? Contributions in 401(k) Retirement Plans." *In Pension Design and Structure: New Lessons from Behavioral Finance*, edited by Olivia S. Mitchell and Stephen P. Utkus. Oxford, U.K.: Oxford University Press.

Recommendation: Study the needs of employers with very small numbers of employees (less than 21 employees) to ascertain how best to provide a payroll deduction retirement savings opportunity for their employees.

The Commission believes that all employees whose employers do not sponsor a tax-favored defined benefit or defined contribution plan should have access to tax-favored retirement savings through an automatic payroll deduction arrangement, subject to employee opt-out. The Commission recommendation described above includes a small-employer exception for employers with fewer than 21 employees. Such employers employ millions of full-time workers.¹⁶⁶ Small employers have indicated, however, that they will oppose requirements that impose almost any additional administrative burdens.¹⁶⁷ Therefore, the Commission recommends that studies be undertaken to determine whether an appropriate automatic payroll deduction arrangement could be developed that would not burden small employers to almost any extent but that would meet the needs of their employees.

D. Promote Investor Education, Advice, and Reporting

Recommendation: Increase financial literacy by encouraging education authorities to make financial education part of the standard curriculum nationwide from elementary through high school and also in adult education programs.

As discussed, more retirement assets are held in defined contribution plans and IRAs than in defined benefit plans. In a retirement savings system dominated by such tax-favored retirement savings vehicles, financially literate employees are essential if such a system is to be successful. Unfortunately, most people have a low level of financial literacy. Financial education must play an important role in increasing financial literacy. Although many model financial curricula exist, the subject is not taught as part of the standard education curriculum in many schools.¹⁶⁸ The Commission recommends encouraging education authorities to modify the basic curriculum of elementary and especially secondary schools nationwide to incorporate financial education. The Commission also recommends that education authorities consider including financial education in all adult education programs. Moreover, because the results of financial education programs vary widely, the Commission recommends

¹⁶⁶ Copeland, Craig. "Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2005." *EBRI Issue Brief*, no. 299 (Employee Benefit Research Institute, November 2006).

¹⁶⁷ Olsen, Kelly and Dallas Salisbury. "Small Employer Survey on Individual Social Security Account Administration." *EBRI Notes*, Vol. 20, no. 4 (Employee Benefit Research Institute, April 1999).

¹⁶⁸ Vitt et al. (2005) op. cit. See also National Council on Economic Education. "Nation's Youth Targeted Through Major National Economic and Financial Literacy Initiative." November 8, 2006. http://www.ncee.net/news/story.php?story_id=93.

that education authorities consider using model financial curricula that have been proven effective.

Recommendation: Promote studies on how to better reach minority groups with financial information and advice; promote better understanding of currently available government-provided benefits; and promote the use of the Internet for financial education.

The United States is a country of staggering ethnic and cultural diversity.¹⁶⁹ To successfully meet the needs of diverse groups, programs of financial education may need to consider differences in familiarity with and trust in everyday financial institutions such as banks, differences in fluency in English, and cultural differences regarding attitudes toward savings and risk. The Commission recommends that the appropriate interest groups consider promoting studies on how to better reach diverse groups with financial information and advice.

Social Security is the most important source of retirement income for most retirees.¹⁷⁰ Medicare benefits also are critical to many retirees' security.¹⁷¹ Many people, however, know very little about how the Social Security system works, about how much of their retirement savings should be expected to come from the system, about which types of benefits are available under the system, or how such benefits are earned, calculated, offset, and taxed.¹⁷² Most people can be expected to know even less about the Medicare system. To promote financial literacy, clear and concise communication materials about both programs need to be available and distributed.

For people with access to it, the Internet is changing the way that information is disseminated. The Internet provides an inexpensive way of distributing information, such as financial education materials. The Commission recommends promoting the use of the Internet for financial education by increasing Internet access. For example, more computers could be made available in more public libraries (particularly inner-city and rural libraries) cultural centers, and other facilities open to the public.

169 U.S. Census Bureau. "Overview of Race and Hispanic Origin: Census 2000 Brief." March 2001. <http://www.census.gov/prod/2001pubs/c2kbr01-1.pdf>.

170 Social Security Administration, Office of Policy. "Income of the Population 55 or Older: 2004" May 2006. http://www.socialsecurity.gov/policy/docs/statcomps/income_pop55/2004/index.html#toc.

171 U.S. Department of Health and Human Services. "Your Medicare Benefits." <http://www.medicare.gov/Coverage/Home.asp>.

172 Alan Gustman and Thomas Steinmeier. "What People Don't Know About their Pensions and Social Security." In *Private Pensions and Public Policy*, edited by William Gale, John Shoven, and Mark Warshawsky. Washington, D.C.: Brookings Institution, 2004, pp. 57-125.

Recommendation: Provide investment information and advice about mutual funds in a user-friendly standardized format, including complete, understandable, comparable, and specific information about risks, returns, fees, and other investment costs; provide simplified asset allocation information; and provide a mechanism for determining how IRA assets are invested.

Investment information is often complex and counterintuitive. For example, unsophisticated investors frequently are inclined to sell a stock when its price is low because it is performing poorly and to buy it when its price is high because it is performing well, which runs counter to standard investment advice.¹⁷³ Investment education and advice should be structured taking into account such human tendencies. Moreover, investment advice is currently provided in a format that many investors find difficult to understand.¹⁷⁴

Employees often have little understanding of the fees and costs they pay for administration of their retirement savings plans. For example, in 2004, 80% of employees who participated in employer-sponsored 401(k) plans did not know the amount of fees and other costs they paid (either directly through charges to their accounts or indirectly through reduced investment earnings).¹⁷⁵ To address these issues, the Department of Labor, the SEC, and other interested market participants should develop a standard format for disclosure of all fees and expenses paid directly or indirectly by plan participants.

Similarly, the Commission recommends that investment advice for mutual funds should be provided in a more user-friendly standardized format that allows employees to easily compare investment option risks, returns, fees, and other costs.¹⁷⁶ The standardized

173 See John Turner, "Errors Workers Make in Managing 401(k) Investments," *Benefits Quarterly* 19(4) Winter 2003: 75-82.

174 SEC. "Invest Wisely: An Introduction to Mutual Funds." <http://www.sec.gov/investor/pubs/inwsmf.htm#pitfalls>. See also Investment Company Institute, "Understanding Investor Preferences for Mutual Fund Information." 2006. http://www.ici.org/stats/res/rpt_06_inv_prefs_full.pdf.

175 John Turner and Sophie Korczyk. "Pension Participant Knowledge About Plan Fees." AARP Public Policy Institute Data Digest no. 105, November 2004. http://www.aarp.org/research/financial/pensions/pension_participant_knowledge_about_plan_fees.html.

176 Much work has already been done by the SEC and NASD's Mutual Fund Task Force to attempt to standardize investor disclosures in the form of, respectively, the point of sale and Profile Plus disclosure proposals. See, e.g., *Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Fund*, Securities Act Rel. no. 33-8358 (January 29, 2004) (proposal) and *Point of Sale Disclosure Requirements and Confirmation Requirements for Transactions in Mutual Funds, College Savings Plans, and Certain Other Securities, and Amendments to the Registration Form for Mutual Funds*, Securities Act Rel. no. 33-8544 (February 28, 2005) (reproposal). Without endorsing either the NASD or SEC proposals, the Commission supports simplifying and clarifying investor disclosures and recommends moving forward expeditiously to address any unresolved issues.

format should allow incorporation of other documents, such as an applicable prospectus, by reference and should use Internet delivery to the extent feasible. Use of the standardized format should provide a safe harbor from litigation.

As discussed previously, many employees do not know how to balance their portfolios, and many employees do not balance or periodically rebalance their portfolios. Employees need to understand the various risks associated with different types of investments and how asset allocation within diversified portfolios affects those differences.¹⁷⁷ The Commission recommends providing asset allocation information in a simplified form.

As noted, in 2005, there were \$3.67 trillion dollars in IRAs. Relatively little is known about the way that individuals are managing this enormous pool of retirement savings, because the detailed data by demographic criteria that are necessary for this analysis are not being collected.¹⁷⁸ To better understand, and therefore better serve, this population of individual investors, more information is needed about their current practices. To gather this information, financial institutions should report to policy-makers about how IRA assets are being invested. The Commission recommends minimally burdensome reporting requirements.

E. Encourage Sustainable Payment Streams in Retirement

Recommendation: Encourage as default investments at retirement reasonable-cost group annuities that provide guaranteed income for life and mutual fund programs that provide for systematic withdrawals from plans over expected lifetimes; facilitate the availability of reasonable-cost group annuities for nonemployment-related groups; and encourage the issue of long-maturity inflation-protected securities.

The ultimate goal of retirement income policy is to promote adequate income throughout retirement. Annuitization and phased withdrawals provide valuable mechanisms for spreading retirement savings at sustainable levels.

An advantage of traditional defined benefit plans is that they automatically pay out an income stream for the retiree's life or for the lives of the retiree and spouse (unless

¹⁷⁷ SEC. "Beginners' Guide to Asset Allocation, Diversification, and Rebalancing." <http://www.sec.gov/investor/pubs/assetallocation.htm>.

¹⁷⁸ See generally Investment Company Institute, "Appendix: Additional Data on the U.S. Retirement Market." Research Fundamentals 15(5a) July 2006, p. 10 http://www.ici.org/issues/ret/fm-v15n5_appendix.pdf.

other distribution forms are available and elected).¹⁷⁹ In effect, these plans function as a group annuity for the plan participants. Defined contribution plans often do not provide an annuity payment option or, if they do, the option is priced more like an individual annuity and does not reflect the more favorable pricing available for group annuities.¹⁸⁰ Employees who do not participate in employer-sponsored plans, but who wish to purchase annuities to have a guaranteed income stream, generally pay more to purchase individual annuities.¹⁸¹ Group annuities are less expensive than individual annuities in part because the financial risk is spread among a large group, as opposed to being limited to a single person, and commissions are lower.¹⁸²

Phased withdrawals from plans and other retirement savings vehicles allow retirees the opportunity to spread their retirement savings over their and their spouse's life expectancies. Phased withdrawals, such as the systematic withdrawal arrangements offered by mutual funds, are withdrawals made at a regularly scheduled rate and interval. With phased withdrawals, rules of thumb that make estimates based on probability models and average life expectancies can help retirees establish a rate at which they can withdraw their assets. Properly designed, this option would provide a high probability that retirement investments would be sufficient to meet individual retirement needs. Although the risk of outliving one's assets still remains, this option would provide more flexibility in managing assets than other postretirement approaches.

The Commission recommends that all tax-favored account-based retirement savings plans or arrangements offer two presumptive investments at retirement. One of these presumptive investments would be reasonably priced employment-based group annuities that provide guaranteed income for the life of the employee and the employee's spouse.¹⁸³ The other would be a mutual fund type of investment that provides phased withdrawals at levels intended to be for the life of the employee and the employee's spouse. To address the mechanics of a "double default" option and to enhance employee choice, the Commission recommends requiring an employee, at the time of first enrollment, to elect one of the two presumptive investments. Upon retirement, the employee then could choose to (i) keep the elected investment option by doing nothing; (ii) replace the elected investment with the other required investment option; or (iii) elect any other available option.

179 See George A. (Sandy) Mackenzie. *Annuity Markets and Pension Reform*. Oxford, England: Oxford University Press, 2006.

180 Ibid.

181 Ibid.

182 Ibid.

183 The Commission recognizes that defined contribution plans historically have offered an individually purchased annuity option and that this option has generally been eliminated because most employees failed to utilize it. The approach recommended by the Commission is intended to address the unattractive features of earlier annuities by creating a market that reduces the cost.

The role and benefit of group annuities could be expanded if they were offered to nonemployment-related groups, such as trade associations, membership organizations, or college alumni associations.¹⁸⁴ The purchase of nonemployment-related group annuities may be a particularly desirable option for individuals with IRAs because IRAs generally are not connected to a particular employer. The Commission recommends that steps be taken to facilitate the availability of annuities to nonemployment-related groups.

Treasury Inflation-Protected Securities (TIPS) are Treasury instruments for which the principal is indexed to the Consumer Price Index.¹⁸⁵ A fixed rate of return is paid on the inflation-adjusted principal.¹⁸⁶ The interest rate remains fixed throughout the term of the security, and thus TIPS are subject to some interest rate risk.¹⁸⁷ Currently, the Treasury sells 5-year, 10-year, and 20-year TIPS, but it does not sell 30-year TIPS.¹⁸⁸ TIPS with a 30-year duration would be particularly advantageous for pension plans because of the long length of their liabilities.¹⁸⁹ The Commission recommends that the issuance of long-maturity inflation-protected securities, such as 30-year TIPS, be encouraged.

184 Ibid.

185 U.S. Treasury. "Treasury Inflation-Protected Securities (TIPS). http://www.treasurydirect.gov/indiv/products/prod_tips_glance.htm.

186 Ibid.

187 Ibid.

188 Ibid.

189 David Blake. *Pension Finance*. John Wiley & Sons, 2006.



CHALLENGES CONFRONTING ISSUERS AND AUDITORS

I. Introduction	71
II. Earnings Guidance.....	72
A. History of Quarterly Earnings Guidance	72
B. Empirical Studies on Earnings Guidance.....	74
1. The Costs of Quarterly Guidance	74
2. The Effects of Ceasing to Provide Guidance	75
C. Recommendations	77
III. Federal Prosecution of Business Organizations	80
A. Waiver of Attorney-Client Privilege and Work-Product Protection	80
B. Vicarious Liability of Corporations for Employee Action	84
C. Government Interference with Advancement of Legal Fees and Expenses to Directors and Employees	86
IV. Private Securities Litigation	88
A. Environment and Background of Securities Litigation	88
B. Fair Funds	88
C. Scope of Liability for Professional Service Providers.....	90
D. Selective Waiver.....	92
V. The Challenges Facing Public Company Auditing	96
A. Role of Audit Firms in the U.S. Economy	96
B. Expectations About the Role of Auditors.....	97
C. Concentration of Audit Practice	101
D. The Risk of Audit Firm Collapse	102
1. Criminal Indictment.....	103
2. Catastrophic Litigation	104
a. Other Solutions.....	108
E. Recommendations	109
1. Focus Criminal Indictments on Culpable Individuals	110
2. National Charter and Capital Raising	110
3. Global Approach Through the Group of Eight	112
4. Develop a More Competitive Audit Profession	113
5. Managing Costs of Audit Practice Protection: Arbitration Provisions	114



I. INTRODUCTION

The strength of the U.S. capital markets depend upon healthy and successful public companies. Investor confidence and willingness to invest in these companies also depends, in part, on the sound contributions of the audit practice. As noted, the United States has historically been the financial center for companies, domestic and foreign, in search of public capital. In recent years, however, there has been growing concern that issuers are looking to other capital markets instead, with a resulting decline of the United States' share in global capital markets activity. The reasons for this are complex; however, factors in the relative decline of U.S. capital market activity include several issuer concerns regarding the fairness and efficiency of our system. These concerns include a sense that the U.S. system of criminal and civil litigation has become risky, inefficient, and, in some instances, unfair. Similar concerns, combined with the concentration of the public company audit practice, threaten the continued vitality of public company auditing.

To address these concerns, the Commission has developed recommendations that relate to the experiences of issuers and auditors in the U.S. capital markets. These recommendations are designed to find a proper balance between ensuring investor protection and investor confidence and allowing for the robust formation of capital. These recommendations focus on discrete ways that the Commission believes our system could be improved and do not represent a comprehensive plan to enhance the competitiveness of our capital markets.



Bob Pozen, facilitator of the Issuers and Auditors Working Group, articulates the need to move away from quarterly earnings guidance.



II. EARNINGS GUIDANCE

Many corporate executives admit that pressures from investors cause their companies to focus far too much on short-term earnings to the detriment of long-term growth. A 2004 study by the National Bureau of Economic Research (NBER) found that many companies are willing to sacrifice economic value to meet a short-term earnings target.¹⁹⁰ For example, the NBER study found that 78% of the more than 400 executives surveyed would reduce discretionary spending in areas such as research and development, advertising, or maintenance to maintain a smooth pattern of earnings. If it meant missing the current quarter's earnings consensus, 55% of corporate managers would forego a transaction that is good for the company over the long run.

Most corporate executives are not enthusiastic about giving quarterly earnings guidance. But they worry that missing an earnings target or reporting volatile earnings will reduce the predictability of earnings and damage their company's stock price. Many of these executives would prefer to stop providing quarterly guidance and refocus on long-term growth, but they are afraid that analysts might then stop following their company and that its stock price would decline as a result.

The Commission believes that the future of the American economy depends on a long-term focus by U.S. companies. As the NBER study makes clear, when a company has projected its quarterly earnings per share to the penny, there are strong pressures to do whatever is necessary to meet that quarterly number. Although the Commission recognizes that the effects of ending quarterly guidance could be problematic for an individual company, it believes that these potential effects would be minimized if a substantial number of well-performing companies banded together to eliminate quarterly earnings guidance. The Commission recommends that companies substitute for quarterly earnings guidance a fuller explanation of their long-term goals and their strategies for achieving those goals.

A. History of Quarterly Earnings Guidance

The practice of issuing quarterly guidance used to be constrained by uncertainty about the legal liabilities associated with making future projections. These uncertainties were largely resolved when Congress enacted the Private Securities Litigation Reform Act of 1995 (PSLRA).¹⁹¹ The PSLRA created a "safe harbor" for companies that make forward-looking statements concerning matters such as revenue projections, future business plans, and expected earnings, so long as the forward-looking statements are accompanied by meaningful cautionary language.

¹⁹⁰ Graham, John R., Harvey, Campbell R. and Rajgopal, Shivaram, "The Economic Implications of Corporate Financial Reporting," *NBER Working Paper No. W10550*, June 2004.

¹⁹¹ 15 U.S.C. §§ 78u-4(a)(1), 77z-1(a)(1).

Following enactment of the PSLRA, many companies began providing earnings guidance in reliance on the new safe harbor. According to a McKinsey analysis of 4,000 companies, the number of companies providing earnings guidance rose from just 92 in 1994 to 1,200 in 2001, and stayed roughly at that level from 2001 through 2004.¹⁹² At the end of 2006, roughly two-thirds of the Standard & Poor's (S&P) 500 provided quarterly earnings guidance on a regular basis.¹⁹³

As more companies began offering earnings guidance, many found themselves inundated with constant questions from analysts and institutional investors seeking interim updates and private feedback on their earnings models. To address these and other concerns, the SEC promulgated Regulation FD in late 2000.¹⁹⁴ Regulation FD requires that when a company discloses material nonpublic information to market professionals or others who may trade on the basis of the information, the company must make public disclosure of that information by filing or furnishing a Form 8-K or by another method or combination of methods that is reasonably designed to effect broad, nonexclusionary distribution of the information to the public.

While the regulators were fine-tuning the rules for issuing guidance, the number of companies that stopped providing quarterly or annual guidance steadily increased, from 30 in 1998 to 220 in 2004, according to the McKinsey study. A survey of public statements from October 2000 to January 2006 found that 72 companies publicly announced their decision to stop providing quarterly guidance and 24 firms publicly announced a switch from quarterly guidance to annual guidance.¹⁹⁵

The year 2000 edition of Warren Buffett's annual letter to shareholders encouraged management teams to focus on long-term strategy rather than quarterly earnings. Mr. Buffett wrote:

[I]t is both deceptive and dangerous for CEOs to predict growth rates for their companies. They are, of course, frequently egged on to do so by both analysts and their own investor relations departments. They should resist, however, because too often these predictions lead to trouble.... Over the years ... I have observed many instances in which CEOs engaged in uneconomic operating maneuvers so that they could meet earnings targets they had announced. Worse still, after exhausting all that operating acrobatics would do, they sometimes played a wide variety of

192 Peggy Hsieh, et al., "The Misguided Practice of Earnings Guidance," *McKinsey Quarterly*, March 2006, at 1.

193 Source: StarMine Corporation database.

194 17 C.F.R. § 243.100, et seq.

195 Shuping Chen, Dawn A. Matsumoto and Shiva Rajgopal, "Is Silence Golden? An Empirical Analysis of Firms that Stop Giving Quarterly Earnings Guidance" (Available at SSRN: <http://ssrn.com/abstract=820644>) October 2006.

*accounting games to 'make the numbers.' These accounting shenanigans have a way of snowballing...*¹⁹⁶

Shortly after Mr. Buffett's comments on the dangers of providing guidance, Coca-Cola and the Washington Post Co., two Buffett-related companies, announced that they would cease giving quarterly guidance. More recently, Intel, McDonald's, Motorola, and Pfizer decided to stop issuing quarterly earnings guidance. Many interpret these announcements as efforts by chief executive officers (CEOs) to focus more on the long-term growth of their companies.¹⁹⁷

Some recent empirical studies suggest a different motivation for discontinuing the practice of providing earnings guidance. The survey of public statements from October, 2000 to January 2006 found that most companies that cease providing guidance have poor trailing stock performance and lower institutional ownership.¹⁹⁸ A somewhat different but equally troubling conclusion was reached in a recent study of 167 companies that stopped giving guidance in 2002 and 2003 (whether or not publicly announced), including 25% that stopped and then resumed giving guidance:

*We find that the most consistent reason for stopping and subsequently resuming guidance is a firm's record of meeting/beating analyst forecasts: Firms that stop providing guidance have a poor record before they eliminate guidance, and when this record improves, guidance tends to be resumed.*¹⁹⁹

B. Empirical Studies on Earnings Guidance

1. The Costs of Quarterly Guidance

Several recent studies have examined the relationship between issuing guidance and corporate economic behavior. As noted, the NBER study, which was based on interviews with more than 400 executives, shows that many corporate managers will make suboptimal company decisions to meet analyst expectations. A 2005 study of companies that were "dedicated guiders" versus "occasional guiders" during

196 Warren Buffett, *Chairman's Letter to Berkshire Hathaway's Shareholders*, 2000, at 17, <http://www.berkshirehathaway.com/letters/2000.html>.

197 CFA Institute, "Breaking the Short-Term Cycle: Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors, and Analysts Can Refocus on Long-Term Value," 2006; *see also*, Dan Roberts, "Guidance Falling Out of Favour on Wall St.," *Financial Times*, March 12, 2006.

198 *See supra*, note 195.

199 Joel F. Houston, Baruch Lev, and Jenny Tucker, "To Guide or Not to Guide? Causes and Consequences of Stopping and Subsequently Resuming Earnings Guidance" (Available at SSRN: <http://ssrn.com/abstract=875184>) January 10, 2006.

the 2001–03 period found that many dedicated guiders invest significantly less in research and development than do occasional guiders. The study also found that the long-term earnings growth rates of dedicated guiders are significantly lower than those of occasional guiders, although dedicated guiders more often meet analysts' quarterly consensus numbers than do occasional guiders.²⁰⁰

A 2003 Cornell study examined companies that marginally exceed consensus forecasts by managing earnings and firms that miss consensus forecasts by a little without managing earnings. The study found that companies that relied on adjusting accruals or reducing discretionary expenditures to exceed consensus numbers achieved short-term positive impact on their share prices, but that over the long-term, those companies tended to underperform relative to firms that did not manage their earnings to exceed forecasts.²⁰¹

The costs of providing—and then steering to—precise earnings targets are well documented in studies cited in this report. The CFA Institute study captures these costs in four areas:

- Unproductive and wasted efforts by the company in preparing the guidance numbers;
- Neglect of long-term business growth to meet short-term expectations;
- A quarterly results financial culture characterized by disproportionate reactions among internal and external groups to the downside and upside of earnings surprises; and
- Macroincentives for companies to avoid earnings guidance pressure altogether by moving to the private markets.²⁰²

2. The Effects of Ceasing to Provide Guidance

Many corporate executives believe that once their companies have begun to provide quarterly guidance, they cannot discontinue issuing guidance without risking their analyst following and their company's stock price. These beliefs are often anecdotal, however, and are not based on systematic analysis.

200 Mei Cheng, K.R. Subramanyam, and Yuan Zhang, "Earnings Guidance and Managerial Myopia," Available at SSRN: <http://ssrn.com/abstract=851545>. November 2005.

201 Sanjeev Bhojraj, Paul Hribar, and Marc Picconi, "Making Sense of Cents: An Examination of Firms that Marginally Miss or Beat Analysts Forecasts" (Available at SSRN: <http://ssrn.com/abstract=418100>) June 19, 2003.

202 See *supra*, note 197.

The McKinsey study offers an empirical analysis of 4,000 companies to measure the alleged negative effects of ceasing to provide quarterly earnings guidance. It compares companies that provide quarterly guidance to those not giving quarterly guidance on several parameters:

- **Valuations.** The study found that frequent guidance does not lead to higher valuations relative to industry medians.
- **Total returns to shareholders.** The study did not find a significant correlation between “frequent guiders” and higher shareholders returns.
- **Share price volatility.** The study found that when a company begins providing quarterly earnings per share (EPS) guidance, its share price volatility is as likely to decrease as increase relative to companies that do not offer guidance.
- **Trading volumes.** The study found that when a company begins to issue quarterly EPS guidance, its trading volume tends to rise in the first year relative to nonguiders, but that it often falls back in the second year.²⁰³

This survey of public statements from 2000 to 2006 likewise found that, after eliminating quarterly guidance, companies experience “no change in overall stock return volatility or analyst following.” However, this survey also found that an announcement to stop issuing quarterly guidance is linked to a decline in stock price over the next three days because of a perceived association between such an announcement and poor future performance.²⁰⁴ A study by Houston, Lev, and Tucker, reached a different conclusion about the relationship between earnings guidance and analyst following. This study found that when a company stops earnings guidance, the number of analysts following the company declines significantly.²⁰⁵ These differing conclusions may result in part from differences in methodologies employed by each study.

Although the studies to date have reached differing conclusions on the effects of ceasing to provide quarterly earnings guidance, there is total agreement on one fact—the stock price of any company will drop sharply if it misses quarterly earnings expectations, regardless of whether these were generated by the analyst community or company managers.

203 See Hsieh, *supra*, note 192.

204 See *id.*

205 See *supra*, note 199.

C. Recommendations

The Commission believes that all public companies should eliminate the practice of providing quarterly earnings guidance and that companies should instead provide shareholders and Wall Street with meaningful additional information on their long-term business strategies. If corporate managers are concerned that the potential harm from ceasing quarterly guidance may outweigh the likely benefits, even after reviewing the data summarized in this report, the Commission suggests that these managers take a step in the right direction by moving to provide annual guidance with a range of earnings rather than quarterly guidance with earnings projections to the penny. This latter suggestion is based on the current practice of many European public companies.

Seventy-six percent of CFA Institute members surveyed said they would support moving away from providing quarterly earnings guidance. Of these supporters, 96% further agreed that companies should provide additional information on the fundamental, long-term drivers of the business.²⁰⁶ Although the precise parameters of an alternative information package are unclear, the CFA Institute is expected to propose a model information package in 2007. One expert, a senior vice president of an investor relations firm, has suggested four broad categories of long-term information that she believes would be most useful to shareholders and analysts:

- Business drivers and company-specific factors, such as sales, labor costs, technology expenses, gross margins, and tax rates
- Discretionary expenses such as research and development, nonmandatory capital expenditures, and certain selling, general, and administrative (SG&A) spending
- Required expenditures, such as interest expenses, and lease payments
- Macroeconomic factors such as interest rate levels, currency values, geographic instability, and government spending²⁰⁷

Some proponents of quarterly guidance argue that the practice increases management focus on financial targets. The Commission believes, however, that investors and analysts already shine a bright light on corporate quarterly earnings, regardless of whether a given company provides its own quarterly guidance. The Commission believes there is no need to intensify the glare of these searchlights

²⁰⁶ See *supra*, note 197.

²⁰⁷ Heather Harper, "Don't Give Up Guidance," *Strategic Investor Relations*, Spring 2003.

because corporate managers focus solely on meeting their own earnings predictions to the penny. Instead, the Commission believes that company managements should broaden their focus on delivering solid earnings growth for their shareholders over the long term.

The Commission also believes that stock price volatility is largely a function of how effectively management communicates a steady stream of information on the company's long-term business strategies. Some of the studies cited above have suggested that the spread among analyst estimates may widen after a company ceases issuing earnings. In response, the Commission recommends that public companies consider the use of both of the following approaches to address these concerns:

- To minimize surprises, companies should make frequent use of SEC Form 8-K on which a company reports a broad range of material changes between quarterly press releases. These changes involve changes in senior executives, acquisitions or dispositions of assets, and amendments to a company's code of ethics, as well as any other events the company deems of importance to investors, including any information published under Regulation FD. The recent changes to SEC disclosure rules require many companies to file Forms 8-K with increased frequency, and as a result, these filings are an increasingly critical tool for communicating strategic issues and material developments to investors.
- To avoid misunderstandings that can be associated with the issuance of press releases on quarterly earnings without the provision of earnings guidance, companies should (as always, in a manner that satisfies the stringent requirements of Regulation FD) hold conference calls and analyst meetings after the press release is issued to ensure that investors have a uniform and up-to-date understanding of the companies' business strategies, opportunities, and risks. These important communications enable analysts to verify and update the assumptions underlying their financial models, without putting managers in danger of accusations of providing selective disclosure.

Finally, the Commission believes that many of the reportedly adverse effects on stock prices following guidance elimination have been driven by the performance histories of the companies involved. With a few notable exceptions (such as Exxon, Coca-Cola, and Intel), most companies that have eliminated guidance have done so following a series of quarterly earnings misses or several periods of below-average returns on equity. The Commission believes that these realities have created a false impression that the elimination of quarterly earnings guidance is effectively a "negative signal"—one suggesting that a company is likely to miss earnings or otherwise perform poorly in the future. The Commission believes this negative signaling effect could be avoided if a large group of respected companies with good



performance records announced that they were eliminating the practice of issuing quarterly guidance

The success of American companies in the increasingly competitive global marketplace depends largely on how well corporate managers execute their long-term business strategies. Reducing the pressures to meet precise quarterly earnings targets announced by these very managers is an important first step in shifting the focus of the U.S. capital markets away from quarterly results and toward the long-term performance of U.S. companies.



III. FEDERAL PROSECUTION OF BUSINESS ORGANIZATIONS

Criminal indictments pose a unique threat to business entities. Under existing federal law, corporations can be criminally charged vicariously for the acts of their employees, even where the employee's conduct violates corporate policies and internal controls.²⁰⁸ In the face of criminal conduct by some of its employees, a corporation's compliance program and prior prophylactic efforts may appear to be ineffectual and incomplete to prosecutors, thereby offering little protection from criminal charges.

Corporations, as a practical matter, are extremely reluctant to risk the prospect of a criminal indictment or conviction because of the catastrophic collateral consequences that often follow such developments. This aversion, combined with the relatively low threshold for vicarious liability, leaves corporations and other business entities exposed to pressure to give in to the demands of prosecutors. Among other things, they feel pressured to accede to demands for waiver of attorney-client privilege and attorney work-product protections and to accept plea arrangements. The Commission is concerned about the negative impact of this trend on innocent employees and investors. In the longer term, the Commission is concerned about the negative impact this trend will have on the ability of corporations and other business entities to receive and implement effective legal advice. In the Commission's view, criminal prosecutions generally should be focused on the responsible individuals, rather than the whole entity, unless the criminal activity is pervasive throughout the top echelons of the entity.

A. Waiver of Attorney-Client Privilege and Work-Product Protection

The Commission is concerned that business entities, when facing the prospect of a criminal indictment, feel compelled to waive attorney-client privilege and work-product protection as a direct result of policies and practices adopted by the Department of Justice (DOJ) over the past five years.

208 See Memorandum from Paul J. McNulty, Deputy Attorney General, DOJ, Principles of Federal Prosecution of Business Organizations, December 12, 2006, at 12-15 ("A corporate compliance program, even one specifically prohibiting the very conduct in question, does not absolve the corporation from criminal liability under the doctrine of respondeat superior.") (hereinafter, "McNulty Memorandum"); see also *United States v. Basic Construction, Co.*, 711 F. 2d 570 (4th Cir. 1983) ("[A] corporation may be held criminally responsible for antitrust violations committed by its employees if they were acting within the scope of their authority, or apparent authority, and for the benefit of the corporation, even if . . . such acts were against corporate policy or express instructions."); *United States v. Hilton Hotels Corp.*, 467 F.2d. 1000 (9th Cir. 1972) (affirming antitrust liability based on the conduct of a purchasing agent for a single hotel, even though the agent's actions were contrary to corporate policy and express instructions).

In 2003, reaffirming a memorandum issued by his immediate predecessor (Eric Holder) and confronted by a series of corporate scandals that augured an increased enforcement role for his department, then-Deputy Attorney General Larry Thompson revised the guidance to U.S. attorneys entitled “Principles of Federal Prosecution of Business Organizations” to reflect his understanding of the factors that should guide the consideration of an indictment of a business entity. Under the so-called Thompson Memorandum, as well as under the Holder Memorandum before it, federal prosecutors were instructed that they may decide not to bring criminal indictments against a company in part because the company waived its attorney-



client and work-product privileges. A survey of corporate counsel has disclosed that federal prosecutors frequently request that companies waive these privileges to avoid facing criminal indictment.²⁰⁹ A “culture of waiver” has developed as a significant part of the federal prosecution landscape.²¹⁰

Alarmed by the development of the “culture of waiver,” a coalition representing a broad spectrum of perspectives (ranging from the

American Civil Liberties Union to the U.S. Chamber of Commerce) sought to persuade the Justice Department or Congress to revise substantially the relevant sections of the Thompson Memorandum. In December 2006, legislation was introduced in the Senate that would have prohibited the DOJ or any other federal agency from requesting waiver of attorney-client privilege and attorney work-product protection. The bill would have explicitly permitted a federal prosecutor to accept a voluntary disclosure of privileged or work-product materials but barred a prosecutor from soliciting a waiver of privilege and work-product protections.

On December 12, 2006, U.S. Deputy Attorney General Paul J. McNulty announced that the DOJ had revised its corporate criminal charging guidelines for federal criminal prosecutors. The new memorandum, informally titled the “McNulty Memorandum,”

209 See *The Decline of the Attorney-Client Privilege in the Corporate Context* (Presented to the United States Congress and the U.S. Sentencing Commission) available at <http://www.acca.com/Surveys/attyclient2.pdf>.

210 The culture of waiver has not been limited to the DOJ. The SEC has to some extent also been encouraging the waiver of attorney-client privilege. See *below*, note 239.

supplants the Thompson Memorandum. The McNulty Memorandum classifies privileged materials and work product into two categories labeled Category I and Category II information.

Category I information consists of factual information relating to the alleged misconduct and consists of materials, including witness statements, factual interview memoranda, and factual materials (*e.g.*, chronologies and organization charts) prepared by or at the request of counsel. Prosecutors are instructed to first request purely factual information, which may or may not be privileged, relating to the underlying misconduct. Before requesting that a corporation waive the attorney-client or work-product protections for Category I information, prosecutors must obtain written authorization from the U.S. Attorney who, before authorizing the request, must provide a copy of the request to, and consult with, the Assistant Attorney General for the Criminal Division. If authorized, the U.S. Attorney must communicate the request in writing to the corporation. A corporation's response to the government's request for waiver of privilege and work-product protection for Category I information may be considered in evaluating its cooperation and in making charging determinations.

The McNulty Memorandum provides that in the "rare circumstances" in which Category I information provides an incomplete basis to conduct a thorough investigation, prosecutors are authorized to seek access to Category II information, which is defined under the McNulty Memorandum as attorney-client communications and opinion work product. The McNulty Memorandum explicitly states that Category II information includes "legal advice given to the corporation before, during, and after the underlying misconduct occurred" as well as "attorney notes, memoranda or reports . . . containing counsel's mental impressions and conclusions, legal determinations reached as a result of an internal investigation, or legal advice..." Requests for Category II information must be authorized in writing by the Deputy Attorney General and communicated in writing to the corporation by the U.S. Attorney. Unlike cases involving Category I information, however, prosecutors are instructed not to consider a business entity's refusal to provide Category II information in charging decisions.

The Commission believes that the McNulty Memorandum does not adequately address the concern that companies feel pressured to waive attorney-client privilege and work-product protection under threat of indictment or other enforcement action.

The Commission has additional and related concerns regarding the McNulty Memorandum's waiver review process. First, it remains to be seen whether the requirements of high-level authorization and written requests will curb the frequency with which waivers are sought. The McNulty Memorandum does not identify what will and will not constitute a "legitimate need" for purposes of requesting otherwise

privileged and protected materials. Although the McNulty Memorandum identifies factors to be considered in evaluating the government's need for information against the likely impact on the disclosing corporation, the Memorandum does not explain how the factors will be applied and weighed in practice.

Second, the McNulty Memorandum merely sets forth internal guidelines for prosecutors. Its pronouncements are not enforceable and there is no clear remedy in the event of a breach of the guidelines. Given the prevalence of parallel criminal and civil-administrative proceedings, however, the McNulty Memorandum ultimately may have only a muted impact on government waiver demands. Civil administrative regulators, like the SEC, are not bound by the McNulty Memorandum's requirements and can demand waivers from corporations. In a separate section of this report, the Commission urges Congress to enact a selective waiver for the SEC that would restrict sharing confidential information provided under this waiver. Nothing in the McNulty Memorandum or elsewhere would prevent federal prosecutors from circumventing the McNulty Memorandum's authorization requirements by obtaining attorney-client privileged information and attorney work product from other government agencies. This should not be permitted to happen.

Third, and most important, the Commission believes that the McNulty Memorandum's provisions relating to Category II information constitute a dangerous expansion of the government's practice of requesting corporate waivers of privileged and protected information. Contrary to previous government assurances that government waiver requests relate only to factual attorney-client privileged information and attorney work product, the McNulty Memorandum outlines a procedure for penetrating attorney opinion work product, including legal advice and legal determinations reached as a result of an internal investigation. The Commission does not believe that the government should be trying to articulate a "legitimate need" for opinion work product. Moreover, the Commission views the Memorandum's purported safeguards as inadequate. Corporations are likely to feel pressured or compelled by the mere request for Category II information, especially if these requests are authorized by senior DOJ officials. Although prosecutors are instructed not to consider a company's refusal to disclose Category II information in a charging decision, it would be nearly impossible to prove the actual ramifications of a company's refusal to disclose such information, because charging decisions are discretionary and the process behind any charging decision is confidential.

In light of the foregoing concerns, the Commission recommends that the DOJ fully address concerns over coerced waiver by eliminating as a cooperation credit factor whether a company waives attorney-client privilege or attorney work-product protection.

The attorney-client privilege and attorney work-product doctrine play a vital role in ensuring that individuals and corporations receive clear, comprehensive, and

unvarnished advice from their counsel. In brief, the attorney-client privilege protects confidential communications between an attorney and his or her client, while the work-product protection insulates from disclosure materials prepared by counsel in anticipation of litigation. As a general matter, a distinction is recognized between ordinary attorney work product (*e.g.*, materials gathered by or compiled at the request of a lawyer in anticipation of litigation) and opinion work product revealing an attorney’s mental impressions, opinions, judgments, theories, and conclusions. Typically, opinion work product is afforded a high level of protection and will be disclosed only on a showing of “extraordinary need.” Without the protection afforded by these privileges, corporations may choose to forego obtaining advice from their attorneys or counsel may choose not to commit their advice to paper. Both of these outcomes would be deleterious to efficient, and legitimate, business activity.

Although corporations should be free to cooperate on a truly voluntary basis with government investigations through decisions to waive attorney-client privilege and attorney work-product protections, the Commission views government use of waiver as a cooperation credit factor to be improper. The Commission believes that the McNulty Memorandum’s approach to the waiver issue is antithetical to the attorney-client privilege and the attorney work-product doctrine, as well as to the underlying principles they seek to promote. Because corporate counsel, and those they advise, do not know for certain in advance which communications will be kept confidential, government efforts to pierce the attorney-client relationship chill frank discussion and hinder the effectiveness of corporate legal departments. As the Supreme Court explained, in *Upjohn v. United States*, “an uncertain privilege is ... little better than no privilege at all.”²¹¹

As long as waiver is considered a cooperation credit factor, the “voluntary” nature of such a waiver is questionable. The Commission therefore endorses the ongoing efforts to have the DOJ eliminate as a cooperation credit factor a company’s decision to waive attorney-client privilege or attorney work-product protection.

B. Vicarious Liability of Corporations for Employee Action

The Commission believes that Congress and the DOJ should undertake a fresh evaluation of the circumstances under which vicarious criminal liability for corporations is appropriate and should articulate detailed guidance that corporations can follow to protect themselves from vicarious criminal prosecution for the acts of employees. The criminal authorities should concentrate on those employees primarily responsible for the criminal conduct, if they have acted contrary to corporate policy.

²¹¹ *Upjohn* 449 U.S. 383, 393 (1981).

In virtually all federal jurisdictions, corporations may be held criminally liable for the acts, omissions, or failures of its officers, agents, or employees (collectively, “employees”), if the employee’s criminal conduct occurs (i) within the scope and nature of his or her employment (*i.e.*, the employee is performing acts of the kind that he or she is authorized to perform); and (ii) with the intent to benefit, at least in part, the corporation.²¹² Generally, an employee will be found to be acting within the scope of his or her employment if the employee has actual or apparent authority to engage in the conduct in question.²¹³ Although some states have adopted statutes that limit criminal liability for corporations to those acts committed by high-level management, the federal courts have not adopted this position and have held that a corporation can be criminally liable for the actions of its agent regardless of the individual’s position within the organization.²¹⁴ In considering the benefit requirement, courts have held that the corporation does not actually have to receive a benefit, but rather that the employee’s intent to confer a benefit to the corporation is sufficient.²¹⁵

Moreover, whether or not a company has implemented policies and procedures designed to prevent illicit activity by employees has little impact on whether it will be subject to criminal prosecution should one of its employees in fact engage in criminal conduct.²¹⁶ Under current DOJ practice, compliance programs, codes of ethics, regular employee training, and aggressive internal enforcement will not absolve a corporation from criminal liability. Although the McNulty Memorandum encourages prosecutors to take into account the effectiveness of such programs in

212 See The McNulty Memorandum, *supra* note 208 at 2-3 (noting that to hold a corporation liable for criminal acts, the government must establish that the corporate agent’s actions (i) were within the scope of his duties and (ii) were intended, at least in part, to benefit the corporation.)

213 See, *e.g.*, *United States v. Basic Construction, Co.*, 711 F.2d 570 (4th Cir. 1983) (“[A] corporation may be held criminally responsible for antitrust violations committed by its employees if they were acting within the scope of their authority, or apparent authority, and for the benefit of the corporation, even if...such acts were against corporate policy or express instructions.”)

214 The McNulty Memorandum, *supra* note 208 at 3 (citing to *United States v. Automated Medical Laboratories*, 770 F.2d 399 (4th Cir. 1985) (noting that “whether the agent’s actions ultimately rebounded to the benefit of the corporation is less significant than whether the agent acted with the intent to benefit for the corporation”)).

215 See *New York Central and Hudson River Railroad Co. v. United States*, 212 U.S. 481 (1909) (establishing corporate criminal liability through the doctrine of *respondeat superior*); see also The McNulty Memorandum, *supra* note 208 at pg. 6 (noting that acts of low-level employees may result in corporate criminal liability, but cautioning that “in certain limited circumstances, it may not be appropriate to impose liability upon a corporations . . . under a strict *respondeat superior* theory for the single isolated act of a rogue employee”).

216 In certain cases under the current vicarious liability regime, a company may decide that it is better off not having a rigorous education and compliance program because such a program effectively gives its employees constructive knowledge of the law. In many instances, knowledge of the law is a necessary component of establishing that a person violated a criminal statute.

rendering charging decisions, the Memorandum makes clear that such programs are not sufficient, in and of themselves, to justify not charging a corporation. Moreover, in practice, the mere occurrence of criminal conduct by a company employee can create the mistaken impression that a compliance program is flawed and not effective.

The Commission believes that a broad reevaluation of the policies and procedures relating to the criminal prosecution of business organizations is warranted. Old rationales for corporate criminal liability no longer carry the same weight in the context of national and global organizations. The proliferation of e-mails and corporate controls means that, far more often than not, there is a well-documented paper trail so that culpable individuals can be held directly responsible for their conduct. No public interest is served by holding the entire organization accountable for the misconduct of identifiable individuals, especially when such conduct is undertaken by employees acting in contravention of explicit corporate policies and procedures. In such circumstances, criminal charges against the whole company impose substantial costs on law-abiding employees and innocent shareholders.

The Commission recommends that Congress and the DOJ reevaluate the standards of corporate criminal liability. Such a reevaluation should lead to standards that focus on the specific policies and practices of the corporation and place more weight on the proactive efforts of corporations to prevent criminal conduct. The Commission believes that corporate criminal conduct should be largely reserved for instances in which the corporate form is a mere shell or in which criminal conduct is pervasive within the company's senior executive ranks. The standards could also provide detailed guidance on corporate compliance initiatives that can, in appropriate circumstances, lead the DOJ to conclude that an indictment is unnecessary. For example, the Commission believes that corporations should be given incentives to invest in state-of-the-art compliance policies and procedures characterized by oversight of independent directors, annual certifications of compliance programs, training of employees, as well as hotlines and other channels for anonymous reporting. Corporations should be given incentives to make compliance a priority.

C. Government Interference with Advancement of Legal Fees and Expenses to Directors and Employees

Many corporations advance attorney fees and legal expenses to their executives and directors pursuant to corporate bylaws, employment contracts, or state statutes. In fact, several state statutes set, as the default rule, the advancement of counsel fees to officers and directors. In the absence of indemnification and advancement provisions, qualified individuals will either be less likely to take on positions of leadership and responsibility or will demand other forms of compensation to offset the personal risk.

Under DOJ policy as articulated in the Thompson and Holder Memoranda, prosecutors were permitted to consider as part of their charging determinations whether a corporation appeared to be protecting its “culpable” employees and agents by agreeing to advance attorneys’ fees and legal expenses. According to the memoranda, a corporation’s promise of support to “culpable” employees and agents through the advancing of attorney fees could be considered by the prosecutor in weighing a corporation’s cooperation, even in the case of preexisting obligations.

In June 2006, in a case involving former executives of KPMG, U.S. District Judge Lewis Kaplan of the Southern District of New York accused federal prosecutors of violating the rights of defendants by putting pressure on KPMG, which at the time was at risk of being indicted, to cut off attorney fees to former employees. Government interference in indemnification arrangements was held unconstitutional by Judge Kaplan, who took issue with government efforts to deprive so-called culpable employees of the economic resources necessary to mount defenses, observing, “The imposition of economic punishment by prosecutors [pursuant to the Thompson Memorandum], before anyone has been found guilty of anything, is not a legitimate governmental interest—it is an abuse of power.”²¹⁷

In a clear shift from earlier Department policy, the McNulty Memorandum instructs prosecutors that, as a general matter, they cannot consider a business organization’s indemnification or advancement of attorneys’ fees to individual employees when evaluating corporation cooperation. The Memorandum provides a limited exception in the “extremely rare” cases in which “the totality of circumstances show that [indemnification or the advancement of attorneys’ fees is] intended to impede a criminal investigation.” The McNulty Memorandum provides that, in such cases, the fee arrangement will be considered as a factor in making a determination that the corporation is acting improperly. In cases in which these circumstances exist, approval must be obtained from the Deputy Attorney General before prosecutors may consider this factor for charging purposes.

The Commission recommends that the DOJ not base charging decisions on whether a corporation advances legal fees to its executives and employees. On the whole, the Commission believes that the McNulty Memorandum’s response to Judge Kaplan’s decisions regarding the indemnification and advancement of attorney fees is appropriate. The private sector should closely monitor the DOJ’s new policies to ensure that the exceptions identified in the McNulty Memorandum are not used to circumvent the new policies.

217 *U.S. v. Stein*, 435 F.Supp.2d 330, 363 (2006).



IV. PRIVATE SECURITIES LITIGATION

A. Environment and Background of Securities Litigation

Securities litigation in the United States is an often criticized aspect of U.S. capital markets. On the one hand, it is acknowledged that investor protection is a cornerstone of strong capital markets and that securities litigation is one of the ways in which the United States works to provide such protection. On the other hand, there is the realization that the U.S. system of securities litigation is perceived internationally as excessively costly and extremely risky. As discussed in the section titled “U.S. Capital Markets in the Global Marketplace,” the Commission outlines its recommendation that the SEC study the current state of U.S. securities litigation, considering especially whether the PSLRA achieved its stated goals or created consequences not anticipated by the legislation.

Although the Commission has not fully studied the costs of securities litigation in the United States in comparison with other countries, the Commission has found that there are several problem areas in the U.S. securities litigation system. Below we discuss three areas—(i) “Fair Funds,” (ii) the scope of liability for professional services providers, and (iii) selective waiver—and make recommendations that should reduce costs while preserving investor protections.

B. Fair Funds

In Section 308 of the Sarbanes-Oxley Act (SOX), Congress authorized the SEC to combine civil penalties and any disgorgement obtained from a securities law violator into a Fair Fund to recompense harmed investors.²¹⁸ When it passed SOX, however, Congress did not specify whether payouts from these Fair Funds were intended to supplement or offset funds obtained by an investor from the same securities law violator as the result of private litigation. As discussed in “U.S. Capital Markets in the Global Marketplace,” the costs of private litigation, in terms of defense and settlement are already quite large. Fair Funds, if not offset against the damages obtained by investors in private litigation, potentially double these costs for the identified violation.

The SEC has not taken a formal position with respect to this issue. From the date Fair Funds were first authorized by law, those created have been generally treated as distinct from any recompense paid to investors in private litigations.²¹⁹ Investors

²¹⁸ Sarbanes-Oxley Act of 2002 § 308, 15 U.S.C. § 7201 (Supp. 2006).

²¹⁹ See Stephen M. Cutler, Director, Division of Enforcement, *SEC, Speech at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute*, April 4, 2004, <http://www.sec.gov/news/speech/spch042904smc.htm> (Making a related distinction between penalties and disgorgement, “One thing that the introduction of the Fair Fund has not changed, however, is the purpose of civil penalties, which remains distinct from the purpose of disgorgement. Despite the fact the penalties, like disgorgement, can now be used to compensate harmed investors, they are still fundamentally a punitive measure intended to enhance deterrence of securities laws violations.”)

have been potentially able to obtain compensation from the same company twice—through the SEC Fair Fund and through a traditional private action.²²⁰

The SEC has been moving to reduce administrative costs by combining the administration of Fair Fund payments with the administration of related private class-action payments.²²¹ The SEC has also begun to appreciate the duplicate investor compensation problem posed by allowing dual systems of investor compensation.²²² There have been indications that the SEC has been informally moving, through Fair Fund settlement agreements, toward offsetting amounts investors receive through Fair Funds from amounts they receive in class actions. The SEC, however, has not issued any formal policy or guidance on that subject.

The Commission recommends that the SEC adopt a formal policy that prohibits duplicate payments from Fair Funds and private litigation on similar claims. Specifically, any amount investors receive from a Fair Fund should offset the amount that they are allowed to collect as damages in private securities litigation on similar claims. This system of duplicate payments to investors is not only contrary to notions of just recompense, but also is an inappropriate burden on innocent shareholders. Long-term holders of a company's shares generally would not qualify as a purchaser or seller of securities for purposes of class actions under federal securities laws. If the corporation pays twice for the same alleged violations, the bulk of that excess cost will be borne by its long-term shareholders.

From time to time, there is a case in which a private action is proceeding ahead of an SEC enforcement action. In these relatively infrequent situations, the Commission recommends that the SEC consider whether seeking a postponement of the completion of the private settlement until after the Fair Fund is established would be beneficial in order to ensure coordination of the damages to be paid as a result of these two proceedings.

The costs of administering an offset rule need not be high. In a growing number of cases, the same staff is charged with gathering contact information for shareholders

220 See Kenneth M. Lehn, "Private Insecurities," *Wall Street Journal*, February 15, 2006; Lyle Roberts, "End the Dual Approach," *The National Law Journal*, October 24, 2005.

221 In at least a few cases, the SEC has sought to reduce these administrative costs by tying the Fair Fund payment process to the private action payment process. This practice may be becoming an informal SEC policy. See Deborah Solomon, "Plan to Give Defrauded Investors Money from Fines Faces Hurdles," *Wall Street Journal*, July 7, 2005; Deborah Solomon, "For Wronged Investors, It's Payback Time," *Wall Street Journal*, July 7, 2005.

222 See Paul S. Atkins, Commissioner, Securities and Exchange Commission, Remarks before the U.S. Chamber Institute for Legal Reform, February 16, 2006, <http://www.sec.gov/news/speech/spch021606psa.htm>.

and dispersing payments for both a Fair Fund and its related class action. In situations in which the administration of these tasks is already combined, calculating an offset should not be a costly or administratively difficult process.

C. Scope of Liability for Professional Service Providers

Public companies are not the only parties subject to securities litigation. Professional service providers, such as investment bankers, attorneys, and auditors, are also often defendants or codefendants in securities litigation. The substantial costs and risks that class-action litigation imposes on these defendants inevitably lead them to raise their fees, which increases the direct costs of raising capital in the United States. As discussed in the “U.S. Capital Markets in the Global Marketplace,” the cost of raising capital is an important driver in the competitiveness of U.S. capital markets.

In *Central Bank*, the Supreme Court took an important step toward narrowing the scope of lawsuits against professional service providers by invalidating the aiding and abetting theory of liability under Section 10(b) of the Securities Exchange Act of 1934.²²³ However, this important Supreme Court decision has been undermined by the development of similar theories of liability under different names. A split among the circuits has emerged with regard to the type of conduct by a secondary actor that constitutes a primary violation of Section 10(b). In addition, some courts have adopted a theory of “scheme liability” under which professional service providers can be liable as primary actors if they are associated with a scheme led by others.

Section 10(b) of the Securities Exchange Act of 1934 makes it unlawful to “use or employ, in connection with the purchase or sale of any security...any manipulative or deceptive device.” To implement Section 10(b), the SEC promulgated Rule 10b-5, which provides that, “in connection with the purchase or sale of any security,” a person may not (i) “employ any device, scheme, or artifice to defraud”; (ii) “make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading”; or (iii) “engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.”²²⁴

²²³ *Central Bank of Denver v. First Interstate Bank*, 511 U.S. 164, 185 (1994).

²²⁴ 17 C.F.R. § 240.

In *Central Bank*, the Supreme Court concluded that aiding and abetting securities fraud liability was not a valid cause of action by which to sue secondary actors, such as a professional services firm.²²⁵ Nevertheless, the Supreme Court made clear that secondary actors can be found to be primary violators:

*[t]he absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability[.] Any person or entity, including a lawyer, accountant or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under Rule 10b-5, assuming all of the requirements for primary liability ... are met.*²²⁶

To distinguish between legitimate lawsuits charging that professional services firms themselves committed a primary violation of the securities fraud laws and illegitimate lawsuits founded, in essence, on theories of aiding and abetting securities fraud committed by others, the Courts of Appeals have developed varying, and conflicting, approaches. The Second Circuit, correctly in the Commission's view, applies a "bright-line" test. The professional services firm itself must make a material misstatement to investors, or omit a material fact in a statement to investors, to be liable for Section 10(b) securities fraud.²²⁷ The Ninth Circuit, by contrast, has adopted a looser "substantial participation" test in which a secondary actor may face primary liability in cases in which there is "substantial participation or intricate involvement" of the secondary party in the preparation of fraudulent statements "even though that participation might not lead to the [secondary] actor's actual making of the statements."²²⁸

The Commission advocates the adoption by other Circuits of the Second Circuit's bright-line test for primary liability in securities fraud cases. Moreover, the Commission recommends that the SEC support the adoption of this test. This test is the most consistent with the Supreme Court's holding in *Central Bank*. With a standard like the substantial participation test, professional service providers may be forced to litigate a myriad of lawsuits, even when other actors were the moving forces behind the alleged securities fraud.

²²⁵ *Central Bank*, 511 U.S. at 185.

²²⁶ *Id.* at 191.

²²⁷ *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997).

²²⁸ *Howard v. Everex Systems, Inc.*, 228 F.3d 1057, 1061 n.5 (9th Cir. 2000).

In recent years, the plaintiffs bar has developed a new variant of securities fraud liability: “scheme liability.” Relying on sections (a) and (c) of Rule 10b-5, plaintiffs have contended that professional services firms and other secondary actors should be held liable in cases in which they participated with the issuer in a “scheme to defraud.” In high-profile cases involving secondary actors, a number of district courts around the country have permitted actions to go forward based on theories of “scheme liability.”²²⁹ Having favored aiding and abetting liability at the time of *Central Bank*, the SEC has also supported the imposition of scheme liability in *amicus curiae* briefs filed in various courts around the country. The SEC contends that plaintiffs must only demonstrate that the professional services firm “engage[] with the corporation in a transaction whose principal purpose and effect is to create a false appearance of revenues, intending to deceive investors in the corporation’s stock.”²³⁰ Significantly, the SEC’s test does not require that the secondary actor’s own conduct have a deceptive purpose and effect. With its holding for *In re Charter Communications, Inc., Securities Litigation*, however, the Eighth Circuit emphatically rejected such “scheme liability,” concluding that

*any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5.*²³¹

The Court further stated that to impose such scheme liability “would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings.”²³² The Commission supports the Eighth Circuit’s holding and advocates that other courts similarly reject scheme liability as incompatible with the Supreme Court’s rejection of aiding and abetting theories under Section 10b and Rule 10b-5. The Commission also recommends that the SEC reevaluate its position on this issue and support the adoption by other circuits of the Eighth Circuit’s ruling.

D. Selective Waiver

As previously explained, attorney-client privilege is a cornerstone of our legal system. It facilitates effective legal advice and corporate compliance by encouraging candor between attorneys and employees seeking guidance on what can very often

229 See, e.g., *In re Lernout & Hauspie Sec. Lit.*, 236 F. Supp. 2d 161 (D. Mass. 2003); *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472 (S.D.N.Y. 2005); *In re Enron Corp. Sec., Derivative and ERISA Lit.*, 2006 U.S. Dist. Lexis 43146 (S.D. Texas June 5, 2006).

230 See, e.g., Brief for the SEC as *Amicus Curiae* Supporting Appellant, *Simpson v. AOL Time Warner, Inc.* 452 F.3d 1040 (9th Circuit 2006) (No. 04-55665).

231 *In re Charter Communications, Inc. Securities Litigation*, 443 F.3d 987, 992 (8th Cir. 2006)

232 *Id.* at 992-93.

be difficult and sensitive issues. The privilege helps to ensure that a business entity's lawyers are provided with a comprehensive understanding of the facts and positioned to render informed, accurate and effective advice to an organization. Because of the privilege's importance, the Commission does not believe that it is ever proper for government law enforcement officials or regulators to compel or coerce business entities to waive the attorney-client privilege.

Nevertheless, in many circumstances, a company may have developed a wish or need to share with outside parties information and analysis covered by the attorney-client privilege. For example, it has become fairly common for public companies to voluntarily share privileged information with the SEC in the course of cooperating with an investigation into a company's corporate governance or financial or accounting practices. Or, a company may wish to initiate its own inquiry with the SEC with respect to a compliance matter. Recently, many public companies have faced demands from their audit firms to provide complete access to internal documents and files, which often include privileged information and communications, including for the purpose of complying with the internal control requirements of SOX. The government is increasingly requiring business entities with alleged regulatory or legal violations to appoint corporate compliance monitors, which are independent third parties who supervise and report on corporate compliance efforts. Given their position and mandate, these court-appointed monitors often are in a position to access privileged information and communications.²³³

As a result, both business groups and government agencies have in the past called for the establishment of a selective waiver that would preserve the privilege in these types of circumstances. Under current law, a business entity that shares privileged information with a government agency, audit firm, or court-appointed monitor waives its right to assert that privilege against other third parties. Broadly speaking, a selective waiver would allow disclosure of privileged communications to certain select recipients such as government agencies, audit firms, and court-approved monitors, while maintaining and asserting the privilege with respect to other third parties. The benefits of permitting parties to selectively waive the privilege can be measured in terms of more effective federal and state regulation, heightened corporate compliance, and greater transparency.²³⁴

233 James K. Robinson, Philip E. Urofsky, and Christopher R. Pantel, "Deferred Prosecutions and the Independent Monitor," *2 Int'l. J. Of Disclosure And Governance* 325, 333 (2005) (noting that all recent deferred prosecution agreements for corporations require the appointment of a monitor "independent" of the company and that no attorney-client relationship exist between the monitor and the corporation).

234 In fact, the flow of information that would be facilitated through the recognition of a selective waiver is a fundamental cornerstone of proposals for more prudential regulation of financial firms in the United States, which are discussed elsewhere in this report.

Over the years, business entities, with the support of the SEC, have tried to assert a selective waiver in an effort to keep privileged information out of the hands of private litigants. However, the majority of courts in the United States have rejected these assertions and, generally, the doctrine of the selective waiver has not been adopted in any meaningful way by U.S. courts.²³⁵ Accordingly, if a private party waives the attorney-client privilege in connection with an SEC examination or investigation, the courts are likely to require that party to give over the privileged information to the plaintiffs in a class action, even when there is an express agreement between the SEC and the private party limiting the waiver to just the SEC.²³⁶ The consequences of such full waivers can be severe, resulting in damaging disclosures.

Because the courts refused to recognize the doctrine of selective waiver, the SEC proposed that Congress enact legislation to recognize the doctrine. In 2004, the SEC supported legislation introduced in the House of Representatives to amend Section 24 of the Securities Exchange Act of 1934 to provide for a selective waiver with respect to privileged documents or information shared by any private party with the SEC pursuant to a written confidentiality agreement. Although that legislation was not enacted, in 2006 the Congress enacted similar legislation that recognized a selective waiver in the context of regulated banks and financial services organizations that are required by federal law to disclose sensitive and confidential (and sometimes privileged) information to regulators.²³⁷ This legislation protects privileged information produced in compliance with federal law from disclosure to the general public.

The Commission supports efforts to establish selective waiver. Specifically, the Commission makes two recommendations in this area. First, the Commission recommends that Congress, at a minimum, enact legislation establishing a selective waiver that would permit corporations to share privileged information with the SEC and continue to assert the privilege against other third parties where a confidentiality agreement is in place. This selective waiver must protect the privilege even if the

235 Currently, most Circuit Courts do not recognize the selective waiver, and only the Eighth Circuit argues that there can be selective waiver without an accompanying confidentiality agreement.

236 *See, e.g., McKesson HBOC, Inc. v. Superior Court of San Francisco County*, 9 Cal.Rptr.3d 812, 821 (Cal. 2004). While under investigation for accounting fraud, McKesson, a medical supply company, turned over protected documents to the SEC—specifically, a report generated from an internal investigation outside counsel conducted. McKesson turned over the documents on the condition that the SEC sign a confidentiality agreement and stipulate that the company hadn't waived its privilege. Plaintiffs in a private securities litigation then requested the documents. McKesson refused to hand them over, citing attorney-client privilege. The case went to the California state appeals court, which ruled that a company may not selectively waive privilege, thereby forcing McKesson to give plaintiffs the documents. *See also McKesson Corp. v. Green*, 597 S.E.2d 447, 554 (Ga. App. 2004).

237 *See* Section 607 of the Financial Services Regulatory Relief Act of 2006, P.L. 109-351.

SEC, acting in the public interest, subsequently shares the information with other government agencies. For example, because of the relationship between the SEC and the DOJ, which often conduct parallel investigations, the SEC as a matter of practice will refuse to guarantee that it will not share the information with a related government body such as the DOJ. Once the privileged information is shared outside of one government agency with another government agency, the privilege would be considered waived with respect to all parties, including private plaintiffs, absent a selective waiver.

Second, the Commission recommends that Congress enact legislation establishing a selective waiver that would permit a private party to share privileged information or documents with external audit firms or government-appointed corporate compliance monitors (subject to a confidentiality agreement) without waiving the attorney-client privilege to other third parties. As mentioned, auditors are increasingly requesting that corporations provide them with access to internal documents, including privileged material, and regulators are frequently appointing corporate compliance monitors. Without a selective waiver for such entities, the privilege associated with information to which auditors and monitors have been given access would be considered waived as to all parties, including third-party plaintiffs.

In making these recommendations, the Commission is mindful of concerns expressed by many that the recognition of a selective waiver may actually increase government demands for privileged information.²³⁸ The Commission does not believe that waiver of attorney-client privilege should ever be compelled and recommends that the SEC and the DOJ cease pressuring companies to do so.²³⁹ Given these concerns, the Commission recommends that a selective waiver be adopted only after the government resolves that it will cease requesting or considering it as a cooperation credit factor.

238 Furthermore, there are concerns that selective waiver may provide a separate avenue for the DOJ to seek to pressure companies for privileged information. Currently, the SEC has a practice of insisting that its confidentiality agreements allow it to share information with the DOJ. It is crucial that the availability of selective waiver as to the SEC does not lead to a situation where the SEC or the DOJ pressures companies to waive their legal privilege.

239 See discussion on the Federal Prosecution of Business Organizations, above. The SEC, although perhaps not as uniformly as the DOJ, has been exerting pressure on companies to waive privilege so that they are deemed “cooperative.” (*See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions*, SEC Release No. 34-44969, October 23, 2001). See also Paul Atkins, SEC Commissioner, “SEC’s Atkins Calls for Review of Legal Protections,” *Wall Street Journal* on-line, Feb. 9, 2007, available at <http://online.wsj.com/article/BT-CO-2007029-712248-search.html>, (remarks noting concerns that those under SEC investigation may be pressured to forego legal privileges).



V. THE CHALLENGES FACING PUBLIC COMPANY AUDITING

A. Role of Audit Firms in the U.S. Economy

Independent audits are a critical linchpin between a company's financial statements and their credibility with the investing public. Thus, the continued vitality of the audit profession is a necessary component of healthy and competitive U.S. capital markets. However, the current legal and regulatory environment places extensive burdens and constraints on the profession that raise potential risks to the future competitiveness of U.S. capital markets, because these burdens and constraints are much heavier here than in Europe or Asia.

In the discussion that follows, the Commission outlines challenges facing the audit profession. As it stands today, the profession finds itself in a precarious situation. On the one hand, the investing public heavily relies on audit firms to provide independent and reliable attestation of public company financial information. This reliance speaks to the significant and important role that audit firms play in the capital markets.

On the other hand, policy-makers and the investing public often misunderstand and underappreciate the complexities of the accounting function and the extent to which audit firms can provide reasonable assurance about a company's financial position. Audit firms can and should provide reasonable assurance, but they cannot and should not be expected to provide near-absolute assurance that the financial statements of public companies are complete and accurate. If several high officials of a company collusively engage in a complex and covert fraud, it would be extremely difficult for any outside auditor of that company to ferret out the fraud.

In this environment, there are only four firms left to audit the largest public companies. In fact, the Big Four audit firms audit a substantial portion of the total market capitalization in the United States and, indeed, the world. In effect, the investing public's confidence has been largely vested in a handful of private partnerships, and these firms are, in turn, subject to extraordinary legal and regulatory challenges. Although there may be arguments about the role played by the profession in reaching this state—and complaints about how auditors have reacted to the challenges they have faced—this is a point of substantial

risk for our capital markets that must be addressed and resolved by the serious and committed involvement of policy-makers.

There can be little doubt that the failure of a major auditing firm—for whatever reason—could cause a crisis in our capital markets and harm investors. Possible



Drawing from his experience as CEO of Deloitte & Touche, Jim Copeland considers the future role of the auditing profession.

solutions are complex; additional work, analysis, and dialogue are needed before the correct answers become apparent. This report contains a modest set of proposals going in the right direction, but the Commission's basic message is that Congress and various government agencies should address this issue with urgency and purpose. This cannot be another instance in which the solution to a problem in our capital markets is developed only after the crisis has occurred.

Because auditors of public companies play an essential role in the operation of our capital markets, the Commission believes that every reasonable effort should be made to ensure the continuation of the audit profession, both domestically and globally. The assurance audit firms provide on the financial information of public companies enhances the confidence of investors and other users of this information. If the public audit function were to disappear, the Commission believes that confidence in the capital market would drop and the cost of capital would rise substantially.

B. Expectations About the Role of Auditors

The responsibility of a firm that audits the financial statements of a public company registered with the SEC is stated succinctly in the auditor's opinion required by federal law:

The [PCAOB's auditing] standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion. In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of [at] December 31, 20__ and 20__, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20__, in conformity with U.S. generally accepted accounting principles.²⁴⁰

That brief statement conceals considerable complexity:

- What are the Generally Accepted Accounting Principles (GAAP) that govern the financial statements of public companies? Is the application of these principles to a company's financial transactions a mechanical exercise or does it require making significant estimates and otherwise exercising of judgment?
- How specific are the auditing standards governing the audit firm's "plan[ning] and perform[ance]" of the audit? Do they require the exercise of judgment?

240 PCAOB Standard AS1.

- What is a “material misstatement”? Material relative to what standard?
- What is the nature of the “reasonable assurance” that the audit firm provides? In percentage terms, is the audit firm opining that there is a 90% probability that the financial statements are free of material misstatements? A more than 50% probability? Is the probability the same for misstatements due to honest errors as it is for misstatements due to intentional fraud?

The lack of understanding about each of these as well as other questions — among both sophisticated and unsophisticated users of financial statements, including judges and juries—has led to significant confusion about the auditor’s role.

Some perceive a company’s financial statements to have a degree of exactitude akin to the total on a cash register tape. As a recent American Assembly report observed, “[f]inancial statements, simply because of the way they are presented to the user, appear to claim a degree of exactitude that is, in fact, unrealistic.”²⁴¹ Assembling a company’s financial statements is, as the SEC has observed, an inherently indeterminate process because it requires the “translation of economic reality into an accounting framework as defined by a set of standards.”²⁴² Those standards, which are applied in the first instance by management, whose duty it is to produce the financial statements, “can tolerate a range of reasonable treatments, leaving the choice among alternatives to management.”²⁴³

U.S. GAAP are rules based—and have been criticized for that specificity—but that does not eliminate the need for judgment. Indeed, the SEC has recognized that “the exceptions and internal conflicts inherent in a rules-based system of accounting standards” mean that judgment is often required and GAAP “provides numerous ways to account for even common items such as inventory and depreciation as well as exotic ones such as derivatives.”²⁴⁴ The auditor’s role is to determine whether

241 The Am. Assembly of Columbia Univ., *The Future of the Accounting Profession*, (103d Am. Assembly) Nov. 13-15, 2003, at 8. *See also id.* at 7 (“Too many members of the investing public believe financial statements can portray—with precision—the assets, liabilities, and financial performance of an issuer.”)

242 Securities and Exchange Commission (“SEC”), Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System, at *id.* (last modified 07/25/2003), available at http://www.sec.gov/news/studies/principlesbasedstand.htm#P273_49422 (hereinafter “SEC Study”).

243 *Thor Power Tool v. Comm’r*, 439 U.S. 522, 544 (1979).

244 Amy Shapiro, “Who Pays the Auditor Calls the Tune?: Auditing Regulation and Clients’ Incentives,” 35 *Seton Hall L. Rev.* 1029, 1052 (2005); *see also* Lawrence A. Cunningham, “Sharing Accounting’s Burden: Business Lawyers in Enron’s Dark Shadows,” 57 *BUS. LAW.* 1421, 1435. (“GAAP’s conventions authorize a wide variety of treatments for identical economic events, from relatively standard contexts such as inventory and depreciation to more challenging contexts such as derivatives and leases.”).

management's accounting treatment complies with U.S. GAAP, not whether it is the accounting treatment that the auditor would have selected.

Of course, the auditor does not verify the accounting treatment of each of the literally millions of transactions and other events that underlies management's financial statements. The audit process involves a risk-based review of a sample of transactions selected by the auditor as well as an assessment of a sampling of the company's internal controls over its financial reporting process. Given the huge scale of today's global enterprises, the auditor obviously can sample only a very small percentage of the items that constitute inputs into the company's financial statements.²⁴⁵ This sampling requires a considerable exercise of judgment. Thus, the audit process, like the accounting process, is *both* art and science; it must take into account the practical constraints of time—audited financial statements must be filed with the SEC shortly after the close of the registrant's fiscal year—and the relative costs and benefits of incremental procedures.²⁴⁶

The role of the public company auditor was expanded by the requirement in Section 404 of SOX that auditors attest to the adequacy of a company's internal control over financial reporting. Under this regime, the auditor must decide whether there is reasonable assurance that internal controls of the company are effective, or whether there are "significant deficiencies" or "material weaknesses" in a company's internal controls. Thus, the definitions of materiality and reasonable assurance are critical to the functions of the auditor.

The concept of materiality is simple in theory—"[a]n item is material if its inclusion or omission would influence or change the judgment of a reasonable person"—in practice, however, it has proven extraordinarily resistant to standardization and

245 See, e.g., *Bily v. Arthur Young & Co.*, 834 P.2d 745, 749-50 (Sup. Cal. 1992) ("[The auditor] may verify the existence of tangible assets, observe business activities, and confirm account balances and mathematical computations."). The Bily court described vouching—a process whereby an auditor "will select transactions recorded in the company's books to determine whether the recorded entries are supported by underlying data" and tracing, whereby "an auditor might choose particular items of data to trace through the client's accounting and bookkeeping process to determine whether the data have been properly recorded and accounted for." *Id.* at 749-50.

246 See American Assembly Report, *supra*, note 241 at 4 ("The reality is that producing and auditing a complete set of financial statements in our increasingly complex global economy is now more of an art than a science, and one that must be, by definition, reliant on judgments that flow from experience and a sophisticated understanding of business and accounting.").

regularization.²⁴⁷ The assessment as to whether a particular matter is material is highly context dependent and is rendered even more complex by the fact that misstatements that are immaterial when considered individually may aggregate to a material level. Accounting standards that became effective on December 15, 2006, place an even greater emphasis on the role of the auditor's perception and assessment of surrounding circumstances in making materiality determinations.²⁴⁸

The definition of "reasonable assurance" has been evolving. It has long been recognized that reasonable assurance is not a guarantee and that the mere fact that the financial statements contain a material misstatement does not mean that the auditor failed to perform properly.²⁴⁹ The Public Company Accounting Oversight Board (PCAOB) originally defined "reasonable assurance" of effective internal controls to mean that there is a "remote likelihood that material misstatements will not be prevented or detected on a timely basis." This definition was sharply criticized on the ground that the "remote likelihood" of a material misstatement is too strict a standard for the effectiveness of internal controls. As a result, the PCAOB has recently proposed that reasonable assurance of effective controls means that it is "reasonably possible" or "probable" that material misstatements will not be prevented.²⁵⁰ The PCAOB has stressed that reasonable assurance involves a significant degree of judgment on the part of the auditors.²⁵¹

All of these uncertainties combine to produce a situation in which there is a large gap between what many investors expect of auditors and the job they actually are charged with performing and have the capacity to perform. As a result, when a

247 Donald E. Kieso et al., *INTERMEDIATE ACCOUNTING* 44 (11th ed. 2004); *see also* SAS No. 47 ("The concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with [GAAP], while other matters are not important."); Interim PCAOB Auditing Standards at AU § 312.10 (defining materiality as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement"); *cf.* 17 C.F.R. § 230.405 (defining materiality for purposes of § 11 of the Securities Act of 1933 as "those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered").

248 *See* SAS No. 107 ("The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users of financial statements."); *see also id.* ("[M]ateriality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.").

249 *See* AU § 230.10; *id.* § 230.11 ("Even with good faith and integrity, mistakes and errors in judgment can be made.").

250 PCAOB Release No. 2006-007, December 19, 2006 at 9. ("In accordance with FASB Statement No. 5, the likelihood of an event is 'more than remote' when it is either 'reasonably possible' or 'probable'.")

251 *See e.g., id.*, Appendix 1, §§ 94-96, Reporting on Internal Control, at A1-37 – A1-40.

company's financial statements are claimed to have been misstated, the auditors are often drawn into the accompanying civil litigation. Moreover, auditors, aware of this "expectations gap," may feel obligated to practice "defensive medicine" in their examination of financial statements—this practice is not in the ultimate best interests of investors.

The challenges faced by the profession—and the expectations placed on them—have led to a number of complaints about the deterioration of the relationship between auditors and issuers. Although auditor independence is essential, an adversarial relationship between auditors and issuers is neither necessary nor conducive to open and productive communication.

C. Concentration of Audit Practice

According to a 2003 U.S. Government Accountability Office (GAO) study, the Big Four firms audit 78% of all U.S. public companies and 97% of those with sales of more than \$250 million. In addition, the Big Four audit 99% of all public company revenues and dominate the international audit market. The Commission further quantified the role the Big Four audit firms play in the capital raising process in the United States, based on data provided by the Securities Industry and Financial Markets Association (SIFMA). Of the 172 initial public offerings (IPOs) launched in the United States by U.S. companies during calendar year 2005, 140 (or 81%) were launched with audit opinions issued by the Big Four, versus 32 (or 19%) by other audit firms. The IPOs associated with the Big Four on average had twice the proceeds as those associated with non-Big Four firms.²⁵²

The European Commission–sponsored study analyzed the consequences of destruction of an audit firm because of private litigation. It concluded that

*[a] failure of one of the Big-4 networks may result in a significant reduction in large company statutory audit capacity if partners and other senior staff at the failed firm, the remaining Big-4 firms, and possibly even some middle-tier firms, were to decide that auditing is a too risky activity and therefore shift to other business lines. This would obviously create very serious problems for companies whose financial statements need to be audited.*²⁵³

²⁵² These data were provided to the Commission by SIFMA, whose source for the raw data was Thomson Financial.

²⁵³ EC Study at xxxvii; *see also id.* at 134-136.

Furthermore,

*[t]here could also be an impact on capital markets, especially during the transition phase. If the disappearance occurs close to the end of the financial year, investors may have to wait longer for the release of audited accounts. They may also be less familiar with the new auditor. Whether this would lead to significant perturbations in capital markets is an open question.*²⁵⁴

As noted above, the Big Four audit firms dominate the public company audit sector. The next tier of global firms, the largest of which are Grant Thornton, BDO Seidman, and McGladrey & Pullen, generally lack the capacity to audit the largest public companies.²⁵⁵ As important, public statements of experts indicate that the next-tier firms have no strategic interest in significantly entering the Fortune 1000 businesses given the liability risks involved.²⁵⁶

Accordingly, if a Big Four firm failed, vast numbers of public companies that are clients of that firm would be left scrambling to get one of the three remaining big firms to provide audit services. Further compounding the problem is the fact that certain of these remaining big firms may not qualify as “independent” under the SEC’s auditor independence rules. Most public companies already use one or two of the Big Four to perform various services, such as consulting. Obtaining both auditing and certain consulting services from a single firm is contrary to the SEC’s independence rules. Thus, in the event a Big Four firm failed, a public company client of that firm likely would be forced to select a new auditor from between, at most, two firms.

D. The Risk of Audit Firm Collapse

A large public audit firm could be put out of business in short order in two instances: (i) if it were subject to a criminal indictment, and (ii) if it were forced to pay a “mega-claim” in civil litigation.²⁵⁷

254 EC Study at xxxviii; *see also id.* at 134-136.

255 *See* American Assembly Report, *supra*, note 241.

256 *See* Robert Bunting, former Chairman, American Institute of Certified Public Accountants, Comments at the Commission’s Chicago Town Hall Meeting (Sept. 18, 2006) (Mr. Bunting indicated that the mid-tier U.S. audit firms perceive that the liability risks associated with auditing a Fortune 1000 company outweigh the benefits, and, accordingly, these firms have little interest in taking this business away from the Big Four firms.)

257 According to Aon, a “mega-claim” is considered to be a case where damages of more than \$1 billion are sought from auditors or in litigation where auditors are additional defendants, the damages sought are more than \$10 billion. Aon Professional Risks, *Mega-Claims 2006: Analysis of a Selection of Large Publicly Known Matters Involving Auditors* (Risk Briefing Paper, Oct. 2006) at 1.

1. Criminal Indictment

All companies whose securities are available to the general public through U.S. exchanges are required to have their financial statements audited by an outside independent registered public audit firm. Under the SEC rules of practice, criminal conviction of an audit firm automatically disqualifies that firm from signing registration statements or signing 10-Ks, unless waived by the SEC.²⁵⁸ Although the SEC has the right to waive this disqualification, uncertainty over a possible conviction and delay in agreeing to grant a waiver will quickly erode the firm's client base and will effectively put an indicted audit firm out of business. After the indictment of Arthur Andersen, the SEC did not promise to grant a waiver to the firm after its conviction, and its client base therefore quickly evaporated before its trial and conviction. By the time the criminal conviction of Arthur Andersen was overturned by the Supreme Court, the audit firm no longer existed.²⁵⁹

Moreover, an audit firm's reputation is critical to the basic service that it provides—that is, an “opinion” regarding a registrant's financial statements. The opinion has value only because investors, lenders, and the capital markets are willing to respect the audit firm's opinion. The pendency of an indictment raises substantial questions about the value of the opinion that can have real-world impacts more severe than indictment of any other type of business enterprise. The registrant will be concerned that the markets will no longer value the audit firm's opinion because of the immediate injury to reputation that comes with an indictment. The registrant's audit committee is likely to be reluctant to retain an audit firm that is under indictment, because of the possible devaluation of the auditor's opinion and because of fear of criticism by shareholders for choosing an indicted firm. Current and potential investors who would rely on the audit of the financial statements will worry that an audit firm under indictment may not have the financial stability to provide recourse if for any reason the investor were to later sue the firm. Because three years of financial statements are included in SEC registrations and annual filings, not only will the audit firm's clients need to likely find new auditors for their current financial statements, but also they may be required to have a new firm re-audit prior years at considerable expense.²⁶⁰

In addition to the considerable cost and inconvenience imposed on public company clients, the indictment of an audit firm will likely result in its bankruptcy. If any major public audit firm were to be indicted, the Commission believes that the firm's public company clients would immediately look for another audit firm to certify their

258 SEC Rules of Practice, 17 C.F.R. § 201.102(e)

259 See Kathleen F. Brickey, *Andersen's Fall From Grace*, 81 WASH. U.L.Q. 917, 921 (Winter 2003).

260 In the Arthur Andersen case, the SEC provided relief to that firm's clients in which the clients were not required to have their past financial statements re-audited by another audit firm. SEC Temporary Final Rule and Final Rule: Requirements for Arthur Andersen LLP Auditing Clients, 17 CFR §§ 210, 228, 229, 230, 240, 249, and 260 (2002).

financial results. As a consequence, the indicted firm would lose most of its revenues and likely would be forced to disband within a short period of time after the criminal indictment. Even if the SEC later chose to waive the firm's disqualification, the audit firm already would have been severely (likely fatally) affected. Accordingly, a criminal indictment of a public audit firm effectively puts that firm out of business.

It is reported that the DOJ has become more cautious about filing criminal indictments against audit firms since the demise of Arthur Andersen following its indictment. The recent experiences of KPMG in the United States, however, suggest that this threat is still quite real. According to published reports, the Justice Department was close to bringing a criminal indictment against the audit firm for the role of certain KPMG partners in promoting a specific type of tax shelter.²⁶¹ Subsequently, in August 2005, KPMG entered into a deferred prosecution agreement with the DOJ under which KPMG admitted to criminal wrongdoing and agreed to pay \$456 million in fines.²⁶²

2. Catastrophic Litigation

The biggest threat facing audit firms today is that a single mega-claim or several such civil claims in succession could destroy an audit firm. Columbia Law School Professor John Coffee, a respected expert on liability issues, has observed that the largest recoveries against audit firms occurred in the last six years and that "the risk of catastrophic loss . . . is the factor most likely to cause the market for [audit services] to unravel."²⁶³ "Sooner or later," Coffee says, "there will be a financial disaster that will impair the solvency of one of these [four large accounting] firms without some change."²⁶⁴ Ed Nusbaum, chief executive officer of Grant Thornton, told the Commission that "the threat of 'bet the firm' liability is a reality to every accounting firm in the country."²⁶⁵ And it is a reality now, today. Although the threshold for failure differs by firm, the risk of catastrophic failure does not."²⁶⁶

261 See David Reilly, "Narrow Escape: How a Chastened KPMG Got by Tax Shelter Crisis," *Wall Street Journal*. A1 (February 15, 2007).

262 The potential impact of indictment on an audit firm, even if they are ultimately exonerated, encourages early settlement and decreases the number of cases which are argued on their merits and decided by a court.

263 John C. Coffee, Jr., "Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms," 84 B.U.L. REV. 301, 342 (2004).

264 "Coffee Advises Paulson Panel of Ways to Mitigate Securities Litigation Threat," *BNA Daily Report FOR EXECUTIVES* (October 16, 2006).

265 Testimony at Chicago Town Hall Meeting (September 18, 2006).

266 See also, Patrick Danner, "BDO Seidman Case Gears Up," *Miami Herald* (January 16, 2007) (Stating that a verdict against the firm for the claimed \$170 million could result in thousands of people losing their jobs.).

The European Union (EU) has determined that the risk of the collapse of another large audit firm is serious, although the rules governing private lawsuits there impose a much lower level of liability than those in the United States.²⁶⁷ A 332-page report prepared under the auspices of the European Commission concluded that “[i]n light of the number of large actual or potential claims outstanding [in Europe], the risk of an award or settlement in excess of the tipping threshold is far from nil, and one of the major Big-4 networks could possibly fail as a result.”²⁶⁸

The available data have not enabled this Commission to make a determination about the statistical likelihood of a mega-claim destroying a firm. Nevertheless, there are clear indications that the risk is real and substantial. First, trends in the wider universe of securities class-action suits have an effect on audit firm liability. Those trends indicate that settlements are large and growing. As mentioned earlier in the discussion on securities litigation in “U.S. Capital Markets in the Global Marketplace,” an increasing number of these cases are being settled for extremely large dollar amounts. In 2004 and 2005, nine cases settled for \$100 million or more, compared with four in 2002; 30 cases settled for more than \$20 million in 2005, compared with 23 cases in 2004.²⁶⁹ Cornerstone’s analysis of the size of these claims filed in 2004 found that the average size was \$883 million, with eight cases of \$5 billion or more and three cases of \$15 billion or more.²⁷⁰ Six cases filed in 2005 involved \$5 billion or more.²⁷¹ As large as these statistics are, they should not be surprising. Company size, in terms of market capitalization, has grown substantially.²⁷² Damages claims in securities class actions are a function of the decline in market capitalization that occurs when the “true state” of the company’s financial situation is revealed. Larger capitalization, therefore, inevitably leads to lawsuits with larger claims.²⁷³

267 The European Parliament and Council directed the European Commission to provide a report on “[t]he impact of the current liability rules for carrying out statutory audits on the European capital markets and on the insurance conditions for statutory auditors and audit firms, including an objective analysis of the limitations of financial liability.” See Directive 2006/43/EC.

268 See *Study on the Economic Impact of Auditors’ Liability Regimes*, MARKT/2005/24/F (September 2006), available at http://ec.europa.eu/internal_market/auditing/docs/liability/auditors-final-report_en.pdf. [hereinafter EC Auditor Liability Study] at xli.

269 PricewaterhouseCoopers, *2005 Securities Litigation Study* at 16 (2006), available at <http://www.pwc.com/extweb/pwcpublishings.nsf/docid/7999A70324592B738525715C0059A948>.

270 Cornerstone Research, *Securities Class Action Case Filings, 2004: A Year in Review* at 10-11 (2005), available at <http://securities.cornerstone.com/>.

271 Cornerstone Research, *Securities Class Action Case Filings, 2005: A Year in Review* at 11 (2006), available at <http://securities.cornerstone.com/>.

272 The total average U.S. equity market common stock capitalization from 1989 to 2006 grew from \$3.5 trillion to \$17.8 trillion.

273 Unfortunately, the available data do not indicate how many securities class actions are filed against audit firms. Cornerstone reports only the identity of the defendants named in the initial complaint. Cornerstone Research, *Securities Class Action Case Filings, 2005: A Year in Review*

Second, although audit firms are not party defendants in all securities class-action suits, they are parties to some and therefore are affected by these general trends. The litigation costs for audit firms are substantial and increasing in value. As shown in the table below, the Big Four audit firms in 2004 paid \$978 million in judgments, settlements, legal costs, and reserves, up from \$463 million in 1999. Moreover, although the PSLRA required proportionate liability for audit firms, a recent study has shown that in cases with an accounting firm as a codefendant, average settlements nearly double.²⁷⁴ The net cost of audit practice protection as a percentage of revenues for the Big Four in 2004 was 14.9%, nearly twice the 7.69% of revenues in 1999.

Third, although there is no comprehensive data regarding private damages claims against auditors under state law, anecdotal reports show that these lawsuits, too, can be quite large, seeking billions of dollars in damages.²⁷⁵ Aon, in 2006, found at least seven, presumably, state law mega-claims brought by clients against their auditors.²⁷⁶

Finally, there is substantial evidence that audit firms cannot get insurance to pay large claims in civil litigation. Aon advised the Commission that “[t]he auditing profession is one of the very few where insurance protection for catastrophic losses simply is not available.”²⁷⁷ Aon further stated,

Figure M
Aggregate Audit Practice Protection Costs - Four Largest U.S. Firms

	1999	2000	2001	2002	2003	2004
Revenues from Audit Services	6078	6557	6701	6598	7930	8981
Judgements, Settlements, Legal Costs	463	630	679	733	816	978
Insurance Premiums Net of Recoveries	5	-89	91	89	31	296
Net Practice Protection Costs	468	541	770	822	847	1274
Net Costs as % of Revenues	7.69%	8.25%	11.49%	12.45%	10.68%	14.19%

(In millions) Source: Charles River Associates, Inc. study

at 16 n.12 (2006). Because plaintiffs in these cases typically file several amended complaints expanding both the claims and the number of defendants named, the initial complaint is not a reliable basis for determining the number of claims that auditors face. Given that more than 60% of all securities class actions filed in six of the last seven years involved alleged inaccurate financial reporting (PricewaterhouseCoopers, *2005 Securities Litigation Study* at 9 (2006)), it seems reasonable to conclude that a substantial number of cases involve claims against auditors.

274 Todd Foster, Ronald I. Miller, Stephanie Plancich, Recent Trends in Shareholder Class Action Litigation (NERA Economic Consulting) at January 8, 2007. (The study did not draw conclusions as to why the settlements tend to double.)

275 See Aon Professional Risks, Mega-Claims 2006.

276 *Id.* at 15. (The claims by clients against their auditors would generally be state law claims such as negligence.)

277 Letter from Aon to U.S. Chamber of Commerce Commission on the Regulation of U.S. Capital Markets in the 21st Century (October 19, 2006).

*the loss experience of the international accounting networks has been such that significant commercial risk transfer insurance limits are generally unavailable to these firms. Such limits as are available are, in the views of actuaries and other experts [Aon] consulted, insufficient to pay the possible maximum losses to which accounting firms are subject.*²⁷⁸

The study sponsored by the European Commission reached the same conclusion with respect to the availability of insurance, even with the lower liability risks in Europe:

*[t]he level of auditor liability insurance available for higher limits from the commercial market has fallen sharply in recent years in terms of both the level and amount of insurance, and the conditions under which the insurance cover is effective. The current level of commercial insurance is such that it would cover less than 5% of the larger claims some firms face nowadays in some EU Member States.*²⁷⁹

Manufacturing enterprises or other businesses with substantial physical or even intangible assets often can protect themselves to some extent by borrowing against those assets and using the proceeds to moderate the financial impact of adverse litigation outcomes. Audit firms have few such assets to borrow against: their capital does not come close to equaling their liability exposure, and most of it is employed in their businesses.²⁸⁰

In sum, there is substantial evidence that audit firms face litigation threats so large and so uninsurable that they could lead to the demise of one or more audit firms.

²⁸¹ The Commission believes that this problem should be addressed promptly by policy-makers.

²⁷⁸ *Id.*

²⁷⁹ London Economics in association with Professor Ralf Ewert, *Study on the Impact of Auditor's Liability Regimes*, (MARKT/2005/24/5), prepared for EC-DG Internal Market and Services, at xxi, September 2006 ("EC Study"); *see also id.* at 99.

²⁸⁰ As the European Commission study concluded, this capital "essentially represents the working capital of the firm and the partners' income of the year and, therefore, cannot be viewed as an additional potential source of funds to meet any claims." EC Study, *supra*, note 279 at 104. Bankruptcy is another option sometimes used by businesses faced with severe litigation threats, but that too may not be a viable alternative for audit firms. An audit firm's critical asset is its reputation; a bankruptcy filing would inflict irreparable damage upon that asset.

²⁸¹ Some observers have noted that many of the large claims against audit firms were filed during the 2001-2002 downturn, and that the number of new very large lawsuits has declined in recent years. Although the frequency apparently has diminished, large claims continue to be filed. Aon has observed that "mega-claims remain a source of concern to audit firms for three reasons. One is that such claims are linked to economic cycles and may increase – once again – during the next economic downturn. The other is that various business, economic, and financial factors that have fueled mega-claims during economic downturns in the past are factors that remain strong today – and may be growing more potent. Finally, numerous plaintiff strategies – some old, some new, some still-evolving – make mega-claims potentially more costly to defendants." Aon Professional Risks, *Mega-Claims 2006*, at 19.

a. Other Solutions

The risks posed by catastrophic litigation to the large international public audit firms is a commonly and internationally recognized problem. Solutions to this problem, however, remain more elusive and fragmented.

The Europeans are ahead of the United States in developing possible solutions. In January 2007, the European Commission proposed four possible options for reforming auditor liability regimes in the EU's 27 member states.²⁸² These options were put forth in the form of a consultative paper, on which comments were requested by March 15, 2007. The four options are as follows:

- Establishment of an EU-wide fixed cap on liability²⁸³
- Establishment of a liability cap based on the size of the audited company's market capitalization
- Establishment of a liability cap based on a multiple of the audit fees charged by the audit firm to the company
- Adoption by member states of proportionate liability²⁸⁴

In the United States, several solutions to the risk of catastrophic liability have recently been put forth. A report commissioned by Mayor Michael Bloomberg and Senator Charles Schumer proposed that liability caps be imposed for securities-related claims against audit firms, so that the audit firms could once again become insurable and consequently lessen their costly risk-averse behavior.²⁸⁵ Another report, issued by the Committee on Capital Markets Regulation, proposed the consideration of several

282 See European Commission: Directorate General for Internal Market and Services Commission Staff Working Paper: Consultation Report on Auditors' Liability and Its Impact on the European Capital Markets (January 2007), available at http://ec.europa.eu/internal_market/auditing/liability/index_en.htm.

283 Currently, Austria, Belgium and Germany have adopted absolute caps. According to the EC Study, *supra* note 279, this option would be "difficult to achieve" because: (i) finding the appropriate level would be challenging – a high cap would disadvantage mid-tier firms to the benefit of the Big 4, while a low cap may negatively impact the overall quality of audits); and (ii) a "one-size-fits-all approach" for all member states fails to account for diversity of circumstances. EU Internal Markets Commissioner McGreevy has endorsed adoption of limits on auditor liability in private lawsuits to prevent the destruction of another large firm. (See "Commissioner Urges Liability Cap for Big Four Accountancy Firms," *Financial Times* at 7, Oct. 27, 2006).

284 According to the Consultative Paper, most of the EU member states have joint and several liability.

285 *Sustaining New York's and the US' Global Financial Services Leadership* (2007) p.102, available at http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf.

solutions, including the creation of safe harbors and establishing liability caps in specified circumstances.²⁸⁶ Moreover, the SEC has recognized and spoken about the need to protect public audit firms from the risk of catastrophic litigation claims.²⁸⁷

E. Recommendations

The Commission believes that Americans should be concerned with the problems facing the audit firms because (i) much of the confidence of the entire market now rests on just four private businesses, and (ii) criminal and civil litigation risk is a substantial impediment toward expanding the number of audit firms willing to audit large public companies. The Commission believes that the risk of criminal indictment or of a civil mega-claim destroying a firm is real and that the rapid loss



Former Sen. Don Nickles stresses the need to address the problems facing public companies and audit firms.

of yet another firm would lead to a significant problem in our capital markets. Because the potential for this problem is apparent, we need to develop solutions without delay to maintain the major public audit firms and to encourage more firms to join the ranks of global public auditors. The Commission believes it is time for public companies, audit firms, the SEC, and the PCAOB, as well as other financial service regulators, policy-makers, and leading investor advocates, to take affirmative steps to reset public expectations about the actual degree of precision inherent in financial statements and the actual ability of auditors to uncover material misstatements, especially in cases in which the audit client has been involved in collusive, purposefully hidden fraud. In addition, given the significant public policy ramifications in the event

of a catastrophic loss of a large public company audit firm, the Commission calls on domestic and international market participants and policy-makers to immediately engage in a serious evaluation and discussion of possible means to address this risk of catastrophic loss, including this Commission's recommendation regarding backup insurance sponsored by G-8 governments or international financial

286 See *Interim Report of the Committee on Capital Markets Regulation* (November 2006) p. 88-89, <http://www.capmksreg.org/index.html>.

287 "Hewitt Suggests Audit Profession Consider Seeking Liability Limitations," *BNA Corporate Law & Business*, Vol. 39, No. 7 (February 19, 2007), available at <http://corplawcenter.bna.com/pic2/clb.nsf/id/BNAP-6YEV4B?OpenDocument> (In remarks before Practising Law Institute's annual SEC Speaks conference, SEC Chief Accountant Conrad Hewitt said that the audit profession may be well advised to seek congressional protection from damage awards that could threaten the continuing vitality of the Big Four audit firms).

organizations, and various other proposals regarding safe harbors or damage limits in specified circumstances.

The Commission puts forth below certain ideas that it believes warrant serious consideration. These recommendations are not intended to represent a comprehensive answer to the problem or to resolve all issues regarding audit firm liability, but rather are intended to present helpful suggestions to spark dialogue on this pressing problem.

1. Focus Criminal Indictments on Culpable Individuals

The Commission recommends that criminal actions be brought against responsible partners of audit firms, rather than the whole firm, in light of the experience of Arthur Andersen and the likely fatal consequences to audit firms under criminal indictment.

Although the Commission urges caution in seeking criminal indictments against audit firms, the Commission fully supports efforts by the DOJ to seek out for prosecution and punishment culpable individuals who work for audit firms. Culpable individuals and groups of individuals should pay for their crimes. In bringing criminal cases; however, the DOJ should avoid collateral damage to innocent employees of audit firms and the public companies they audit.

The Commission recommends that the McNulty Memorandum be revised to instruct prosecutors to weigh the negative consequences for public companies and their shareholders against the benefits of a criminal indictment. The DOJ at a minimum should consider adding some formulation of the following language to the McNulty Memorandum to warn prosecutors about the broader implications of indicting a public company audit firm:

Because of the specter that an indicted public company audit firm may lose its ability to practice before the SEC, such a firm will likely lose all the revenues from its audit clients if it is indicted, effectively putting the public audit firm out of business. By law, all companies whose securities are available to the general public through U.S. exchanges are required to have their financial statements audited by an outside, registered public audit firm. A decrease in the number of large public audit firms would have a negative impact on public companies in particular, and, more broadly, the U.S. capital markets.

2. National Charter and Capital Raising

The Commission recommends that Congress enact legislation to establish a national charter designed to be available for large national audit firms. The Commission

has not engaged in a comprehensive study to determine what these requirements definitively should be, but the charter might, for example, be made available to any audit firm that derives more than 50% of its revenue from public company audit clients. Qualifying criteria might also be that the firm conducts auditing functions in more than half of the 50 states. These restrictions should effectively limit the charter availability to 10 to 15 national audit firms.

The Commission envisages that the national audit firm charter would be modeled on the national bank charter and would confer similar benefits. Currently, audit firms are subject to licensing and oversight by the accounting or audit boards of each state in which the firms operate. For large national firms, this can mean being licensed by and subject to the regulatory oversight of 50 state boards, as well as the SEC and PCAOB. This multistate regulatory system can lead to significant burdens for large audit firms in the enforcement context. For example, the settlement of an enforcement action against an audit firm by the SEC often leads to enforcement actions being initiated by many states against the audit firm on the same matter. Although some of these state actions may be informal in nature, they can require a significant amount of an audit firm's resources, in managerial time and litigation expenses. The optional national charter provision would substantially reduce the administrative costs of running a national audit firm and avoid the "cascading effect" of multijurisdictional regulation and enforcement activities that pose a barrier to interstate and global service.

Furthermore, the national audit firm charter would provide a form of business organization that would allow the audit firm to have shareholders other than its own audit partners. This national charter would supplant independence rules that place limits on non-Certified Public Accountant (CPA) partners²⁸⁸ and requirements that prohibit companies from hiring auditors that are not majority owned by CPAs. By allowing national audit firms to raise equity capital through sources other than audit firm partners, the national charter would foster an environment in which market-based solutions could evolve in response to the financial challenges faced by large audit firms.

The Commission believes that two particularly beneficial results could come from this environment. First, the availability of capital from other sources could provide an opportunity for the current Big Four to recapitalize and better protect themselves against the risk of catastrophic litigation. Second, private parties in the capital

²⁸⁸ Some states do allow a certain minority percentage of non-CPAs to be partners in an audit firm, but there are various limitations, including the percentage of partners who must be CPAs, and the qualifications necessary for non-CPAs to be allowed as partners. Regardless, national audit firms must satisfy the standards of the most restrictive state requirements.

markets, such as private equity firms, may decide to create a fifth large audit firm by starting a new one or investing heavily in an existing midsize firm. Given the risk of catastrophic litigation, investors may avoid investing capital in an audit firm, but they might also be motivated to become involved in finding solutions to manage this risk.

The Commission recognizes that certain concerns regarding auditor independence and conflicts of interest have kept regulatory bodies from embracing the idea of non-CPA ownership of audit firms. Although it is true that the sound professional judgment of auditors is important and should be protected, this is true of many other actors in our economy. Terminating the requirement that professional services firms be owned by their principals is not without precedent in other contexts. For example, the New York Stock Exchange (NYSE) once required its member firms to be formed as partnerships and barred public ownership of the firms. In 1953, the NYSE permitted member firms to incorporate and, in 1970, the NYSE permitted public ownership of member firms.

It bears emphasis that the adoption of a national charter would not adversely affect the ability of the Justice Department, the SEC, or the PCAOB to bring criminal or civil actions against national audit firms or their partners. Nor would the adoption of this national charter adversely affect the ability of private plaintiffs to bring claims against audit firms or their partners under federal securities laws or most state securities laws. By limiting the availability of national charters to 10 to 15 audit firms with a national scope of business, the proposal would leave with the states the powers of licensing and enforcement over more than 99% of public company audit firms in the United States. Because their practice is mainly local or regional in nature, these audit firms should be the focus of state attention. By contrast, the regulation of the largest national audit firms by 50 states is administratively inefficient, especially in light of the recent creation of the PCAOB, which is required to inspect these large audit firms every year.

3. Global Approach Through the Group of Eight (G-8)

The Commission believes that the problem of catastrophic litigation against, and a lack of adequate insurance coverage for, public audit firms is not just a national problem—rather, it is an international problem. The demise of a large international audit firm would have grave consequences for U.S. and non-U.S. public companies operating throughout the world. The problem is international and, therefore, the solution should be international. Accordingly, the Commission recommends that the SEC work with the U.S. Department of Treasury to place the issue of the need to develop a framework to support multinational accounting firms on the agenda

of the G-8.²⁸⁹ This framework could take many forms, including guarantees for insurance sponsored by G-8 countries or international financial organizations. The appropriate methods of ensuring the existence of a robust global accounting and auditing sector should be studied under G-8 auspices and should be brought forward for discussion by finance ministers at the upcoming G-8 meetings with a view toward approving a specific plan that could be endorsed by the G-8 leaders.

4. Develop a More Competitive Audit Profession

The Commission believes that public companies, regulators, and other market influencers must take action to build a more robust, dynamic, and competitive accounting profession. As noted above, liability risk is, in and of itself, a significant impediment to the expansion of the number of audit firms willing and able to undertake audits of large public companies in the United States. Beyond liability reform, however, the Commission believes that other actions can be taken to encourage the next tier of audit firms to expand the scope of companies that they are willing to audit.

Effectively matching company size and needs with audit firm size and capabilities not only allows companies to find the best combination of quality, service, value, and reach, but also protects markets by spreading risk among a greater number of firms. Companies should be encouraged to periodically evaluate a broader universe of audit firm choices to find the best fit. In addition, regulators and service providers should collectively begin to influence the next tier of audit firms to expand the scope of the companies they audit and to encourage broader acceptance of this next tier.

In the Commission's view, several practical steps can help to bring about this change. First, the SEC and our nation's stock exchanges should encourage, as a best practice, public companies to conduct a periodic review of their audit firm choices to ensure that they are getting the best combination of quality, service, value, and reach. Second, public company boards and audit committees should "right-size" their audit firm by matching company size, complexity, and requirements with firm size and capabilities. Third, companies and other capital markets influencers — including investors, analysts, commercial and investment bankers, and attorneys — should open the door to more audit firm choices. Although more than four audit firms are capable of serving midsize and smaller public companies, misperceptions in the capital markets may narrow the alternatives seriously considered by companies issuing

²⁸⁹ The Commission recommends that this process begin with the G-8 because public audit firm activities are concentrated in these countries. However, other countries should be consulted in the process, particularly in light of the fact that some global audit firms operate in more than 140 countries.

IPOs. Finally, the PCAOB and the audit profession should implement coordinated best practices for the audit process, including audit procedures, evaluation of fraud risk, and possibly even audit software. All firms should periodically assess whether they have the requisite attributes to serve specific clients.

5. Managing Costs of Audit Practice Protection: Arbitration Provisions

The Commission believes that the use of arbitration clauses and similar alternative dispute resolution (ADR) agreements by audit firms and their clients should be encouraged to manage the costs of civil liability and audit practice protection. Some audit firms and clients currently include these provisions in their engagement letters. The Commission recognizes that the use of these provisions may reduce the costs of audit practice litigation but not the risk of firm collapse from a civil mega-claim.

Arbitration as an alternative dispute resolution mechanism can be an effective way for audit firms to manage litigation costs. Arbitration is generally considered to be a less expensive and more efficient forum than the federal courts.²⁹⁰ Keeping potential defense expenses down with agreements to arbitrate benefits not only the audit firms, but also their clients and shareholders by keeping the cost of an audit from increasing.

Arbitration requirements are common in many areas.²⁹¹ Congress has actively promoted the ability of parties to choose the alternative forum of arbitration through the Federal Arbitration Act.²⁹² Arbitration has been increasingly favored by the federal courts over the last several decades.²⁹³ As the Supreme Court has noted, “suspicion of arbitration as a method of weakening the protections afforded in the substantive law to would-be complainants . . . has fallen far out of step with our current strong endorsement of the federal statutes favoring this method of resolving disputes.”²⁹⁴

290 See David Reilly, “Tracking the Numbers/Outside Audit: A Generally Accepted Accounting Principle? – Auditor Pacts with Companies that Prevent Suits, Limit Awards Draw Scrutiny as Disclosure Grows,” *Wall Street Journal* (March 6, 2006) (quoting a KPMG spokesman); see also, Joseph W. Bartlett, Buzz Article: Tort Reform in the Securities Sector, VC Experts, October 31, 2006.

291 See G. Richard Shell, *Arbitration and Corporate Governance*, 67 N.C.L. REV. 517, 525-6 (1989).

292 9 U.S.C.A. § 1, *et seq.*

293 See Myriam Gilles, “Opting Out of Liability: The Forthcoming, Near-Total Demise of the Modern Class Action,” 104 MICH. L. REV. 373, 393 (2005).

294 *Rodriguez de Quijas v. Shearson/American Express*, 490 U.S. 477, 481 (1989).



CHALLENGES FACING THE FINANCIAL SERVICES INDUSTRY

I. Introduction.....	116
II. President’s Working Group on Financial Markets – Increased Coordination of U.S. Financial Services Regulatory Policy	117
III. Securities and Exchange Commission (SEC).....	120
A. SEC Dual Mandate	120
B. SEC Rulemaking	121
1. Make the Sarbanes-Oxley Act Part of the Exchange Act	122
2. Adjust the SEC Rulemaking Process	123
3. Ensure Office of the Chief Accountant Complies with the APA	125
C. SEC Supervisory Practices.....	128
1. Benefits of Prudential Supervisory Frameworks.....	129
2. A More Prudential Supervisory Approach at the SEC	131
D. Structure of Securities Market Regulation	133
1. Office of Compliance Inspections and Examinations	134
2. International Affairs	136
3. Division Structure.....	137
IV. Jurisdiction of Trading Futures on Securities	139
V. Strengthened Self-Regulatory Regime Through Establishment of a Federal Self-Evaluation Privilege.....	141
VI. Optional Federal Insurance Charter	143
VII. Conclusion.....	146



I. INTRODUCTION

As noted, the U.S. capital markets have historically been perceived as the safest, most transparent, and well-regulated markets in the world. Our strong regulatory oversight and our dedication to transparency and investor protection, combined with our independent judicial system, are the principal reasons for our historical global dominance in capital markets activity. However, over the past few years, there has been a growing concern that our capital markets may now be operating at a competitive disadvantage



Christine Edwards (left), facilitator of the Financial Services Working Group, listens to testimony from Steve Bartlett, president and CEO of the Financial Services Roundtable, at a town hall meeting.

To address this concern, the Commission has developed recommendations designed to enhance coordination among financial service regulators and improve other aspects of our capital markets regulatory system. The recommendations have been crafted to ensure that the interest of U.S. investors, issuers, and financial service intermediaries are protected.



II. PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS – INCREASED COORDINATION OF U.S. FINANCIAL SERVICES REGULATORY POLICY

The position enjoyed today by the United States as the dominant global financial hub is coming under increasing pressure, which has long-term implications for our entire economy. Our competitive position is handicapped in part by the fact that we lack a shared supervisory vision, actionable strategy, and unified regulatory structure for our financial services sector.²⁹⁵ By contrast, the United Kingdom has such a unified regulatory structure through the Financial Services Authority (FSA). In order to maintain and enhance the United States' competitiveness in the global capital markets, the Commission believes that greater coordination of U.S. financial services regulatory policy is critical.

In the United States today, there is no single, comprehensive regulatory authority with accountability across the financial services industry. For example, at least three separate regulators exist for different types of financial holding companies—the Federal Reserve Board (FRB), the Office of Thrift Supervision (OTS), and the Securities and Exchange Commission (SEC). Each has a different mandate, each a different regulatory philosophy, and each a different approach to regulation. Moreover, specialized, and often overlapping, regulators oversee various functions within the capital markets. Banks are regulated by one or more of the four different federal banking agencies (the Office of the Comptroller of the Currency (OCC), OTS, Federal Deposit Insurance Corporation (FDIC), and FRB). Securities firms are regulated by the SEC and state securities regulators as well as by self-regulatory organizations (SROs). Futures firms are regulated by the Commodities Futures Trading Commission (CFTC) and the National Futures Association, itself an SRO. And the insurance industry is regulated by the 50 state insurance regulators.²⁹⁶ This fragmentation of our regulatory system leaves the U.S. markets open to the risk that gaps could develop where appropriate regulation is needed or that overlaps in regulation could lead to market inefficiencies. Meanwhile, the parent companies of those entities have begun to look more and more alike, particularly after the Gramm-Leach-Bliley Act (GLBA) removed statutory prohibitions on affiliations between banking, insurance, and securities firms.

In addition, while various regulatory agencies have attempted to address this fragmentation problem by entering into information sharing agreements that foster and promote interagency coordination, no formal mechanism exists for all U.S. financial services regulators to interact in a coordinated way to address issues of

295 See Gregory P. Wilson, Testimony at the Commission's Town Hall Meeting in Washington, DC (October 20, 2006).

296 See "Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure," GAO Report 05-61 (October 2004).

mutual concern.²⁹⁷ For example, no such formal agreement exists between the FRB and the SEC, arguably the two most important financial services regulators, given their oversight role of financial holding companies (FRB) and investment bank holding companies (SEC). While the Commission recognizes that there is substantial and regular informal dialogue between the FRB and SEC, it is still quite telling that these two agencies separately have formal information sharing agreements with many other regulators, including many foreign regulators, but they do not have a formal supervisory information sharing agreement with each other and depend instead on informal relationships.

The Commission believes that the time has come for the U.S. Government at the highest levels to immediately launch a program to consider, maintain, and enhance the competitive position of U.S. financial institutions in the global economy.²⁹⁸ In order to achieve this goal, the Commission recommends that the President's Working Group on Financial Markets (PWG) be assigned greater responsibility for and role in coordinating the nation's financial services regulatory and supervisory policy.

In particular, the Commission recommends that the PWG take steps to²⁹⁹

- Develop a unified, coherent vision for the financial sector and a more efficient and unified regulatory structure.
- Develop a comprehensive, forward-looking strategy for the sector and its regulation.
- Develop a set of shared values to support the vision and drive the strategy.
- Develop mechanisms and policies regarding the U.S.'s interaction with foreign markets and regulators.

²⁹⁷ The federal agencies that regulate depository institutions are all members of the Federal Financial Institutions Examination Council (FFIEC), which is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the FRB, the FDIC, the National Credit Union Administration (NCUA), the OCC, and the OTS, and to make recommendations to promote uniformity in the supervision of financial institutions. Notably, the FFIEC does not include the SEC, CFTC, or any state insurance or securities regulators.

²⁹⁸ See Wilson *supra*, note 295 at 11.

²⁹⁹ As a preliminary step, the PWG should review the reports published by high-level commissions and study groups that have recently reviewed capital markets competitiveness issues, including this report, the *Interim Report of the Committee on Capital Markets Regulation*, and *Sustaining New York's and the U.S.'s Global Financial Services Leadership*.

-
- Define the relationship between federal and state jurisdiction in different aspects of the U.S. capital markets.
 - Develop a blueprint for a modern U.S. financial services regulatory regime that will ensure that our markets remain competitive and globally attractive.

Moreover, the PWG and the financial services regulators should continuously seek to identify and remove barriers that unnecessarily impede market participants from taking advantage of new opportunities as well as identify emerging problems that might harm or undermine the interests of U.S. financial firms or U.S. investors.

The Commission recognizes that the PWG is currently not capable of achieving this new mandate.³⁰⁰ It lacks the appropriate membership and necessary resources. The PWG is currently chaired by the Secretary of the Treasury and includes the Chairs of the FRB, the SEC, and the CFTC. Thus, the President should require the PWG to involve other regulators and markets participants, including SROs, regulated institutions, investors (both institutional and retail), and state regulatory authorities. The Commission also recommends that the President and Congress ensure that the PWG has the necessary resources, including staffing and funding, to implement these new recommended mandates.³⁰¹

300 The Commission endorses similar calls for greater federal coordination of U.S. financial services policy made by the Committee on Capital Markets Regulation (which identified the PWG as “one natural venue for ensuring that such coordination takes place”) and *Sustaining New York’s and the U.S.’s Global Financial Services Leadership*.

301 Staffing for these projects should come from the existing federal and state banking, insurance, and securities regulators, which should solicit input from private sector organizations affected by financial services regulatory policy.



III. SECURITIES AND EXCHANGE COMMISSION (SEC)

The Commission's study of the U.S. legal and regulatory framework principally focused on the federal securities laws and the operations and practices of the SEC. Unquestionably, the SEC has played a significant role in protecting and preserving the vitality, strength, and integrity of our capital markets. Moreover, the SEC's historic dedication to investor protection has made the U.S. markets the investment destination of choice for investors—and issuers—around the globe.

However, given the recent advances in technology, the globalization of the markets, and increased competition from foreign capital markets, the Commission believes it is an appropriate time for the SEC to reexamine the legal and regulatory framework of our capital markets.

The discussion below begins with a brief overview of the SEC's dual mandate of investor protection and the promotion of efficiency, competition, and capital formation. In the Commission's view, this mandate for securities markets regulation has served the U.S. capital markets very well in the past and will continue to do so well into the future. Nonetheless, the Commission believes that there is strong reason, consistent with this mandate, to make meaningful modifications to the SEC's rulemaking procedures, supervisory practices, and internal structure.

A. SEC Dual Mandate

The National Securities Markets Improvement Act of 1996 (NSMIA) declares in its preamble that its purpose is “to promote efficiency and capital formation in the financial markets.”³⁰² Then, in identical language added to each of the three principal securities statutes—the Securities Act of 1933, Securities Exchange Act of 1934, and the Investment Company Act of 1940—Congress mandated that the SEC carry out responsibilities that extend beyond the protection of investors:

*Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider and determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.”*³⁰³

This language demonstrates that these broader objectives—efficiency, competition, and promotion of capital formation—have equal standing with the protection of

³⁰² Pub. L. No. 104-290 §§ 106(a)-(c) (1996).

³⁰³ *Id.*

investors. The fact that the language was inserted in all three principal securities laws emphasizes its importance.³⁰⁴

The Commission needs to attend to the equal application of these factors to every new regulation or interpretation. That is to say, the focus cannot be to simply apply the “efficiency of capital markets” standard to those regulations that appear to deal with markets and to apply investor protection to those regulations intended to principally deal with issues of investors. Instead, the equal weighting of these standards requires the SEC to consider whether market-related regulations inappropriately impact investors and whether investor protection measures inappropriately impact the efficiency of markets.

The Commission strongly endorses the equal application of each of these two standards, recognizing that too strong of a focus on either one can undermine the overall mission of the SEC. In its recommendations below, the Commission has endeavored to balance the SEC’s dual mandate.

B. SEC Rulemaking

The Commission believes that it is critical that when formulating new or reexamining existing regulations, regulators properly take into account the costs and benefits of regulation and be ever cognizant of, and address, any unnecessary and duplicative regulation. As Treasury Secretary Paulson recently stated:

*When it comes to regulation, balance is key. And striking the right balance requires us to consider the economic implications of our actions. Excessive regulation slows innovation, imposes needless costs on investors, and stifles competitiveness and job creation. At the same time, we should not engage in a regulatory race to the bottom, seeking to eliminate necessary safeguards for investors in a quest to reduce costs. The right regulatory balance should marry high standards of integrity and accountability with a strong foundation for innovation, growth, and competitiveness.*³⁰⁵

The Commission strongly agrees with Secretary Paulson’s statement, and it makes the following three broad recommendations concerning SEC rulemaking.

304 See Peter J. Wallison and Cameron D. Smith, *The Responsibility of the Securities and Exchange Commission for Efficiency, Competition and Capital Formation: Reforms for the First 1000 Days*, (presented at the Financial Services Roundtable and available at the American Enterprise Institute for Public Policy Research at http://www.aei.org/publications/pubID.23359/pub_detail.asp), at 2.

305 Treasury Secretary Henry M. Paulson, Secretary, the Department of the Treasury, Address at the Economic Club of New York: Remarks on the Competitiveness of U.S. Capital Markets (November 20, 2006) (available at <http://www.ustreas.gov/press/releases/hp174.htm>).

1. Make the Sarbanes-Oxley Act (SOX) Part of the Exchange Act

SOX introduced substantial changes to the securities laws regimen, including the positive effect of causing boards, management, and external auditors to be more thorough and attentive in fulfilling their responsibilities. However, the Commission believes that SOX inappropriately departs from the historical deference and respect accorded to the SEC to implement the securities laws through its rulemaking and supervisory practices.

The Commission believes that SOX should be more integrated with the Commission's traditional role in implementing the federal securities laws through exemption and rulemakings. For example, section 36(a) of the Securities Exchange Act of 1934 (hereafter called the Exchange Act) grants the SEC broad exemptive authority under the Exchange Act. This exemptive authority gives the SEC flexibility to quickly respond to changing market circumstances without the need to seek congressional authorization.

Although portions of SOX were imbedded into the Exchange Act, certain key sections, including Section 404, were not.³⁰⁶ For the sections not included under the Exchange Act, it is not clear whether the SEC has the authority to formulate rules in a way that tailors the provisions for different market participants. For example, some argue that the SEC and the Public Company Accounting Oversight Board (PCAOB) are limited in their ability to make tailored rules under Section 404 for small and mid-cap companies or for foreign registrants.³⁰⁷

Congress should remove doubts about the SEC's authority to tailor SOX to evolving market circumstances, through the rulemaking and exemptive processes, by formally incorporating SOX into the Exchange Act. As part of the Exchange Act, Section 404, like other requirements of SOX, would be clearly under the Exchange Act's grant of authority to the SEC to promulgate tailored rules and to grant exemptions. The Commission further recommends that once Section 404 is a part of the Exchange Act, the SEC should use its Section 36(a) authority to exempt foreign registrants from Section 404 to the extent that the SEC determines that the home country of the foreign registrant applies comparable protections to those existing under

306 See Response to SEC Release 33-8666 Seeking Comments on the Exposure Draft of the Final Report of the Advisory Committee on Small Business from James D. Cox and a group of law professors, March 22, 2006. (This letter argues that because of the disparate treatment of elements of SOX, it is significant that Section 404 was not made a part of the Exchange Act.)

307 Compare Cox Response to SEC Release 33-8666 with Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission, April 23, 2006, with Letter from Rep. Michael G. Oxley and Rep. Richard G. Baker to Chairman Christopher Cox of the SEC, March 2, 2006.

Section 404,³⁰⁸ as, for example, is the case in the United Kingdom. (As discussed in the Global Marketplace section, the Commission endorses even broader efforts to recognize in a reciprocal manner comparable legal and regulatory regimes in foreign countries.)³⁰⁹

2. Adjust the SEC Rulemaking Process

During the many meetings and discussions we held over the course of our review, the Commission repeatedly heard concerns about the SEC's use of "undertakings" in enforcement action settlements to impose requirements that suggest industry-wide application to regulated entities. These concerns were not related to instances in which the SEC required a company to engage in undertakings designed to respond to the specific situation of the company settling the case. Rather, the concerns addressed instances in which the SEC required an undertaking in a settlement agreement that itself constituted a change in the law, which was then later applied to the entire securities industry.

These types of settlement agreements have come to be viewed as having all the force of rules, applicable as "best practices," to an entire industry. This approach negates the protections and benefits of the Administrative Procedure Act of 1946, as amended (APA).³¹⁰ The APA requires the SEC to make rules and regulations by providing a public notice of the proposed rulemaking along with a detailed explanation of the proposal and an opportunity for public comment. This way, those affected by rules and regulations have an opportunity to review and comment on proposed rules before they become final, and to petition for judicial review of rules once finalized by the SEC.

The most frequently cited example of such an undertaking occurred when the SEC reached a "global settlement" with 10 securities firms that addressed potential conflicts of interest between various internal divisions of these firms.³¹¹ Under the

308 The Commission commends the SEC for its decision to publicly reassure parties that Section 404 does not apply to a company listed only on an overseas exchange but owned by a company incorporated in the United States.

309 Since 1992, banks generally have been subject to Section 404-like requirements. Specifically, Section 36 of the Federal Deposit Insurance Act requires management of an insured bank to perform an annual assessment of the effectiveness of the bank's internal control structure and procedures for financial reporting, and an independent public accountant must examine, attest to, and report separately on, management's assessment. The Commission is concerned that compliance difficulties could arise for banks that are subject to both the FDIC's and the SEC's internal control requirements. For example, the two agencies could adopt contradictory positions on interpretive issues. The Commission therefore recommends that the FDIC and SEC coordinate their activities to ensure that such contradictory positions do not occur.

310 See APA at 5 U.S.C. § 511 et seq.

311 See SEC Statement Regarding Global Settlement Related to Analyst Conflicts of Interest (April 28, 2003), available at <http://www.sec.gov/news/speech/spch042803com.htm>.

terms of the settlement, the firms agreed to undertakings, which included, among other things, separating their investment banking and research departments.³¹² Other securities firms were compelled to comply with the terms of the settlement agreement, despite the fact that these firms were not a party to the settlement agreement and that the terms of the settlement agreement were never subjected to public comment and review under the APA.³¹³

To resolve these concerns, the Commission recommends that the SEC make clear that any new, significant policies that apply to the whole industry will be vetted through the APA process.³¹⁴

In addition, taking into account the SEC's imperative in the rulemaking process of protecting investors, the Commission believes that the SEC also needs to recognize the economic and market impact of the regulatory process. Although the Commission acknowledges that the SEC spends a good deal of resources analyzing the economic impact of new regulations, the Commission recommends that the SEC expand its efforts in this area. In particular, when new regulations are required, or existing regulations are amended, the Commission believes that the SEC should thoroughly examine all possible options with a focus on their relative costs and benefits, and their overall economic impact.

To accomplish this, the Commission recommends that the SEC in its rulemaking process place an increased reliance on input from the SEC's Office of Economic Analysis and the Chief Economist.³¹⁵ The Commission also recommends the SEC consider performing an independent review of the economic impact of new, major

312 *Id.*

313 *See* Wallison at 29-30, *supra* note 304.

314 *See id.* (Another example of this trend is the settlement with Putnam Investment Management, MFS Financial, and many other entities that agreed to certain undertakings after Commission findings of unlawful market timing and late trading.) *See id.* at 32. (Another example is the policy of the Division of Market Regulation that exchanges cannot directly share more than 50% of their market data revenue with their members. This policy is not based on any provision of the Exchange Act, nor has it been embodied in any rule or regulation that was adopted by the SEC pursuant to notice and comment.)

315 The significance of conducting regulatory cost-benefit analysis received recent attention from President Bush, who on January 18, 2007, issued an Executive Order calling for increased cost-benefit analysis in the regulatory rulemaking process. While certain portions of the Executive Order do not apply directly to the SEC, certain provisions concerning cost-benefit analysis do apply to the SEC. Currently, the SEC is required to develop a regulatory plan that contains a summary of each planned significant regulatory action, including to the extent possible, alternatives to be considered and preliminary estimates of the anticipated costs and benefits. Under the new Executive Order, the SEC is now further required to include in its plan the anticipated costs and benefits of each rule as well as the SEC's best estimate of the combined aggregate costs and benefits of all its regulations planned for that calendar year to assist with identification of priorities.

regulations one to two years after enactment. This “look back” would allow the SEC to assess whether the regulation was operating as expected, and determine whether changes are needed. The pending implementation of Regulation NMS provides an excellent opportunity for this sort of “look back” analysis. To support these recommendations, the Commission calls on Congress to appropriate additional funding to the SEC to be put toward enhancing its ability to perform economic analysis.

3. Ensure Office of the Chief Accountant Complies with the APA

The Commission believes that the Office of the Chief Accountant (OCA) should address critically the application of the APA’s procedures in the establishment of financial reporting rules and policies. Many important initiatives by the OCA in recent years have been accomplished outside APA rulemaking procedures. The last significant rulemaking by the SEC in the area of accounting was the auditor independence rules.³¹⁶ That year, 2000, the SEC also issued a proposal under Item 302(c) of Regulation S-K to provide more transparency on loss accruals, valuations, and impairments.³¹⁷ Following the comment period, the SEC did not adopt the proposal. Demonstrating the benefit of the APA, the SEC responded to criticisms of the proposed rules by commentators with regard to the troublesome implications of disclosing accruals for tax and litigation.

Contrasted with this approach are the activities of the SEC in interpreting the rules of the Financial Accounting Standards Board (FASB), the primary standards-setting body in U.S. financial reporting. The FASB has a history of moving deliberately and providing opportunity for notice and comment. However, the SEC staff, led by the OCA, is free to interpret FASB standards and its own standards (*e.g.*, Regulation S-X) without following rulemaking procedures, sometimes in significant ways.

These important policy initiatives by the OCA, announced without benefit of the public APA deliberative process, can create substantial changes in financial reporting. For example, a speech before the American Institute of Certified Public Accountants (AICPA) in 2004 and a letter from the SEC Chief Accountant to the industry on February 7, 2005, concerning staff positions on lease accounting, caused a wave of restatements and material weakness in internal control over financial reporting to be disclosed in 2005. This speech constituted a reinterpretation of accounting policy that led to many restatements and citations for internal control weaknesses. This speech effectively overturned a decade of accounting with not a word changed in the relevant accounting principle.

316 Securities Act Release No. 33-7919 (Nov. 21, 2000) (“Revisions of the Commission’s Auditor Independence Requirements”).

317 Securities Act Release No. 33-7793 (Jan. 21, 2000).

Additionally, the SEC staff has issued 13 Staff Accounting Bulletins (SABs) in the last decade outside the rulemaking process. Each has had the effect of refining U.S. Generally Accepted Accounting Principles (GAAP), some more significantly than others. For example, the most recent SAB (#108) addresses the issue of determining the materiality of errors. It acknowledges long-standing practice under U.S. GAAP and informs the industry that no longer would two individual approaches be acceptable, but that the SEC staff would expect both tests to be applied and satisfied, clearly an example of a substantive change without the benefit of rulemaking. Apparently responding to concerns on implementation, the SAB included a phase-in date for the new approach.

The Commission recommends that the SEC review its approach to the setting of accounting policy to assess which actions are important policy initiatives for which the SEC should seek public comment through the APA procedures.

The Commission also believes that the SEC should review its standard for requiring restatements of company financial statements. Such restatements have become commonplace. According to the Government Accountability Office (GAO), 1,121 public companies announced 1,390 restatements between July 1, 2002, and September 20, 2005. Some of these restatements resulted from knowing or reckless misapplication of well-established accounting principles. The Commission does not object to the restatement of financial statements when clearly material errors have occurred in such situations. Such restatements are necessary to “correct the record” and inform investors of the appropriate financial condition and results of operations for the affected periods. However, as mentioned above with regard to lease accounting, other restatements appear to result from reinterpretations of existing accounting principles that would have been difficult for the companies and their auditors to anticipate.

Still other restatements result from what are viewed by company executives and securities analysts as immaterial changes, although they may meet a technical threshold for a restatement. This is evidenced by the minimal stock market movements that accompany the announcement of certain restatements. Requiring restatements for marginally material changes in accounting interpretation causes unnecessary expense and devalues the meaning of “restatement” in the market. Consideration should be given to applying any such changes on a prospective basis only, with clear disclosure about the nature and meaning of the accounting changes.

Since 1971, the Accounting Principles Board (APB) 20 has been the leading guidance on correcting errors discovered outside of the current period. Recently, the FASB replaced APB 20 with FAS 154, which contains new concepts. For 35 years, the rule was that restatement of an accounting error was necessary unless it was immaterial to both prior periods and the current period in which the error was discovered. Both APB 20 and APB 28 have indicated that the “current period” was to be an annual

metric.³¹⁸ However, some members of the SEC staff continue to assert that, instead of an annual metric, the current period should be the quarter in which the error was discovered. The result of that approach is to make an error four times as likely to require a restatement.

In 1999, the SEC staff issued the landmark Staff Accounting Bulletin (SAB) 99. Under SAB 99, even quantitatively immaterial errors would be considered material if the result of the error was to affect certain qualitative measures (*e.g.*, to change a loss to a profit, allow the company to meet analyst earnings expectations for the period, allow the company to avoid a debt covenant violation, or to change the trend of earnings). The application of SAB 99 has been one-sided in most cases. That is, qualitative factors are used to make an immaterial quantitative error into a material one, but generally they cannot be used to evaluate what might be considered initially a quantitatively material error and conclude that such error is immaterial—*e.g.*, because it did not disrupt the trend in earnings, cause a debt covenant violation, or allow the company to meet analysts' expectations, among other things. The effect of this one-sided application has been to cause more restatements.

Finally, the staff issued SAB 108 in 2006 to inform the accounting profession and public companies that their long-standing methods for calculating materiality were no longer sufficient. Historically, a company could evaluate the materiality of the results of an accounting error by using one of two techniques to accumulate and quantify misstatements. The first—the “rollover” method—quantifies misstatements based on the effect of correcting the misstatements that exist in the current year income statement, including misstatements that arose in the current year as well as the reversal or correction of the misstatements that arose in prior years. The other method, referred to as the “iron curtain” method, quantifies misstatements based on the effects of correcting the misstatements that exist in the balance sheet at the end of the current year, regardless of the misstatement's year(s) of origin. SAB 108 said that, from December 2006 onward, any accounting error would be deemed material unless a company could satisfy both tests, rather than just one test. The result will be even more restatements of financial statements.

None of these SEC interpretations and pronouncements driving the increase in company restatements came about through the APA rulemaking process, including

318 The Commission believes that the guidance in APB 28 is clear and unambiguous. Paragraph 29 of APB 28 states: “In determining materiality for the purpose of reporting the cumulative effect of an accounting change or correction of an error, amounts should be related to the estimated income for the full year and also to the effect on the trend of earnings. Changes that are material with respect to an interim period but not material with respect to the estimated income for the full fiscal year or to the trend of earnings should be separately disclosed in the interim period.” Accounting Principles Board Opinion No. 20 (1971). In other words, the analysis should be based on annual earnings with disclosure being the vehicle to explain the effect on the current interim period's results of operations resulting from the correction of the immaterial error.

advance notice and comment. Therefore, the Commission recommends that the SEC and its accounting staff reexamine the policy and purposes of requiring a restatement and adopt clear guidelines for requiring a restatement through a rulemaking process. The Commission recommends that, given the huge costs and disruptions caused by a restatement, the SEC reexamine its restatement policies with the following principles in mind:

- a. The policies should provide more guidance on performing a quantitative analysis, with a view to consider a higher quantitative threshold, before applying the “qualitative” analysis of SAB 99.
- b. The policies should address the proper treatment of the accumulation of immaterial errors, which are material only if aggregated over several accounting periods, with a view to permit either a balance sheet adjustment or an aggregate correction in the current period.
- c. The policies should require that all restatement requests by the SEC staff be approved by the SEC’s division of Corporation Finance, to ensure that the potential impact of any restatement on the markets and investors is carefully considered.
- d. In addition to existing guidelines for annual financial statements, the policies should clarify how the materiality guidelines should be applied to quarterly financial information as well as footnote disclosures and other items in filed financial statements.

C. SEC Supervisory Practices

The Commission believes that the best way to protect investors and promote efficient capital formation is for the SEC to identify, provide guidance for, and resolve issues before they become problems. Regulatory rulemaking and supervisory oversight should be conducted with the goal of achieving this objective. Proceeding with an enforcement action should, at least in part, be viewed as an indication that there was a failure to meet this objective.

The Commission strongly believes that more open communication between the SEC and SEC-regulated institutions (*e.g.*, broker-dealers, investment advisers, SROs, etc.) would improve the SEC’s understanding of current practices and issues. Effective and open communication between the regulator and the regulated is a prominent characteristic of the prudential supervisory frameworks adopted by the FSA in the United Kingdom and the federal banking regulators in the United States. The Commission believes that the SEC could achieve better communication with SEC-regulated institutions if it adopted a more prudential supervisory approach. Moreover, the pending consolidation of the NASD and the New York Stock Exchange

(NYSE) member firm regulation into a single SRO provides an excellent opportunity to implement a more prudential supervisory approach at the inception of this new SRO.

1. Benefits of Prudential Supervisory Frameworks

The FSA is a prime example of a regulator that has adopted a prudential supervisory approach to regulation. The FSA, which was first formally established in 1997, is a regulatory agency that oversees banking, insurance, securities, and the investment, building, and mutual societies sectors in the United Kingdom. London's philosophy has long been that regulatory initiatives should be contemplated only after market solutions have been exhausted. This philosophy has carried over into the modern-day FSA.

The Financial Services and Markets Act of 2000 (FSMA) empowers the FSA with a wide range of rulemaking, investigatory, and enforcement powers and certain important responsibilities, including the ability to take action to prevent market abuse and to prosecute offenders for insider dealing. The FSMA gives the FSA four statutory objectives: (i) market confidence: maintaining confidence in the financial system; (ii) public awareness: promoting public understanding of the financial system; (iii) consumer protection: securing the appropriate degree of protection for consumers; and (iv) the reduction of financial crime: reducing the extent to which it is possible for a business to be used for a purpose connected with financial crime.³¹⁹

The FSA has adopted a risk-based approach to regulation in which the FSA identifies and addresses those problems in the market that pose the greatest risk to the FSA's four main objectives. This risk-based approach is based on the theory that regulation should not seek to eliminate all possible failures and deal with all possible problems in the market because such a practice would impose prohibitive costs on both industry and consumers. To a great extent, the FSA's approach provides firms with the flexibility to decide more often for themselves what business processes and controls will better align good regulation with good business practice. This approach creates incentives for firms to focus on compliance in return for less regulatory intervention. The FSA has also opted for principles-based regulation.³²⁰

Similarly, the U.S. bank regulators have devoted significant resources to the development of a prudential supervisory framework. The Commission believes

319 FSMA §§ 3-6. See "A Single Regulator for the Financial Industry in the United Kingdom: Financial Services and Markets Act 2000," *International Capital Markets and Securities Regulation*, Ch. 37, Vol. 10B (2006, Thompson/West).

320 See remarks by Margaret Cole, Director of Enforcement, FSA, dated October 17, 2006, available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1017_mc.shtml.

that such a framework could serve as an additional model for a more prudential supervisory approach of the SEC. The most significant aspects of the prudential framework adopted by the bank regulators are the following:

- a. An open flow of information between the regulator and its regulated institutions that enables the regulator to become aware of important trends and developments within the regulated industry, including emerging risk areas that call for supervisory attention and response. In addition, the regulator is aware of best practices in the industry and may share those practices with and ensure they are instituted at other institutions.
- b. Examiners have full access to institutions, including executive management and boards of directors. The information shared in this context is protected within an examination privilege.
- c. Examiners are experts in their fields, practical, and capable of sharing insights and information about industry practices with their counterparts to determine best practice recommendations.
- d. At large complex institutions, lead examiner experts may be resident in the institution to review and understand transactions and operations, to test management's understanding of their operations and risks, to make recommendations for improvement, and, where appropriate, to take corrective actions up the chain with management and to the board of directors of the institution, if necessary.
- e. Because examiners do not automatically refer all compliance issues to the agency's enforcement division, management at institutions tends to be more open and forthcoming with examiners. Management and examiners recognize a common goal of institutional compliance.
- f. The fundamental goal of the regulator is the safety and soundness of the institutions under its regulatory jurisdiction—that these institutions operate in a prudent manner and pursuant to sound principles.

This system facilitates an open, two-way flow of information that enables the banking regulators to work with banks to identify, discuss, and resolve problems and for banks to achieve compliance without a “first resort” system for punitive enforcement actions. Although an enforcement action is always an option, a bank examiner's referral for enforcement occurs only after employees and management refuse to respond to issues that arise in the examination.

2. A More Prudential Supervisory Approach at the SEC

The Commission believes that the SEC's adoption of a more prudential supervisory approach would enhance the effectiveness of the SEC and improve industry performance. Indeed, in certain areas that is precisely what the SEC has begun to do. For example, the Federal Reserve Bank of New York (New York Fed) along with the SEC, recognizing an industry-wide global problem with the backlog of cataloguing credit derivatives, decided to take a risk mitigation approach over an enforcement approach. Instead of issuing a series of record-keeping enforcement actions, regulators brought securities firms to the table to hammer out a broad plan that would be implemented on a collective basis to resolve the problem of backlogged credit derivatives. In this case, the New York Fed and the SEC, along with other relevant domestic and international regulators and the securities industry, together identified the problem and worked together to find and implement a solution, and it was all accomplished outside of the enforcement context.

Moreover, the SEC exercised a more prudential supervisory approach when it recently issued guidance to regulated institutions concerning the elevated risk associated with complex structured finance activities.³²¹ The statement, which was issued jointly with the federal banking agencies, sought to provide regulatory guidance concerning the types of internal controls and risk management procedures that should help financial institutions identify, manage, and address the heightened legal and reputational risks that may arise from certain complex structured finance transactions. The guidance is the latest effort to discourage the types of financial dealings blamed for helping misrepresent the financial condition of Enron and other now-defunct companies.

The SEC has already made great strides to informally communicate SEC policy to SEC-regulated institutions (*e.g.*, through the issuance of no-action letters, frequently-asked-questions [FAQs], "top 10 lists" at SEC Speaks conferences, etc.). The Commission applauds and encourages these efforts.

The Commission suggests three additional steps that the SEC could take to adopt a more prudential supervisory approach:

a. Create an Ongoing Dialogue

The SEC should actively encourage the securities industry to engage in an ongoing dialogue with the SEC through direct, informal communications. Greater dialogue

³²¹ See Joint Press Release of the SEC and the Federal Banking Agencies, available at <http://www.sec.gov/news/press/2007/2007-3.htm>.

between the SEC's examination and policy teams, on the one hand, and SEC-regulated institutions, on the other hand, will enhance reliability and usefulness of information that the SEC may use to fulfill its mandate of investor protection and promotion of efficient capital markets.

This dialogue also benefits financial services firms because it provides them with the opportunity to consult on and influence the development of appropriate regulatory standards. The SEC could facilitate this dialogue by articulating its intention to utilize these communications as a two-way dialogue and providing guidance during the course of the meetings and more broadly in industry forums. The SEC should rely on this dialogue to make necessary changes to its regulatory standards as appropriate or give ongoing guidance based on current market realities.

The FSA is generally credited with having developed effective methods of communicating with its regulated institutions, including through the issuance of Industry Guidance.³²² The SEC should consider adopting these types of communication practices and formats.

b. Establish an Examination Privilege to Make Communications Confidential

Key to the process of prudential supervision is confidentiality between the regulated institution and its supervisor. Currently, banking institutions enjoy an examination privilege with respect to information shared with their regulators, and Congress recently affirmed that these institutions do not waive any privilege with respect to third parties by sharing privileged information with their regulators.³²³ The next

322 Industry Guidance is information that is developed by the industry, not the FSA, and is intended to assist firms, their staffs, and their advisers in understanding how they can meet FSA requirements. The FSA reviews Industry Guidance before its distribution and, although the Industry Guidance is not mandatory, the FSA will take the Guidance into account when exercising its regulatory functions.

323 This SEC examination privilege should be modeled on the commonly recognized bank examination privilege, which Congress recently codified into law. Although the bank examination privilege has been around for years and recognized by most courts, banking organizations had become concerned about the risk associated with legal privileges when disclosing information to federal banking agencies and the potential effect that a waiver of the privilege could have on litigation involving the institution. In response to these concerns, Congress in 2006 passed the Financial Services Regulatory Relief Act of 2006 (Pub. L. No. 109-351), Section 607 of which codified into law the bank examination privilege. Specifically, Section 607 provided that the submission by any regulated entity of any information to a federal banking agency, state bank supervisor, or foreign banking authority for any purpose in the course of any supervisory or regulatory process of the agency will not be construed as waiving, destroying, or otherwise affecting any privilege the entity may claim with respect to the information submitted as to any person or entity (*e.g.*, an opposing party in litigation) other than the agency. The statute also provided that the waiver provision may not be used to infer that the submission by an institution of information in other contexts would constitute a waiver or that a submission of information to an agency prior to enactment of the statute would constitute a waiver.

logical step is to afford these same protections to SEC-regulated institutions with respect to information shared with the SEC. Without this component, as is apparent in today's environment, institutions constantly struggle with the issue of whether to share information with the SEC. They fear triggering an immediate referral of a matter to the Enforcement Division and the possibility that the information be subsequently leaked to the press.

Accordingly, the SEC should establish in practice a discipline of protecting communications with regulated institutions while simultaneously advocating the passage by Congress of an "examination privilege" to protect against compelled disclosure associated with examiners' communications with institutions as part of the supervisory process. This privilege would be modeled on the bank examination privilege and would apply to all communications with the SEC staff in a nonenforcement context or where the institution can demonstrate a reasonable expectation that the communication should remain confidential vis-à-vis third parties.

c. Consider an On-Site Examination Program

Enhancements to the SEC's examination program could improve the amount and quality of information the SEC obtains concerning developments in the securities industry. For example, the SEC, with input from the industry, could consider establishing a pilot program in which resident examiners would be placed at select SEC-regulated institutions. Having personnel on-site in large institutions is one way in which other financial services regulators effectively monitor industry developments. An Examiner in Charge/On-Site (EIC/OS) program would enable the SEC to identify potential problems more quickly.

The SEC could also create a calendar and reporting mechanism for the EIC/OS program taking into account SEC priorities and resources. Moreover, the SEC could also establish standards for the SEC Divisions to report the results of the EIC/OS program together with specifically defined issues relating to industry concerns that can be the source of guidance provided to the remainder of the industry through speeches made by the Division Directors or the SEC Commissioners.

Information obtained through the EIC/OS program would be subject to the examination privilege and thus would remain confidential.

D. Structure of Securities Market Regulation

Since the SEC's organizational structure was first established, broad changes in the capital markets have occurred. Continuing globalization, increasing international capital flows, and the rapid development of new products and services from financial services intermediaries have created the need for the SEC to reassess its internal

structure for purposes of ensuring that the SEC remains responsive, efficient, and the preeminent capital markets regulator.³²⁴

Based on these considerations, the Commission recommends that the SEC consider the following concepts:

1. The rule-interpretation functions that occur in SEC examinations should be better aligned with the rule-development functions that occur in the SEC Divisions, and the SEC should endeavor to avoid conflicting Office of Compliance, Inspections, and Examinations (OCIE) and Divisional interpretations of regulatory requirements, priorities, and expectations.
2. As the developed world moves toward international harmonization of securities regulatory (including investor protection) standards, the SEC must ensure that it is well-positioned to take a leadership role in helping to formulate those new standards.
3. The Commission recommends that the SEC consider aligning its internal organizational structure to mirror the contours of the current capital markets.

1. Office of Compliance Inspections and Examinations (OCIE)

In its deliberations, meetings, and public hearings, the Commission heard sufficient criticism to warrant further consideration about the lack of communication between OCIE and the other SEC Divisions, particularly the Divisions of Market Regulation and Investment Management. This lack of communication creates a serious disconnect between the SEC Divisions that establish policy (*i.e.*, Market Regulation and Investment Management) and OCIE, which surveils for compliance with that policy at SEC-regulated institutions. The oversight of policy implementation requires a great deal of judgment and necessarily results in policy formulation. Given the significant separation of Market Regulation and Investment Management from OCIE, this leads to the unfortunate result of OCIE making policy on a case-by-case basis, separate from the policy-making expertise within the SEC Divisions.

³²⁴ During the course of its work, the Commission heard from several groups of current and former SEC Commissioners, Division Directors, and other current and former members of the SEC staff, each of whom provided a variety of observations for improving SEC operations and functions. The common or principal themes expressed by these individuals were (i) the need for greater communication and coordination between the policy-making divisions and the Office of Compliance Inspections and Examinations; (ii) greater emphasis on issues raised by the internationalization of the capital markets; and (iii) the need for structural change within the SEC to better align the SEC's operations with industry structure and practice.

In addition, the Commission heard that OCIE oftentimes refers its findings directly to the Enforcement Division without consulting with the other SEC Divisions. Those referrals cause industry problems ranging from interpretive issues to communication barriers—after all, how many questions will you ask examiners if you know the inquiry may prompt an enforcement action? This leads to another Commission concern about OCIE—that its staff communicates poorly with the management and compliance personnel of SEC-regulated institutions. Another common criticism of OCIE is that its examination “sweeps” often seem to go on endlessly with no indication from the SEC concerning whether or not OCIE has reached any conclusions.

Recently, the SEC has taken affirmative steps to address some of these concerns and criticisms. For example, OCIE has moved toward risk-based examinations, identifying high-risk activity and focusing its limited resources on those activities presenting the highest risk to investors. In addition, SEC Chairman Cox testified before the House Committee on Financial Services in May 2006 regarding reforms he has encouraged, which include (i) advance notification to the SEC Commissioners of sweep examinations; (ii) an intensified preexamination planning process to minimize duplicative and disruptive examinations; (iii) notification to registrants if examinations have not been closed within 120 days of the reviews’ field-work portions; and (iv) reaffirmation of a long-standing policy that OCIE notify registrants with letters either identifying compliance problems or announcing examinations’ conclusions with no acknowledged compliance risks. The Commission supports these and other efforts and commends Chairman Cox and the SEC for taking the initiative in these areas.

Although Chairman Cox is moving in the right direction, what is needed are structural reforms to address the communication breakdowns between OCIE and the Operating Division. Specifically, the rule-interpretation functions that occur in SEC examinations should be better aligned with the rule-development functions that occur in the SEC Divisions. One way to do this would be to fold OCIE’s functions back into the SEC’s other operating divisions. Returning OCIE’s inspection and examination authority to the operating divisions—*i.e.*, Investment Management and Market Regulation—would place these crucial functions back within the divisions that oversee these aspects of the securities markets. A return to this pre-1995 structure would enhance the SEC’s ability to focus its resources on companies that are not in compliance with federal securities laws by allowing examiners to operate under the expertise of the Commission staff directly responsible for these companies. The SEC has the authority to effect this change under its existing statutory authority.³²⁵

325 See note 330 *infra*. See also 17 C.F.R. § 200.30-18 (SEC rule effecting original delegation of authority to OCIE).

2. International Affairs

The past several years have seen a dramatic increase in the linkages between U.S. and foreign exchanges. The most dramatic of these linkages is the planned merger of Euronext N.V., which owns five European exchanges, and the NYSE Group Inc., which owns the New York Stock Exchange. In anticipation of this merger, the SEC in January 2007 entered into a memorandum of understanding (MOU) with the College of Euronext Regulators to facilitate cooperation in market oversight.³²⁶ Demonstrating the SEC's resolve in this area, Chairman Cox recently stated: "Our capital markets and our trading markets have long been global, but this pending combination is a sign that the trend is accelerating. The SEC and the Euronext College of Regulators, based on extensive collaboration and consultation, are well prepared to undertake the cross-border regulatory responsibilities to which this combination will give rise."³²⁷ This MOU signals the commitment of these regulatory bodies toward cooperation and collaboration to promote investor protection, foster market integrity, maintain investor confidence, and maintain systemic stability in connection with the regulation of the combined group. The Commission commends the SEC and its European counterparts on this effort.

Other linkages between U.S. and international exchanges are in the works. The Nasdaq currently owns 38% of the London Stock Exchange (LSE) and has made no secret of its desire to acquire the remaining outstanding shares. The NYSE recently bought 5% of India's largest stock exchange, the National Stock Exchange. And, in February 2007, the Tokyo Stock Exchange and New York Stock Exchange announced that they would sign a new cooperative alliance.

Taken together, these developments signal that the world's capital markets will become even more integrated in the next few years and that the structure of exchanges and trading platforms will be completely rebuilt. These linkages present serious structural, supervisory, and legal issues and have substantial consequences for existing investor protection regimes. The Commission believes that the SEC must be on the forefront of these developments. International harmonization of regulatory standards (including investor protection) is on the horizon, and the SEC must ensure that it is well-positioned to take a leadership role in helping to formulate those new standards.

326 The authorities making up the College of Euronext Regulators are the Authority for the Financial Markets (AFM), Netherlands; Autorité des Marchés Financiers (AMF), France; Banking Finance and Insurance Commission (CBFA), Belgium; Comissão do Mercado de Valores Mobiliários (CMVM), Portugal; and Financial Services Authority (FSA), United Kingdom.

327 See SEC Press Release 2007-21 (February 14, 2007).

Moreover, as markets generally become more global in nature, the opportunity for and prevalence of cross-border fraud has increased significantly. To combat this rising tide, the SEC determined to coordinate more with its international counterparts, which eventually led to the International Organization of Securities Commissions (IOSCO) Multilateral Memorandum of Understanding to combat cross-border fraud. The MOU serves to eliminate impediments to obtaining information and evidence located outside our national boundaries. Since it was finalized in 2002, the MOU has been of crucial importance in a number of multinational investigations, including the fraud involving Italian dairy giant Parmalat.³²⁸ The Commission commends the SEC and other IOSCO members on this joint effort.

The Commission recommends that the SEC step up its profile as a global leader in addressing international developments. One way to do this would be to vest the Office of International Affairs with Divisional authority, stature, and—most important—resources, *i.e.*, more funding and staffing. This move will signify the importance of international capital markets and reaffirm the SEC's titular role in guiding the growth of liquid, transparent, and well-regulated global capital markets and relationships with foreign securities markets, regulators, and policy-makers.

3. Division Structure

Over the last several decades, the shape of the financial services and securities industries, the products offered to investors, and the types and categories of investors have changed. There are several factors influencing this ongoing process. For example, individual and institutional investors continue to demand access to increasingly complex products and services. Some take advantage of investments in foreign securities or indices. Some hedge risks. Some diversify existing holdings. Whatever the form, these products and services have evolved in response to various economic factors that are not necessarily reflected in any historical legal or regulatory structure. In particular, the Commission is concerned that the SEC divisional structure has not sufficiently adapted over the years to reflect these major developments.

To keep pace with these changes and to better meet its roles of protecting investors and fostering the capital markets, the SEC should consider realigning its internal organizational structure to mirror the contours of the current capital markets. For example, one thoughtful suggestion is that the SEC consider reallocating the

328 See Remarks by Ethopis Tafara, Director, Office of International Affairs, SEC, before the International Institute for Securities Market Development (April 18, 2005), available at <http://www.sec.gov/news/speech/spch041805et.htm>.

responsibilities of the divisions of Market Regulation and Investment Management into three new divisions along the following lines:

- 1. Division of Market Professionals.** This division would be responsible for the regulation of broker-dealers, investment advisers, and investment companies. Currently, regulation of these types of entities is split between the Divisions of Market Regulation and Investment Management.
- 2. Division of Markets and Exchanges.** This division would be responsible for the regulation of market structure, including all exchanges and the institutions that facilitate those markets (*e.g.*, national securities exchanges, national securities associations, and self-regulatory organizations having jurisdiction over exchange activity and clearing corporations).³²⁹
- 3. Division of Securities Products.** This division would be responsible for the regulation of securities products, including standardized options, exchange traded funds, and derivative and hybrid products, as well as pooled products like mutual funds, common trust funds, commodity pools, etc.

Restructuring the divisions in this manner may more accurately reflect the structure and functions of the modern securities market and could lead to improved SEC regulation. The SEC has the ability to restructure its divisions under its current statutory authority, so no action by Congress would be necessary.³³⁰

329 In January 2007, the SEC issued preliminary approval for the proposal of the NYSE and the NASD to consolidate their member regulation functions in a new self-regulatory organization (SRO). The new SRO will be responsible for all member examination, enforcement, mediation, and arbitration, while NYSE Regulation will continue to regulate the New York Stock Exchange and NYSE Arca trading markets and to oversee listed company compliance. The Commission fully supports this consolidation and commends the SEC for its preliminary approval of the proposal.

330 The SEC's reorganizational authority stems from a combination of several of its discrete grants of authority. *See* 15 U.S.C. § 78w(a)(1) (2004) ("The Commission...shall each have power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this chapter [2B Securities Exchanges] for which [it is] responsible or for the execution of the functions vested in [the Commission] by this chapter..."); 15 U.S.C. § 78d (2004); 5 U.S.C. App. (2004); *see also* 5 U.S.C. § 4802(b) ("The [Securities and Exchange] Commission may appoint and fix the compensation of such officers, attorneys, economists, examiners and other employees as may be necessary for carrying out its functions under the securities laws as defined under section 3 of the Securities Exchange Act.") 15 U.S.C. § 78d-1 (2004). (The Commission delegates its authority through its Rules of Organization and Program Management (*see, e.g.*, 17 CFR § 200.30-1, *et. seq.*))



IV. JURISDICTION OF TRADING FUTURES ON SECURITIES

In the United States today, our commodity markets are regulated by the CFTC while our securities markets are regulated by the SEC. In the past, separate regulation of the securities and the futures markets was useful because the two markets operated in dramatically different fashions and only rarely interacted. Equities and bond issuance and trading were subject to one regulatory system and futures trading to another. At the time the separate regulation was developed, this made sense because most futures contracts covered commodities and foodstuffs rather than government securities, equities, and currencies. Today the opposite is true.

Unlike the United States, most of the rest of the world already views all types of financial instruments as deserving a common regulatory scheme. This approach not only appears preferable for market users but it is also a much more efficient use of government resources. If the New York Stock Exchange merges with

Euronext, including the UK-based Liffe, it will become an important derivatives exchange. The international regulation of that new entity would be greatly simplified if on the U.S. side securities activities and financial futures and derivatives contracts were regulated by a single regulator.



A distinguished panel of Commissioners and experts discuss the challenges facing the financial services industry at a town hall meeting.

The Commission recognizes the wisdom of having a single regulatory and supervisory framework for the securities markets and the commodities markets. However, the Commission also is mindful of the historical underpinnings of the bifurcated system in this country. And the Commission is cognizant of the criticisms against simply merging the functions of the SEC and the CFTC into

a single agency. For example, agricultural groups, including farmers and ranchers, which often use the commodities markets to hedge their risk, fear that their interests will become secondary to the interests of securities firms in a combined agency dominated by securities issues.

However, given the internationalization of the securities and commodities markets and the need to keep the U.S. markets competitive, the Commission believes that some regulatory realignment among the jurisdictions of the SEC and the CFTC is both warranted and reasonable. Accordingly, the Commission recommends that Congress enact legislation that transfers from the CFTC to the SEC sole regulatory and supervisory authority over trading of futures on securities, including single

securities and securities indexes. Currently, these products are subject to a mix of SEC and CFTC regulation.³³¹ Consolidating regulatory responsibility for these products will result in more streamlined regulatory oversight and will reduce the cost of complying with multiple schemes. Under this recommendation, the CFTC would retain jurisdiction over commodity futures. The Commission cautions that the interests of the commodities market participants must be preserved in order for this recommendation to be successfully implemented.

³³¹ Currently, the SEC and the CFTC share jurisdiction over security futures products, which include single stock futures and futures on narrow stock indexes, while futures on broad-based security indexes are subject to the sole jurisdiction of the CFTC.



V. STRENGTHENED SELF-REGULATORY REGIME THROUGH ESTABLISHMENT OF A FEDERAL SELF-EVALUATION PRIVILEGE

In a regulatory and business environment that emphasizes corporate accountability and reform, corporate officers and directors are becoming more aggressive in establishing proactive compliance programs, managing risk, and ferreting out weak systems, problems with control environments, and employee misconduct. Like their counterparts across other industries, officers and directors in SEC-regulated institutions are focusing on compliance obligations, assessments of operations and products, and disclosures to regulators made on a timely basis.

In their efforts to determine whether sufficiently strong controls exist or whether compliance mandates within their institutions have been adequately carried out, SEC-regulated institutions often perform self-evaluations—ideally, a process by which the institution performs a critical, candid, and probing look into its operations. The purpose of the evaluation is to identify and assess areas of risk, to detect weaknesses, to investigate actual malfeasance, and to identify employee misconduct.

Ideally, these self-evaluations should result in a candid report to management and should contain frank reflections on such things as processes, procedures, and management depth. SEC-regulated institutions would then be able to improve their compliance programs and better meet the mandates of the regulatory obligations they face. They would be able to strengthen controls and fight internal fraud. However, self-evaluations performed under today's civil litigation evidentiary rules are likely to be subject to discovery in a civil suit. Because the self-evaluation could potentially serve as a litigation road map for the plaintiffs' bar, SEC-regulated institutions are wary of producing or even commencing complete and thorough self-evaluations. Moreover, management is hesitant to engage in frank discussions with the company's outside auditors. The problem is compounded by the fact that self-evaluations that unearth compliance problems must be reported to the SEC, which oftentimes leads to press accounts and leaks to plaintiff lawyers. An institution that had been attempting to improve its compliance controls then finds itself in the position of defending a lawsuit.

In order to enhance the incentives associated with performing self-evaluations, the Commission recommends that Congress establish a federal self-evaluation privilege for SEC-regulated institutions and for communications in that context with their independent audit firm. Candid self-evaluations of the operations of SEC-regulated institutions are an essential tool for improving corporate governance in the securities industry. Self-evaluations must not be chilled and inhibited by fears of the plaintiff's bar—they should be protected through the availability of a separate, stand-alone “self-evaluation privilege” for these institutions and their independent audit firms.

Existing privileges are inadequate to meaningfully protect information produced in the self-evaluative process. For example, protections afforded by the attorney-client communications privilege and attorney work-product privilege are limited because they apply only to advice on legal matters provided by legal counsel. Oftentimes the

self-evaluation process does not involve attorneys, and even if attorneys participate in the process the analysis may not be covered by the established privilege. Although to date some courts have recognized a generally applicable self-evaluation privilege, most courts have generally declined to recognize the privilege or have created exceptions for the instant cases.³³² However, the concept of the self-evaluation privilege is experiencing a growing body of precedent in both the common law and statutory law.³³³

Additionally, a privilege that encouraged candid self-evaluations, when combined with a Commission-proposed SEC examination privilege, would provide SEC-regulated institutions with the opportunity to discuss concerns with the SEC in an open fashion in order to resolve the issues in an appropriate and timely manner.

The Commission recommends that the self-evaluation privilege be used by SEC-regulated institutions for internal review activities conducted on an “as-needed” basis, such as when responding to a crisis, or if a concern was raised outside the ordinary course of business, or during checks on controls of a company. The existence of the privilege, coupled with the examination privilege, would encourage regulated financial institutions to be candid with themselves, their auditors, and the SEC. By that same token, if an institution’s self-evaluation uncovered information regarding a compliance problem that should be reported to the SEC, and the institution did not share this information with the SEC, the self-evaluation privilege would not be available.

332 See Memorandum at 4-5, *Davis v. Kraft Foods North America*, No. 03-6060 (E.D. Penn. Nov. 30, 2006) (citing cases from the D.C. Circuit upholding the privilege; cases from the 7th, 9th, and 5th Circuits declining to recognize the privilege; and cases from the 4th Circuit refusing to apply the privilege).

333 See, e.g., *McClain v. Mack Trucks, Inc.*, 85 F.R.D. 53 (E.D. Penn. 1979); La. R.S. 6:284.1 (2006) (establishing a self-evaluation privilege for banks); N.D. Cent. Code § 6-13 (2006) (establishing a self-evaluation privilege for financial institutions).



VI. OPTIONAL FEDERAL INSURANCE CHARTER

The Commission recommends that Congress adopt legislation establishing a federal insurance charter. Although reforming the regulation of the insurance industry has been a topic of debate for decades, the discussion has gained new urgency within the last several years as a result of dramatic changes within the insurance market.



John Bachmann, senior partner of Edward Jones, listens as the Commission debates an optional federal insurance charter.

Of all the primary actors in the financial services industry, insurance companies are unique in that they are not regulated on the federal level, but by the 50 separate states. Insurance companies must be chartered by each individual state, and new products must go through state-specific product approval and licensing processes, which are frequently prolonged for years. The significant costs imposed by the current state-by-state regulation include higher compliance costs because of non-uniform regulations and multiple enforcement requirements; complex corporate structures needed to accommodate unique regulatory regimes; delayed implementation of new products and pricing changes due to multistate delays; and less competition due to entry, exit, price, and product approval barriers in numerous states.³³⁴ Although the system's inefficiencies have been noted, insurance companies and insurance commissioners for many years found the benefits of state-by-state regulation—including a closer relationship between local insurance companies and state regulators—to outweigh the costs, and there was therefore little momentum for reform.

However, recent shifts in the insurance market have made the inefficiencies more apparent and costly and have driven the push for reform. First, with the passage of the Gramm-Leach-Bliley Act, the decisions of the Supreme Court in *Nations Bank of N.C., N.A. v. Variable Annuity Life Insurance Co.*³³⁵ and *Barnett Bank of Marion County, N.A. v. Nelson*³³⁶ and the issuance of numerous interpretive rulings and letters by the OCC, banks have entered the insurance market without being subject to the same state regulatory requirements as insurance

³³⁴ Craig Berrington, "An Option Federal Charter: A Remedy for America's Antiquated Insurance Regulatory System," *Legal Backgrounder*, April 4, 2003.

³³⁵ *Nations Bank of N.C., N.A. v. Variable Annuity Life Insurance Co.*, 513 U.S. 251 (1995). (A unanimous court upheld the Comptroller of Currency's grant to national banks of the right to sell annuities.)

³³⁶ *Barnett Bank of Marion County, N.A. v. Nelson*, 517 U.S. 25 (1996). (A unanimous court held that federal legislation authorizing banks to sell insurance in small towns preempted contrary state law.)

companies.³³⁷ It is now apparent that insurers face a severe competitive disadvantage vis-à-vis banks as a result of the burdens of the current insurance regulatory system.³³⁸ Second, the globalization of insurance along with the financial services market as a whole has changed the dynamic of the insurance industry. “U.S. insurers wishing to operate on the world stage do not want to be hampered by restrictive regulation that their foreign competitors do not face.”³³⁹

The Commission supports the efforts currently under way to establish an optional federal insurance charter. The National Insurance Act of 2006—seeking to establish an optional federal charter for life insurance and property/casualty insurers—was introduced in both the Senate and the House of Representatives in 2006, and likely will be reintroduced in the new Congress.³⁴⁰ The elements of the proposal include the following:

1. Establishing in the Department of the Treasury an Office of National Insurance (ONI).
2. Requiring the ONI to supervise National Insurers and National Agencies, including chartering and licensing; also removing them from state oversight of insurance business practices and exempting them from state regulation, except as expressly provided in this Act. It prohibits states from preventing or restricting National Insurers from engaging in specified insurance business practices.
3. Authorizing the ONI to provide for the organization, operation, and regulation of National Insurance Companies and National Insurance Agencies.
4. Providing for conversion of State Insurers to National Insurers or State Insurance Agencies to National Agencies, and vice versa.
5. Applying federal antitrust laws to National Insurers, National Agencies, and federally licensed insurance producers, except regarding standard insurance policy forms.

337 Danielle F. Waterfield, “Insurers Jump on Train for Federal Insurance Regulation: Is it Really What They Want or Need?” 9 CONN. INS. L.J. 283, 292-5 (2003).

338 *Id.* at 298.

339 *Id.* at 307.

340 Senate Bill S. 2509, introduced on April 5, 2006, by Sens. John Sununu (R-N.H.) and Tim Johnson (D-S.D.) and House Bill H.R. 6225, introduced by Rep. Ed Royce (R-Calif.) on September 28, 2006.

Several additional elements are designed to respond to critics' fears that the option of a federal charter would make regulation of insurance brokers cumbersome and would limit abilities of states to levy guaranty monies, including the following:

1. Authorizing the ONI to supervise, regulate, and provide for registration of insurance self-regulatory organizations.
2. Requiring National Insurers to join guaranty associations in each state, which may levy assessments on them for purposes of insolvency protection.
3. Subjecting National Insurers and National Agencies to state taxation.

The proposed optional federal charter will provide insurance companies with a regulatory option that allows them to avoid many of the costs and inefficiencies of a state-by-state system, increase competitiveness within the insurance market and reduce costs for consumers, and provide insurance companies a launch-point from which they may compete more readily in the global market.

VII. CONCLUSION

The strength of the U.S. capital markets depends upon a financial services regulatory system that focuses on both investor protection and the promotion of efficiency, competition, and capital formation. The recommendations of the Commission outlined above are designed to further these dual goals in a rapidly evolving and globalizing environment. Moreover, the recommendations are intended to help the United States maintain its status as the premier financial center in the world—both for companies seeking a premium on their stock and for investors seeking a safe and profitable forum for investment.



REPORT CONCLUSION

The findings of this Commission are unambiguous—the competitive position of the U.S. capital markets is declining in the context of heightened competition from international financial centers and a U.S. legal and regulatory system whose basic framework was established more than 70 years ago.

To better protect investors and foster capital formation, the Commission believes that the United States must seriously reconsider some of the systems, institutions, regulations, and business practices built over the past 70 years that govern our capital markets. Among the Commissioners' key recommendations are the following:

- Reform and modernize the federal government's regulatory approach to financial markets and market participants
- Enact legislation that expressly incorporates the SOX into the Securities Exchange Act of 1934, giving the SEC greater flexibility in implementing SOX
- Convince public companies to stop issuing earnings guidance or, alternatively, move away from quarterly guidance with one earnings per share (EPS) number to annual guidance with a range of EPS numbers.
- Call on domestic and international policy-makers to address serious challenges facing the public company audit profession
- Facilitate the ability of employers of 21 or more employees without any retirement plan to offer retirement savings plans by connecting employers to financial institutions
- Encourage employers to sponsor retirement plans through the introduction of a simpler, consolidated 401(k)-type program

The Commission believes that quick and decisive adjustments to the U.S. legal and regulatory framework will significantly improve the health and competitiveness of the U.S. capital markets, creating greater wealth and prosperity for American businesses and investors.

To learn more about the Commission, visit www.CapitalMarketsCommission.com. To join the fight to protect the competitiveness of America's capital markets, visit www.uschamber.com or call 202-463-5500.



APPENDIX 1: COMMISSIONER BIOGRAPHIES

ARTHUR B. CULVAHOUSE, JR.

Co-Chair, Commission on the Regulation of U.S. Capital Markets in the 21st Century
Chairman, O'Melveny & Myers LLP

Arthur B. Culvahouse Jr. is the chair of O'Melveny & Myers LLP, an international law firm of more than 1,000 lawyers with offices in Beijing, Brussels, Century City, Hong Kong, London, Los Angeles, Newport Beach, New York, San Francisco, Shanghai, Silicon Valley, Tokyo, and Washington, DC. Culvahouse has practiced law with O'Melveny & Myers from 1976 to 1984, and from 1989 to the present. In addition to his executive duties as chair of the firm, Culvahouse has an active corporate governance, transactions, enforcement, internal investigations and compliance, and strategic counseling practice.

From March 1987 through January 1989, Culvahouse served as counsel to the President of the United States. As White House Counsel, he advised President Ronald Reagan on matters ranging from the Iran-Contra investigations to the Supreme Court nominations of Robert Bork and Anthony Kennedy, and to the legal aspects of the Intermediate-range Nuclear Forces Treaty. He also chaired the Inter-Agency Lawyers Committee on War Powers and the President's Committee on Federal Judicial Nominations. In January 1989, President Reagan awarded Culvahouse the Presidential Citizens' Medal, an award established in 1969 to "recognize citizens who performed exemplary deeds of service for the country or their fellow citizens."

From 1990 through 1992, he served as a member of the Federal Advisory Committee on Nuclear Failsafe and Risk Reduction, appointed by the Secretary of Defense, to evaluate and recommend improvements in the United States Nuclear Command and Control System. In December of 1992, Secretary of Defense Cheney awarded Culvahouse the Defense Medal for Distinguished Public Service. His prior service on boards and commissions includes service on the Supreme Court Fellows Commission, the board of visitors of the U.S. Naval Academy, and the Counterintelligence Advisory Panel to the U.S. Senate Select Committee on Intelligence.

Culvahouse is a member of the President's Foreign Intelligence Advisory Board, appointed by President Bush in October 2005. He also serves as a member of the board of trustees of the Brookings Institution and The U.S. Chamber of Commerce Commission on the Regulation of U.S. Capital Markets in the 21st Century.

Culvahouse earned a B.S. in 1970 from the University of Tennessee and a J.D. in 1973 from New York University Law School.

WILLIAM M. “BILL” DALEY

Co-Chair, Commission on the Regulation of U.S. Capital Markets in the 21st Century

Vice Chairman, JPMorgan Chase & Co.

William M. “Bill” Daley is vice chairman of JPMorgan Chase & Co. He represents the firm at the most senior level to clients and is the senior executive for the Midwest region across businesses. He also serves on the firm’s executive committee and on its International Council.

Daley joined JPMorgan Chase in May 2004, after serving as president of SBC Communications for three years. In 2000, he coordinated the effort for permanent Normal Trade Relations with China and chaired Vice President Al Gore’s presidential campaign.

Daley served as U.S. Secretary of Commerce under President Clinton from 1997 to 2000, overseeing a department of more than 40,000 people. As special counsel to President Clinton in 1993, Daley coordinated the successful campaign to pass the North American Free Trade Agreement (NAFTA).

Prior to his distinguished career in public service, he was a partner at the law firm of Mayer, Brown & Platt; president and chief operating officer of Amalgamated Bank of Chicago; and a lawyer at the firm of Daley and George.

Daley serves on the boards of directors of Abbott Laboratories, Boston Properties, Inc., The Art Institute of Chicago, and Loyola University. He also sits on the Council on Foreign Relations.

Daley earned an LL.B. from John Marshall Law School and a B.A. from Loyola University in Chicago.

JOHN W. BACHMANN**Senior Partner, Edward Jones**

John W. Bachmann, senior partner of Edward Jones, grew up in Salem, Illinois. He earned a bachelor's degree in economics from Wabash College in Crawfordsville, Indiana, and a master's in finance from Northwestern University in Evanston, Illinois. Bachmann is also a graduate of the Institute of Investment Banking at the University of Pennsylvania's Wharton School of Business, and the recipient of an honorary doctor of laws from Wabash College and an honorary doctor of arts from the University of Missouri-St. Louis.

Bachmann began his career at Edward Jones as a part-time college intern in 1959. Upon completion of his formal education, he joined the firm full time. Beginning in 1963, Bachmann spent seven years as a retail investment representative in Columbia, Missouri, and in 1970 returned to St. Louis as a general principal with responsibility for fixed-income product marketing. He later gained experience in strategic planning, corporate finance, and technology.

In 1980, Bachmann succeeded Edward D. "Ted" Jones, Jr., as managing partner of Edward Jones. Since then, he has built upon Mr. Jones' philosophy of serving the needs of individual investors from one-investment-representative offices located in communities throughout the United States and Canada. This includes using technology in a way that directly benefits, yet is transparent to, individual investors. During Bachmann's tenure, Edward Jones grew from 200 offices in 28 states to 8,700 offices throughout the United States and, through its affiliates, in Canada and the United Kingdom. In 1994, the firm's Canadian affiliate, Edward Jones Canada, opened its first office. Today, the firm has more than 550 Canadian offices. In 1998, the firm furthered its expansion efforts, opening offices in the United Kingdom under the name of Edward Jones Limited.

Bachmann served two terms as chairman of the Securities Industry Association in 1987 and 1988, a time of great turbulence because of the October 1987 stock market crash. He was active on the U.S. Steering Committee for the Group of 30, an international group that examines global financial issues, and chaired a task force for the implementation of clearance and settlement reform in the U.S. securities markets. Bachmann has been a member of the board of governors of the Chicago Stock Exchange and has served on the Regional Firms Advisory Board of the New York Stock Exchange. He has served as chairman of District 4 for the National Association of Securities Dealers. He also served as a member of the board of directors of Trans World Airlines from 1996 – 2001. Bachmann's current board memberships include AMR Corporation; American Airlines, Inc; Monsanto Company; and National Association of Securities Dealers, Inc.

JOHN A. BOHN
Chairman, Globalnet Venture Partners

John A. Bohn currently serves as a commissioner of the California Public Utilities Commission (CPUC). He was appointed by Governor Schwarzenegger in May 2005 for a six-year term.

In addition to his duties at the CPUC, Bohn serves as a director of the National Endowment for Democracy in Washington, DC, and is on the advisory board of the Yale Institute for Corporate Governance and Performance. He also serves as trustee of Northern Trust Multi-Advisor Fund, and is a member of the commission to reform the capital market for the 21st Century, the Capital Markets Reform Commission, chartered by the U.S. Chamber of Commerce, to re-evaluate the operation of U.S. capital markets in light of globalization. Bohn is a principal in GlobalNet Partners, N.A., LLC, a global advisory and consulting firm.

Prior to his present position, Bohn was a co-founder and executive chairman of CheMatch.com (now Chemconnect), an Internet-based trading exchange for petrochemicals. He spent 1-1/2 years at Burson-Marsteller, where he served as managing director, focusing on international markets and economic resources issues, and was special advisor to the Government of Korea during the Asian financial crisis. From 1989-1996, Bohn served as president and chief executive officer of Moody's Investors Service.

In 1981, Bohn joined the Reagan Administration as special assistant to Treasury Secretary Don Regan, and was subsequently appointed by President Reagan as U.S. ambassador and executive director of the Asian Development Bank. In 1984, President Reagan appointed Bohn to the post of vice chairman of the Export Import Bank of the United States, and later as chairman and chief executive officer.

Bohn began his career practicing law, and subsequently spent 13 years as an international banker with Wells Fargo, which included 4-1/2 years in Tokyo, with responsibility for the bank's Asian activities. Later, he served as division manager for trade finance, private banking, and multinational banking.

As a graduate with honors from Stanford University, Bohn attended the London School of Economics as a Fulbright scholar, and earned a J.D. from the Harvard Law School. He is a member of the California State Bar and the Bar of the Supreme Court of the United States.

JAMES E. “JIM” COPELAND, JR.
Retired Chief Executive Officer, Deloitte & Touche USA LLP

James E. “Jim” Copeland, Jr., retired as chief executive officer of Deloitte & Touche USA LLP (Deloitte & Touche USA) and its global parent, Deloitte Touche Tohmatsu (Deloitte), on May 31, 2003.

During his tenure, Copeland guided Deloitte through a period of the greatest revenue growth in the firm’s history and oversaw the move to the second-largest professional services organization in the world. He also led the task force to define and articulate the Deloitte & Touche USA culture, which contributed to the organization becoming recognized as one of FORTUNE magazine’s “100 Best Companies to Work For” each year from 1998 through 2003. Copeland also received recognition for further advancing Deloitte & Touche USA’s Women’s Initiative and helped to lead the profession in the appointment of women to partner-level positions.

Copeland currently serves as senior fellow for corporate governance with the U.S. Chamber of Commerce, global scholar at Georgia State University’s Robinson School of Business, and as a member of the board of directors for Coca-Cola Enterprises, ConocoPhillips, Time Warner Cable, and Equifax, Inc. Additionally, he is chairman of the audit committee and on the executive committee at both Equifax and ConocoPhillips, chairman of the audit committee at Time Warner Cable, and is chairman of the compensation committee at Coca-Cola Enterprises.

He currently serves on the board of trustees of Georgia Research Alliance and as a board member of the Voices for Georgia’s Children. Previously, he served as an international councilor of the Center for Strategic and International Studies, and on the board of directors of The September 11th Fund, the New York City Partnership, and the U.S.-Japan Business Council, as well as serving on the board of trustees of the Woodruff Arts Center in Atlanta. Copeland was a member of the Business Council of the World Economic Forum and has been a member of the Society of International Business Fellows since 1983.

Copeland is a graduate of Georgia State University, and joined a predecessor of Deloitte & Touche USA in 1967. He became a partner in 1977 and assumed increasing levels of management responsibility, ultimately serving as vice chairman and regional managing partner. In 1992, he was selected as vice-chairman. The organization’s U.S. partners elected him to serve as national managing partner in November 1994. He was elected to the positions of CEO of Deloitte & Touche USA and CEO of Deloitte in 1999.

Jim and Patricia, married since 1968, are both Georgia natives. They have two sons, Trip and David, four grandsons, and one granddaughter.

CHRISTINE EDWARDS**Partner, Winston & Strawn**

Christine Edwards is a partner in Winston & Strawn's corporate practice group. Edwards focuses on the regulation of the financial services industry—particularly the securities and banking industries—as well as corporate governance and public and regulatory policy issues.

Edwards provides proactive counsel to clients on corporate governance, public company boards of director issues, banking and securities industry regulation, consumer banking and securities transactions, and privacy and identity theft matters. She also has extensive experience supervising complex internal investigations and regulatory defense matters.

Prior to joining the firm in 2003, Edwards was executive vice president and chief legal officer at Bank One Corporation, one of the nation's largest bank holding companies. She was in charge of Bank One's 500-person legal, compliance, government relations, and regulatory management department, with responsibility for the bank's worldwide legal and compliance needs. Previously, Edwards served as chief legal officer for various financial services firms, including Morgan Stanley and ABN AMRO, North America.

Edwards is active in a number of community and professional organizations. She is a member of the board of directors for the Chicago Finance Exchange, the board of trustees and the audit committee of Rush University Medical Center, and the board of visitors of the University of Maryland Law School. She previously served on the board of trustees of Ravinia Festival (2000-2003). Her current professional affiliations include the American Bar Association, Business Law Section, Committee of Corporate General Counsel; Maryland Bar Association; Chicago Finance Exchange; The New York Stock Exchange, Legal Advisory Committee; The Economic Club of Chicago, Executive Membership Committee; The Chicago Network; Chicago Council on Foreign Relations; and U.S. Chamber of Commerce: Capital Markets Commission. She previously served as a member of the advisory group for Law Department of the 21st Century, a member of Women in Housing and Finance (Washington, DC), and a member of the planning committee for The Corporate Counsel Institute of Northwestern University School of Law, 41st Annual Corporate Counsel Institute (2002 and 2003).

Edwards earned a B.A. in English and education in 1974 from the University of Maryland (College Park) and a J.D., with honors, from the University of Maryland School of Law (Baltimore) in 1983.

PETER M. GILBERT**Chief Investment Officer, Pennsylvania State Employees' Retirement System**

Peter M. Gilbert has been the chief investment officer of the Commonwealth of Pennsylvania's \$32 billion State Employees' Retirement System (SERS) since February 1993.

Under Gilbert's direction, SERS has earned a reputation as an innovative and top-performing pension fund. SERS was recognized in part for its widely diversified portfolio, which, under his direction, includes private equity, venture capital, real estate, hedge funds, and commodities, in addition to more traditional U.S. and international public equity and fixed-income investments.

At present, Gilbert is serving as a member of the U.S. Chamber of Commerce Commission on the Regulation of U.S. Capital Markets in the 21st Century, an independent bipartisan commission created to address the need for changes in the regulation of U.S. public markets.

Gilbert has been active in promoting good corporate governance practices at public corporations primarily through his involvement with several organizations. He has been a member of the Council of Institutional Investors (CII) since 1987. He is currently a member of CII's board of directors and a member of its policies committee.

Gilbert served as co-chair of a joint task force of the CII and National Association of Corporate Directors. Gilbert served as a member of The Conference Board's "Blue Ribbon" Commission on Public Trust and Private Enterprise.

Gilbert has been repeatedly honored for his work as SERS CIO. Most recently, in December, 2006, he was selected by Money Management Letter to receive its Lifetime Achievement Award "for his work on corporate governance and for being on the cutting edge of investing." In 2005, Gilbert was named the winner of the Institutional Investor Award for Excellence in Investment Management, recognizing him for "outstanding achievement" among public pension fund managers. He also is the recipient of the Richard L. Stoddard Award, presented by the National Association of State Investment Officers in October 2004, in recognition of "his outstanding contributions to the investment of public funds," and the Institute for Fiduciary Education (IFE) CIO of the Year Award in 1997.

Gilbert earned his M.S. from Columbia University and his B.A. from Wesleyan University. A member of the American Alpine Club, he is also a triathlete and three-time Ironman finisher. He and his wife, Linda, live in Carlisle, PA.

MELLODY HOBSON

President, Ariel Capital Management, LLC

Melody Hobson is president of Ariel Capital Management, LLC—a Chicago-based investment management firm founded in 1983. With over \$16 billion in assets under management, the firm serves individual investors and 401(k) plans through its no-load Ariel Mutual Funds and manages separate accounts for institutional clients. As president, Hobson is responsible for firmwide management and strategic planning, overseeing all operations of Ariel's business outside of research and portfolio management. Last fall, she was elected chairman of the Ariel Mutual Funds Board of Trustees. She joined the company in 1991 after graduating from Princeton University where she earned a B.A. degree from the Woodrow Wilson School of International Relations and Public Policy.

Hobson has become a nationally recognized voice on financial literacy and investor education. Specifically, she is a regular financial contributor on ABC's *Good Morning America* as well as a spokesperson for the annual Ariel/Schwab Black Investor Survey, which examines the influences and investing habits of black and white Americans. She is actively involved with a variety of civic and professional institutions. Hobson's community outreach includes her role as a board member of the Chicago Public Education Fund, the Sundance Institute, and the Chicago Public Library as well as its foundation, the Field Museum. She is also a director of three public companies: DreamWorks Animation SKG, Inc., The Estée Lauder Companies Inc., and Starbucks Corporation. Additionally, Hobson is on the board of governors of the Investment Company Institute, a term member of the New York Council on Foreign Relations, and a former trustee of Princeton University. She is a member of the Economic Club of Chicago, the Commercial Club of Chicago, and the Young President's Organization.

Hobson's professional and civic leadership have brought her to the forefront of media attention. In 2004, *The Wall Street Journal* profiled her as one of 50 "Women to Watch" in the corporate world. In 2004, Time magazine identified her as one of 25 business influentials setting the global standards for management, ethics, marketing, and innovation. In 2002, *Esquire* magazine named Hobson one of "America's Best and Brightest" emerging leaders. In 2001, the World Economic Forum in Davos, Switzerland, named her a Global Leader of Tomorrow, and *Fortune* magazine recognized her as one of 25 "Next-Generation Global Leaders."

JAMES A. JOHNSON
Vice Chairman, Perseus, LLC

James A. Johnson is vice chairman of Perseus, LLC, a merchant banking and private equity firm. Beginning in January 1990, and continuing through December 1999, he was employed by Fannie Mae. He served as vice chairman in 1990, chairman and chief executive officer from 1991 through 1998, and chairman of the executive committee in 1999. Prior to joining Fannie Mae, Johnson was a managing director in corporate finance at Lehman Brothers. Before joining Lehman, he was the president of Public Strategies, a Washington-based consulting firm he founded to advise corporations on strategic issues. From 1977 to 1981, he served as executive assistant to Vice President Walter F. Mondale, where he advised the Vice President on domestic and foreign policy and political matters. Earlier, he was employed by the Target Corporation, worked as a staff member in the U.S. Senate, and was on the faculty at Princeton University.

Johnson served as chairman of The John F. Kennedy Center for the Performing Arts and is former chairman of the board of trustees of The Brookings Institution. He also serves on the board of the following organizations: The Goldman Sachs Group, Inc.; KB Home; Target Corporation; Temple-Inland, Inc.; and UnitedHealth Group. He is a member of the Council on Foreign Relations, the National Museum of African American History and Culture, and the Trilateral Commission. He also serves as a member of the visiting committee to the John F. Kennedy School of Government at Harvard University. In March 1994, Johnson was named “CEO of the Year” by The George Washington University School of Business and Public Management. He also was named a 1998 “Washingtonian of the Year” by Washingtonian Magazine. In May 2001, he was elected to the American Academy of Arts and Sciences. In 2006, he was the recipient of the National Hispanic Heritage Vision Award.

Johnson earned a B.A. in political science from the University of Minnesota and a master’s in public policy from the Woodrow Wilson School at Princeton University. Johnson has received honorary degrees from Augsburg College, Colby College, Howard University, Skidmore College, and the University of Minnesota.

MICKEY KANTOR

Partner, Mayer, Brown, Rowe & Maw LLP

Mickey Kantor, formerly secretary of commerce and United States trade representative, is a partner in Mayer, Brown, Rowe & Maw LLP, an international law firm headquartered in Chicago. Kantor represents companies in corporate and financial transactions on a worldwide basis. He is based in the firm's Washington, DC, office.

Kantor serves as a member of the board of directors of CB Richard Ellis. He also serves on the advisory board to ING Americas. He is a member of the international advisory board of Fleishman Hillard and the advisory board of Oilspace. He serves as a senior advisor to Morgan Stanley and is a member of the board of visitors for Georgetown University Law Center.

Kantor joined President Clinton's first cabinet on January 21, 1993, as the United States trade representative. He was the president's chief advisor on international trade policy.

Kantor was sworn in as the 31st United States secretary of commerce on April 12, 1996. As secretary of commerce, Kantor carried forward President Clinton's mandate to provide economic opportunity for American workers and businesses. At the helm of the Department of Commerce, Kantor worked to generate new jobs through increased exports and expanded markets abroad, to create a strong civilian technology infrastructure to promote sustainable development, to spur entrepreneurship, to stimulate the economic development of distressed communities throughout the nation, and, through the regular reporting of vital statistical information, economic data, and census data, to assist the private sector in keeping America strong and competitive.

Kantor served as national chair for the Clinton/Gore '92 Campaign and as a member of the transitional board of directors. He has a long history of public service, including membership on the Christopher Commission, which was formed in the aftermath of the Rodney King beating in Los Angeles. Kantor also has served as consultant to the American Bar Association Special Committee on Crime Prevention and Control, the White House Conference on Children, and the National Legal Aid and Defender Association.

Kantor earned a bachelor's degree from Vanderbilt University in 1961. After four years of service as a naval officer, he went on to study law at the Georgetown University Law Center and earned his degree in 1968.

ERIC MINDICH
Chief Executive Officer, Eton Park Capital

Eric Mindich is chief executive officer of Eton Park, a global, multidisciplinary, team-oriented investment organization dedicated to delivering superior risk-adjusted returns over multiyear periods. The firm has offices in New York, London, and Hong Kong.

Prior to forming Eton Park in 2004, Mindich spent 15 years at Goldman Sachs in two main roles: leading the firm's equities arbitrage business, and managing the firm's equities division. Mindich joined the firm in 1988 in the Equities Arbitrage Department and ran that department from 1992 until 2000. In 1994, at age 27, he became the youngest partner ever in the history of Goldman Sachs. In 2000, Mindich became co-chief operating officer of the Equities Division and in 2002 became co-head of the Equities Division and a member of the Goldman Sachs Management Committee. In 2003, he joined the executive office as senior strategy officer and chair of the Firmwide Strategy Committee.

Mindich serves as a trustee of The Mount Sinai Medical Center, Inc., and as a board member of Lincoln Center Theater, the Whitney Museum of American Art, and The Horace Mann School. He served as a director of the Harvard Management Company from 1996 to 2004.

Mindich graduated from Harvard College in 1988 with a B.A. in Economics, *summa cum laude*, and was elected to Phi Beta Kappa. He resides in New York City with his wife, Stacey, and their three sons.

RICHARD H. MURRAY
Managing Director and Chief Claims Strategist, Swiss Re

Richard H. Murray is managing director and chief claims strategist of Swiss Re in New York and Zurich.

Murray is currently on the supervisory board of the Centre for the Study of Financial Innovation; on the advisory board of Oxford Analytica; on the advisory board of the Northeast Business Law Center; a member of the Commission on the Regulation of U.S. Capital Markets in the 21st Century, the Institute for Law Reform and Global Forum Shopping Task Force, all organized by the U.S. Chambers of Commerce; and a member of the Republican Presidential Roundtable. He has been a member of Lloyd's of London from 1989 to 1994; the British Insurance Association from 1989 to 1994; the Risk and Insurance Management Society from 1985 to 1989; director of the executive committee and lecturer at the Institute of Management Development in Switzerland from 1984 to 1993; and a member of APEP, the Institute of International Insurance. Murray earned his bachelor's degree from Harvard University in 1958 and his law degree from Harvard Law School in 1961.

Previously, Murray has served as the global director of legal and regulatory affairs for Deloitte Touche Tohmatsu and as general counsel of Deloitte Consulting from 1994 to 2002; chairman and chief executive officer of Minet Professional Services in London from 1989 to 1994; executive director of Touche Ross International in New York from 1986 to 1989; general counsel of Touche Ross from 1973 to 1986; and partner and head of the litigation department of Oppenheimer Law Firm in St. Paul/Minneapolis from 1961 to 1973.

Murray writes and speaks frequently on matters involving legal liability, professional responsibility, corporate governance, and the information requirements of the capital markets.

DON NICKLES**Chairman and Chief Executive Officer, The Nickles Group**

Don Nickles is a seasoned and important voice on American politics and the national agenda. This four-term U.S. senator (now retired) is a superb and experienced presenter who brings a sound conservative perspective on economic growth, social issues, and the political landscape. After being steeped in the ways of Washington and the world for decades, Nickles retired from the Senate in 2005 and formed The Nickles Group, a lobbying firm.

Nickles was elected to the United States Senate in 1980 at age 31 (the youngest Republican ever elected to the Senate) and served the state of Oklahoma and the nation for 24 years. He was a key member of the Senate Republican Leadership for more than a decade, serving as chairman of the Republican Senatorial Committee, chairman of the Republican Policy Committee, and as the assistant Republican leader from 1996 to 2002. Nickles was chairman of the powerful Senate Budget Committee during his last two years in the Senate and was a senior member of both the Senate Finance Committee and the Energy and Natural Resources Committee.

Nickles built a legacy of advancing free-enterprise causes throughout his Senate career, from natural gas deregulation and the repeal of the windfall profits tax in the 1980s, to the repeal of onerous ergonomics regulation and the fight against federalized health care during the Clinton administration. He was the author of the Congressional Review Act and the Child Citizenship Act, and the principal sponsor of the president's economic growth package in 2003, which cut capital gains taxes and dividend rates. He developed a reputation as an effective negotiator able to form bipartisan coalitions.

After graduating from college, Nickles served six years in the U.S. National Guard. He worked as vice president and general manager of Nickles Machine Corporation and then served as a state senator in Oklahoma from 1978 until his election to the U.S. Senate in 1980.

ROBERT C. “BOB” POZEN
Chairman, MFS Investment Management

Robert C. “Bob” Pozen is chairman of MFS Investment Management®, which manages approximately \$187 billion in assets for over five million investors worldwide.

During 2002 and 2003, Pozen was the John Olin Visiting Professor at Harvard Law School, teaching interdisciplinary courses focused on corporate governance and financial institutions. He is currently a senior lecturer at the MIT Sloan School and also serves on the Dean’s Advisory Council there.

In late 2001 and 2002, Pozen served on President Bush’s Commission to Strengthen Social Security. More recently, his proposal to restore solvency to Social Security, known as progressive indexing, has been publicly embraced by President Bush. In 2003, he served as secretary of economic affairs for Massachusetts Governor Mitt Romney.

Pozen was formerly vice chairman of Fidelity Investments and president of Fidelity Management & Research Company. From 1987 to 1996, Pozen was managing director and general counsel of Fidelity Investments. Before joining Fidelity, Pozen was a partner at the Washington, DC, law firm of Caplin & Drysdale, where he led the banking/securities department for five years. From 1978 to 1980, he was associate general counsel to the Securities & Exchange Commission and was a law professor at New York University from 1974 through 1977.

Pozen is an outside director of Medtronic, Inc., and Bell Canada Enterprises. He is involved in various nonprofit organizations and is also a fellow of the American Academy of Arts and Sciences. Pozen has published literature on a wide variety of subjects, including the first textbook comparing the regulation of banks to other financial institutions and the main textbook on the mutual fund business. He has also published articles on labor statistics, health care, and hedge funds.

Born in 1946, Pozen earned a B.A. degree from Harvard College in 1968. He graduated summa cum laude and Phi Beta Kappa and was awarded a Knox Traveling Fellowship. In 1972 and 1973, Pozen received a law degree as well as a J.S.D. for a book on state enterprises in Africa from Yale Law School, where he served on the editorial board of the Yale Law Journal.

Pozen lives in Boston, Massachusetts, with his wife, Liz, a psychotherapist and figurative artist.

MICHAEL RYAN**Executive Director, Commission on the Regulation of the U.S. Capital Markets in the 21st Century**

Michael Ryan is executive director of the U.S. Chamber of Commerce's Commission on the Regulation of U.S. Capital Markets in the 21st Century, a bipartisan, independent commission charged with considering the appropriate legal and regulatory framework for modernizing the U.S. capital markets and studying the impact of federal and state regulations on U.S. capital markets, investors, and the economy.

Previously, Ryan was executive vice president, general counsel, and a member of the Office of the Chairman of the American Stock Exchange, which he joined in November 1998. Ryan was responsible for all aspects of the legal functions at the American Stock Exchange and, along with the chairman, chief executive officer, and president, assisted in management of day-to-day operations.

Between April 1997 and November 1998, Ryan served as counsel to the chairman of the National Association of Securities Dealers, Inc. (NASD), where he reported to Chairman & CEO Frank G. Zarb. Prior to joining the NASD, Ryan spent four years at the U.S. Securities and Exchange Commission in the Divisions of Market Regulation and Corporation Finance. Starting in September 1985 and continuing through July 1988, Ryan worked as a senior accountant with Price Waterhouse & Co.

Ryan earned his J.D. from the Catholic University School of Law in 1991 and his B.S. in Accountancy from Villanova University in 1985. Ryan is a member of the bar in Maryland and a certified public accountant. Ryan has also served on the board of directors of the Options Clearing Corporation and on the board of directors of the Children's Neurobiological Solutions Foundation.

Ryan resides in Bethesda, Maryland, with his wife, Lynne Adduci Ryan, their daughter, Claire, and son, Matthew.



APPENDIX 2: ACKNOWLEDGMENTS

Over the past year, the work of the Commission has benefited greatly from the input, cooperation, and guidance of many individuals and organizations. Commissioners and staff met with Executive Branch and congressional officials; current and former SEC officials, including chairman, commissioners, and former division directors; representatives from financial services firms; and representatives from trade associations. In addition, the Commission engaged and sought the expertise of industry practitioners, including market professionals, accountants, lawyers, economists, and academics. The Commission would like to express its sincere gratitude to all of these individuals and their organizations for their time and assistance.

In particular, the Commission would like to thank the following organizations for making available their staff and information resources:

American Enterprise Institute, American Institute of Certified Public Accountants (AICPA), Angel Enterprises, The Brookings Institution, Center for the Study of Financial Innovation (CSFI), Competition Policy Associates (COMPASS), Financial Services Roundtable, Gibson, Dunn & Crutcher LLP, Investment Company Institute (ICI), Managed Funds Association (MFA), Mayer, Brown, Rowe & Maw LLP, NASD, NASDAQ, New York Stock Exchange, O'Melveny & Myers LLP, Securities Industry and Financial Markets Association (SIFMA), Swiss Re, The Institute of Chartered Accountants in England & Wales, Venable LLP, and Winston & Strawn LLP.

Special acknowledgment is owed to the following individuals who made substantial contributions to ensuring successful completion of this project or participated in the “town hall” meetings held in Chicago, New York, San Francisco, and Washington, DC, which greatly contributed to the Commission’s review and analysis:

James Angel (Associate Professor of Finance, McDonough School of Business at Georgetown University), Steve Bartlett (President and Chief Executive Officer, The Financial Services Roundtable), Jack Bogle (Founder and Former Chief Executive Officer, The Vanguard Group), Robert Bunting (Former Chairman, American Institute of Certified Public Accountants), David C. Chavern (Chief Operating Officer and Senior Vice President, U.S. Chamber of Commerce), Clay Corbus (Co-Chief Executive Officer, WR Hambrecht + Co), John Court, (Associate, Winston & Strawn LLP), Jim Doty (Partner, Baker Botts), Amanda Engstrom (Executive Director, Investment & Growth Initiative, U.S. Chamber of Commerce), Lewis Ferguson III (General Counsel, Public Company Accounting Oversight Board), Karen Friedman (Policy Director, Pension Rights Center), Peter Henry (Associate Professor of Economics, Stanford University Graduate School of Business), Shelley S. Hymes (Founder and President, Angel Enterprises), Jonathan Jachym, William R. Kinney, Jr. (Professor, University of Texas), David F. Kroenlein (Partner, Winston & Strawn LLP), Barry Mathews (Deputy Chairman, Aon Professional Risks), Rebecca McEnally (Senior Director, Capital Markets Policy, CFA Centre for Financial Market Integrity), Joe Muscat (Partner,

Strategic Growth Markets, Ernst & Young LLP), Edward Nusbaum (Chief Executive Officer and Executive Partner, Grant Thornton LLP), Kathryn A. Oberly (Vice Chair, Americas and General Counsel, Ernst & Young LLP), Peter Orszag (Senior Fellow, The Brookings Institution), Zoe-Vonna Palmrose (Deputy Chief Accountant for Professional Practice, U.S. Securities & Exchange Commission), Andrew Persson (Director, Investment & Growth Initiative, U.S. Chamber of Commerce), Harvey Pitt (Chief Executive Officer, Kalorama Partners, LLC), Jay Ritter (Cordell Professor of Finance, University of Florida), Dallas Salisbury (President and Chief Executive Officer, Employee Benefit Research Institute), Amar Sarwal (General Litigation Counsel, National Chamber Litigation Center), Serena G. Simons (Venable LLP), Francesca Soria (Associate, Winston & Strawn LLP), Andy Stern (President, Service Employees International Union), John A. Turner, John Villa (Partner, Williams & Connolly LLP), Martha Jo Wagner (Partner, Venable LLP), Peter Wallison (Senior Fellow, American Enterprise Institute), Julie Williams (First Senior Deputy Comptroller and Chief Counsel, United States Department of the Treasury), Gregory Wilson (President, Gregory P. Wilson Consulting), and Christie Wood (Senior Investment Officer for Global Equity, California Public Employees' Retirement System).

Finally, the Commission would like to express special appreciation for the time, effort, and counsel of Robert K. Steel and Richard H. Walker. Robert K. Steel, retired vice chairman of Goldman Sachs & Co., began as co-chair of the Commission and stepped down to become Under Secretary for Domestic Finance, United States Department of the Treasury. Richard H. Walker, General Counsel, Deutsche Bank AG, began as a Commissioner and stepped down for personal reasons.



APPENDIX 3: SUMMARY OF FULL RECOMMENDATIONS

I. U.S. Capital Markets in the Global Marketplace

1. Accounting and Auditing Standards

a. Continued Convergence—Accounting

- i. The Commission supports and encourages the efforts currently under way by the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) to converge International Financial Reporting Standards (IFRS) and U.S. Generally Accepted Accounting Principles (GAAP). Recognizing that IFRS are principles-based standards, the Commission recommends that foreign regulators give full consideration to the positions of their international counterparts regarding application and enforcement of IFRS, and seriously work to avoid conflicting conclusions, such as the divergent standards applicable to derivatives.
- ii. At the same time, the Commission acknowledges and respects the authority of IFRS countries to sort out an agreeable method for interpreting IFRS principles. The Securities and Exchange Commission (SEC) should not involve itself unnecessarily in this process. In this regard, the Commission applauds recent public statements by the SEC Director of Corporate Finance that the SEC does not intend to become the arbiter of IFRS, and it encourages the SEC to apply faithfully the interpretations of the International Financial Reporting Interpretations Committee (IFRIC) of IFRS and to defer to home country regulators, when appropriate, in reviewing financial statements filed by foreign private issuers under IFRS.
- iii. In addition, the Commission would further encourage the SEC to continue and redouble its efforts to work within the International Organization of Securities Commissions (IOSCO) toward the convergence of international disclosure standards, particularly with respect to financial disclosure. Modifying home country disclosure to comply with similar, but different, SEC standards merely adds costs for foreign private issuers.

b. Continued Convergence—Auditing

- i. The Commission also recommends that the SEC and the Public Company Accounting Oversight Board (PCAOB) work with their international counterparts and the International Auditing and Assurance Standards Board (ISAAB) toward global convergence

of U.S. and international auditing standards. The Commission strongly believes that it is imperative that international convergence of accounting standards be accompanied by convergence of audit standards.

- ii. The Commission believes that U.S. and international regulators and standards-setting bodies should accomplish accounting and auditing convergence within five years.

c. Elimination of the Reconciliation Requirement

- i. The Commission recommends that the SEC immediately consider an alternative approach for eliminating the reconciliation requirement. Specifically, the Commission proposes that the SEC establish a process by which it could, on a case-by-case basis, determine that a foreign country's accounting standards are sufficiently equivalent to U.S. GAAP. These foreign companies from that jurisdiction would not be required to reconcile their financial statements with U.S. GAAP for SEC financial reporting purposes. The foreign country would be required to provide reciprocity for U.S. companies.
2. The Commission recommends that the SEC improve the cross-border access of (i) U.S. investors to foreign securities and (ii) U.S. issuers to foreign capital. To achieve these goals, the Commission recommends that the SEC give serious consideration to a form of "substantial compliance" that would provide access to U.S. markets to foreign exchanges and foreign broker-dealers with comparable home-country regulation for U.S. securities regulation, provided that the foreign jurisdiction provides reciprocal treatment for U.S. exchanges and broker-dealers.
 3. This Commission recommends that Congress call upon the SEC to undertake a comprehensive study of state and federal securities litigation, including civil and criminal cases brought by governmental agencies, to determine whether a proper balance is in place between investor protection and capital formation, including whether the Private Securities Litigation Reform Act (PSLRA) is achieving the objectives set forth by Congress. The Commission also recommends that this study contain an analysis of the PSLRA's impact on the effectiveness of the federal securities laws, including the impact of post-PSLRA litigation on the dual objectives of protecting investors and promoting capital formation, to assess whether the current securities litigation environment strikes the right balance between these objectives. The

Commission believes that time is of the essence for this study, because its subject is so important to the global competitiveness of our capital markets as well as to the continued viability of the public company auditing profession.

II. Accumulated Savings and Investor Education

1. To encourage employment-based retirement savings plan sponsorship, the Commission makes the following recommendations:
 - a. The Commission believes that the number of different plan designs and the complexity of those designs deter employers from adopting any type of retirement savings plans. The Commission therefore recommends that Congress consider legislation that would reconcile and simplify plan design and administration by, for example, creating a single defined contribution plan design, possibly for both public and private sector employers.
 - b. A multiple employer plan is a single plan in which a number of unrelated employers, such as members of an association, voluntarily participate (and is not to be confused with a multiemployer plan in which participation is the result of collective bargaining). The Commission believes that multiple employer plans can be beneficial for employees of participating employers because such plans can facilitate benefit portability. The Commission also believes that such plans are particularly desirable for small employers because of the “back-office” cost efficiencies they can offer. The Commission therefore recommends that Congress consider legislation that would facilitate both defined benefit and defined contribution multiple employer plans by, for example, reducing the risks currently associated with participation in such a plan for employers.
2. To maximize the positive use of inertia, the Commission recommends that Congress consider legislation that would require, rather than merely permit, the following presumptive rules and default features in defined contribution plans and that would provide employees with an opt-out of each presumption or default:
 - a. Automatic participation of eligible employees (including a one-time enrollment of current employees);
 - b. Use of appropriate default investment alternatives, including, for example life-cycle, target retirement, asset allocation, and balanced funds;

-
- c. Automatic escalation of employee contributions over time (for example, from 3% to 6% in 1% annual increments, but no more than 10%, as in the Pension Protection Act of 2006 401(k) safe harbor); and
 - d. Automatic transfers of lump-sum distributions to individual retirement accounts (IRAs) upon a job change or retirement.
 3. To encourage retirement savings through automatic payroll deduction, the Commission makes the following recommendations:
 - a. The Commission recommends that Congress consider legislation establishing tax-favored savings accounts for employees of employers with 21 or more employees who do not sponsor a retirement savings plan of any type. This legislation would require such employers to collect employee contributions (through payroll deduction) and transmit those contributions to designated financial institutions that establish and administer the arrangements. The automatic enrollment and default investment presumptions that the Commission recommends be applicable to defined contribution plans (as described above) would be applicable to the arrangements, as would the employee opt-out options. Employer costs and ongoing responsibilities would be minimal. For example, employer responsibilities would be limited to choosing a sound financial institution, monitoring the continued soundness of that institution, and transmitting employee contributions in a timely manner. The recipient financial institutions would have the remaining fiduciary obligations. Employer-sponsored plans could be protected by, for example, permitting only a lower contribution or benefit level in the automatic payroll deduction arrangements.
 - b. The Commission recommends studying the needs of employers with a very small number of employees (less than 21) to ascertain how best to provide a payroll deduction retirement savings opportunity for their employees in an efficient manner that will not be burdensome to such small employers.
 4. To promote investor education, advice, and reporting, the Commission makes the following recommendations:
 - a. The Commission believes that, in a retirement savings system dominated by individual accounts, financial literacy is essential if such a system is to be successful. Therefore, the Commission recommends that the appropriate education authorities consider modifying the basic curriculum of elementary and secondary schools and adult education

programs to incorporate financial education utilizing model financial curricula that have been proven effective.

- b. The Commission believes that to successfully meet the needs of diverse ethnic and cultural groups, programs of financial education may need to consider differences in familiarity with and trust in everyday financial institutions. Therefore the Commission recommends that the appropriate interest groups consider promoting studies on how to better reach diverse groups with financial information and advice. The Commission also recommends that such groups consider promoting better understanding of currently available government-provided benefits and the use of the Internet for financial education.
 - c. The Commission believes that financial information is often too complicated and confusing for the average investor. The Commission therefore recommends that mutual fund investment advice be provided in a more user-friendly standardized format that allows employees to easily compare investment option risks, returns, fees, and other costs. The standardized format should allow incorporation of other documents, such as an applicable prospectus, by reference, and should provide a safe harbor from litigation. The Commission also recommends providing asset allocation information in a simplified form. Finally, the Commission recommends that, because significant assets are held in IRAs but little data are available on how those assets are invested, Congress consider legislation requiring minimally burdensome reporting of IRA data by financial institutions.
5. The Commission believes that the ultimate goal of retirement income policy is to promote adequate income throughout retirement. Annuitization and phased withdrawals provide valuable mechanisms for spreading retirement savings at sustainable levels. The Commission recommends that all tax-favored account-based retirement plans offer two presumptive investments at retirement: a reasonably priced employment-based group annuity; and a mutual fund type of investment that provides phased withdrawals at levels intended to be for the life of the employee and the employee's spouse. During initial enrollment, an employee would choose one of the two presumptive investments and the employee could, at retirement, keep the elected presumptive investment, elect the other presumptive investment, or elect any other available investment option. The Commission recommends that Congress facilitate the availability of group annuities for nonemployment-related groups, and that Treasury be encouraged to issue long maturity inflation-protection securities.

III. Issuers and Auditors

Earnings Guidance

1. To reduce undue management focus on short-term results, the Commission recommends that all public companies permanently eliminate the practice of providing quarterly earnings guidance and that companies instead provide shareholders and Wall Street with meaningful additional information on their long-term business strategies. If corporate managers are concerned that the potential harm from ceasing quarterly guidance may outweigh the likely benefits, even after reviewing the data summarized in this report, the Commission recommends that these managers alternatively could provide annual guidance with a range of earnings rather than quarterly guidance with earnings projections to the penny.

Federal Prosecution of Business Organizations

2. The Commission believes that the Department of Justice should not request waiver of attorney-client privilege and work-product protection from business organizations under the threat of indictment or other enforcement action. Specifically, the Commission believes that waiver should not be considered as a cooperation credit factor in the decision of whether to indict the organization. The Commission believes that the McNulty Memorandum's approach to the waiver issue leaves corporate counsel, and those they advise, unsure of the extent to which communications will be kept confidential, thereby chilling frank discussion. The Commission endorses the ongoing efforts to prohibit the Department of Justice or any other federal agency (including the SEC) from considering waiver as a cooperation credit factor.
3. The Commission believes that the Department of Justice should reassess the circumstances under which vicarious criminal liability for corporations is appropriate and should provide additional guidance to corporations on the proactive efforts they may undertake to avoid vicarious criminal liability. The Commission supports criminal actions brought against the individual employees of a corporation if they can be shown to be responsible for perpetrating the crime.
4. The Commission believes that the Department of Justice should not base charging decisions on whether a corporation advances counsel fees to its executives. On the whole, the Commission believes that the McNulty Memorandum adequately addresses the Commission's concerns about this issue; however, the private sector should closely monitor the practices of the Department of Justice in this area.

Securities Litigation

5. The Commission recommends that Congress enact legislation formally establishing a selective waiver that would permit a private party voluntarily to share privileged information or documents with the SEC, subject to a confidentiality agreement without waiving the privilege with respect to private litigants. Consistent with its recommendations concerning the federal prosecution of business organizations (see above III.2.), the Commission believes that federal agencies (including the SEC) should not request or attempt to compel a business organization to waive privilege.
6. The Commission supports the bright-line test adopted in the Second Circuit under which professional services firms (including audit firms) may be found primarily liable for securities fraud under SEC Rule 10b-5 only if they actually make a material misstatement or omission. In addition, the Commission supports the rejection by the Eighth Circuit of “scheme liability” under SEC Rule 10b-5. The Commission advocates the adoption of these two standards by all Circuits or the Supreme Court and recommends that the SEC actively support the adoption of these standards.
7. The Commission recommends that the SEC clarify that amounts investors receive from an established Fair Fund should offset the amount that investors are awarded in damages as a result of private securities litigation covering substantially similar claims. Similarly, the SEC should consider amounts already awarded to a class in a settlement or case resolution when determining a Fair Fund payout to any investor on substantially similar claims.

Auditors

8. The independent auditing firms play a critical role in our capital markets by providing reasonable assurance regarding the financial statements of public companies. Thus, the Commission believes that sustaining a strong, economically viable public company audit profession is vital to domestic and global capital markets. Investors, public companies, and the global markets depend on the assurance provided by auditors and would suffer significant harm if that audit function disappeared. The viability of the audit function is threatened by various factors, including the following.
 - a. Unrealistic expectations about the precision of financial statements as well as the inherent limits on an auditor’s ability to detect collusive frauds.
 - b. Criminal indictment of audit firms (rather than responsible audit partners), even if ultimately followed by exoneration.

-
- c. Catastrophic litigation claims in a market in which commercial insurance simply is not available to the firms in adequate amounts to cover such claims.
 - d. Multijurisdictional regulation and enforcement activities that pose a barrier to interstate and global service.
 9. In recent years, the audit firms have taken significant steps to address their own performance-related problems and Congress has established new regulatory oversight by the PCAOB that will continue to assist in that effort (as evidenced by the Board's inspection reports). Nevertheless, the firms face several serious threats to their continued ability to provide their critical audit function. To address these threats, the Commission recommends the following steps be taken:
 - a. Public companies, audit firms, the SEC, PCAOB, and other financial services regulators and policy-makers should take affirmative steps toward closing the "expectations gap"—that is, work to establish realistic public expectations about the degree of precision inherent in financial statements and constraints on those auditing these statements.
 - b. The Department of Justice should revise the McNulty Memorandum to address the special considerations relating to the consequences of criminally indicting an audit firm (*i.e.*, the overarching public policy concern that a criminal indictment of a Big Four firm would have severe consequences for public company clients of that firm and for the U.S. economy).
 - c. The Commission recognizes that addressing the risk of catastrophic loss is complicated and that many of the proposals offered are politically charged. Given the significant public policy ramifications in the event of a catastrophic loss of a large public company audit firm, the Commission calls on domestic and international market participants and policy-makers to engage immediately in a serious evaluation and discussion of possible means to address this risk of catastrophic loss, including this Commission's recommendation regarding backup insurance sponsored by G-8 governments or international financial organizations, and various proposals of others regarding safe harbors or damage limits in specified circumstances.
 - d. The SEC should work with the U.S. Department of the Treasury to place the issue of developing a framework for support of multinational accounting firms on the agenda of the G-8. This framework could take many forms,

including backup insurance sponsored by G-8 countries or international financial organizations.

- e. Congress should consider enacting legislation to create the option of a federal charter for no more than 10 to 15 of the largest national audit firms, which would include the ability of audit firms with federal charters to raise capital from shareholders other than audit partners of such firms (subject to addressing relevant concerns about audit independence and potential conflicts of interest).
10. The Commission believes that audit firms and their clients should be encouraged to explore arbitration and other alternative dispute resolution (ADR) agreements as a way of managing the costs of civil liability and audit practice protection. Both parties to these agreements can benefit from the decrease in possible future litigation costs.

IV. Financial Services

1. To address U.S. competitiveness within global capital markets and to take into account the extent to which international regulatory structure affects the U.S. regulatory model, the Commission recommends greater coordination of U.S. financial services regulatory policy. As a first step, the Commission recommends that the president enhance the role of the President's Working Group on Financial Markets (PWG) by calling on the PWG to increase coordination among the nation's financial services regulators. The Commission believes that, to accomplish these objectives, the PWG will need to consult with financial firms, investors, and regulators (federal and state) and request funding for a much higher level of staffing.
2. The Commission makes the following observations and recommendations concerning the SEC rulemaking process:
 - a. The Commission recommends that Congress make the Sarbanes-Oxley Act (SOX) part of the Securities Exchange Act of 1934. With this change, the SEC would be authorized to tailor its SOX regulations to account for practical variations among registrants (*e.g.*, modifications for small company compliance with internal control requirements and an exemption from Section 404 for foreign registrants where comparable home-country requirements exist) and to coordinate with bank regulators on the implementation of SOX, especially Section 404, as it applies to publicly traded banks subject to similar bank regulatory requirements.

-
- b. The Commission recommends that the SEC make clear that any new significant policies that apply to the whole securities industry will be vetted through the Administrative Procedure Act of 1946 (APA) process. Moreover, when new regulations are required, or existing regulations are amended, the SEC should thoroughly examine all possible options with a focus on their relative costs, benefits, and overall economic impact. To accomplish this, the Commission recommends that the SEC in its rulemaking process place an increased reliance on input from the SEC's Office of Economic Analysis and the Chief Economist. The Commission also recommends that the SEC consider performing an independent review of the economic impact of new major regulations one to two years after enactment. This "look back" would allow the SEC to assess whether the regulation was operating as expected and to determine whether changes are needed. To support these recommendations, the Commission calls on Congress to appropriate additional funding to the SEC to be put toward enhancing its ability to perform economic analysis.
 - c. The Commission recommends that the SEC's Chief Accountant adhere to APA rulemaking discipline on substantive accounting pronouncements and interpretations involving important policy initiatives. In addition, the Chief Accountant should address in a rulemaking procedure the conditions under which a restatement of financial statements is required.
 3. The Commission believes that enhanced and more open communication between the SEC and SEC-regulated institutions (broker-dealers, investment advisers, self-regulatory organizations (SROs), etc.) will provide the SEC with market information that would enhance its understanding of current issues, particularly regarding "best practices" and "industry practices." Similarly, the SEC could utilize these communications to identify and resolve issues with institutions in an efficient and timely manner before they become problems. In this regard, the Commission recommends that the SEC adopt a more prudential supervisory approach with SEC-regulated institutions. This approach, most often associated with prudential regulatory models of the U.K.'s Financial Services Authority (FSA) and the U.S. federal bank regulatory agencies, could be adopted by the SEC through the following steps:
 - a. Encourage dialogue—particularly through informal communications—from the industry. By doing so, the SEC will gain a more accurate insight into current issues facing the industry and will provide the industry the opportunity to consult on the development of appropriate regulatory standards. Staff from the Operating Divisions as well as the examination staff should be involved in these communications. The Commission

believes that prompt, candid, and proactive communication between the SEC and regulated institutions is a critical aspect of identifying the best ways to improve conduct by financial services professionals and, thus, one of the most effective ways to facilitate the protection of investors.

- b. Protect the dialogue, and to do this the Commission recommends that the SEC (i) take effective, permitted steps to aggressively protect the confidentiality of communications between regulated institutions and the nonenforcement areas of the SEC, as well as from the media, through new policies and procedures; and (ii) simultaneously, advocate that Congress pass legislation formally establishing a federal “examination privilege” for SEC-regulated institutions, modeled on the bank-examination privilege (*i.e.*, a privilege to protect against compelled disclosure to third parties of examiners’ communications with institutions as part of this supervisory process).
 - c. Create a pilot program by considering (with input from the industry) an Examiner in Charge/On Site (EIC/OS) examination program for a limited number of SEC-regulated institutions. As elements of this program, the SEC could draw staff from current OCIE ranks, launch a major training initiative utilizing reverse secondments, and create a calendar and reporting mechanism for the EIC/OS pilot program taking into account SEC priorities, resources, and its dual mandate, *i.e.*, investor protection and promotion of efficiency and capital formation.
4. Promote industry self-evaluation in addition to self-regulation. The Commission recognizes that the securities industry polices itself through the assistance of SROs. The Commission recommends that industry self-regulation be enhanced through the establishment of a federal “self-evaluation privilege” for SEC-regulated institutions and their independent audit firms. Self-evaluation reports that are privileged, combined with the proposed SEC examination privilege, would strongly encourage regulated institutions to (i) look for their own problems with the help of their outside audit firms, (ii) self-report these problems to the SEC, and (iii) resolve issues in an appropriate and timely fashion—all without being forced to turn over an evaluation report to third parties. Similarly, the Commission recommends the self-evaluation privilege be extended to include communications for this purpose with an institution’s independent audit firm.
 5. Since the SEC’s current organizational structure was first established, broad changes in the capital markets have occurred. Continuing globalization, increasing international capital flows, and the rapid development of new financial products and services create the need for the SEC to reassess its

internal structure to ensure that it remains the preeminent capital markets regulator and continues to be responsive and efficient. The Commission recommends that the SEC consider aligning its organizational structure to mirror the contours of the current capital markets. Along these lines, the Commission suggests that the SEC consider the following concepts:

- a. Align the crucial rule-interpretation functions that occur in examinations with the rule-development functions that occur in the Divisions to avoid conflicting OCIE and Divisional interpretations of regulatory requirements, priorities, and expectations. One efficient way to accomplish this goal would be to fold the OCIE back into the SEC's Operating Divisions.
- b. Take a higher profile in the international markets. The international demands on the SEC have increased immensely in recent years, particularly given (i) the growth in the transactional markets outside the United States, (ii) the recent announcements of links between U.S. and foreign exchanges, and (iii) the significant growth in cross-border securities and financial fraud. The Commission believes that the SEC needs to be a leader in addressing these developments. International harmonization of regulatory standards (including investor protection) is on the horizon, and the SEC must ensure that it is well-positioned to take a leadership role in helping to formulate those new standards. One way to help ensure the SEC's continued leadership in this area would be to vest the Office of International Affairs with Divisional authority, stature, and, most important, resources (*i.e.*, more funding and staffing).
- c. Consider reallocating the responsibilities of the Divisions of Market Regulation and Investment Management into three new divisions along the following lines:
 - i. Division of Market Professionals. This Division would be responsible for the regulation of broker-dealers, investment advisers, and investment companies. Currently, regulation of these types of entities is split between the Divisions of Market Regulation and Investment Management.
 - ii. Division of Markets and Exchanges. This Division would be responsible for the regulation of market structure, including all exchanges and the institutions that facilitate those markets (*e.g.*, national securities exchanges, national securities associations, and SROs having jurisdiction over exchange activity and clearing corporations).

-
- iii. Division of Securities Products. This Division would be responsible for the regulation of securities products, including standardized options, exchange traded funds, and derivative and hybrid products, as well as pooled products like mutual funds, common trust funds, commodity pools, and others.
6. Congress should consider legislation that would transfer from the CFTC to the SEC the primary regulatory authority over the creation and trading of futures on securities, including individual securities and securities indexes. The CFTC should retain jurisdiction over futures not based on securities. Importantly, the interests of commodities markets and their participants need to be addressed both during and after the process of transitioning this jurisdiction to the SEC.
 7. The Commission recommends that Congress enact legislation to establish an optional federal insurance charter to increase competitiveness within the insurance market on both a domestic and global basis and to reduce costs for consumers.



National Chamber Foundation®
1615 H Street, NW
Washington, DC 20062
www.uschamber.com
Tel 202-463-5500
Fax 202-463-3129

