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SENATE REPUBLICAN POLICY COMMITTEE

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Excesses Threaten U.S. Competitiveness

When Excess Damages Success: Have Litigation, Taxation, and Regulation Gone Too Far?

Introduction

On May 21, the Senate Republican Policy Committee hosted a Competitiveness Policy Roundtable at Federal Hall in New York City to discuss U.S. business competitiveness, with particular attention to capital markets. The following Senators who attended the roundtable represented a wide range of committees, including Banking, Finance, and Commerce: RPC Chairman Kay Bailey Hutchison, joined by Senators Robert Bennett, Norm Coleman, Mike Crapo, and Jim DeMint.

The panel of experts was comprised of current and former government officials, business leaders, and industry experts.[1] The panelists shared their practical experiences and insight into three key challenges—litigation, regulation, and taxation—that have begun to hinder America's competitiveness. This paper will summarize the problems and potential solutions they identified.

U.S. Business Competitiveness Being Threatened

Historically, corporations competing with other corporations in the same country were facing the same challenges presented by litigation, regulation, and taxation. That is, they essentially were competing on the same playing field. Today, these companies compete against corporations around the world operating under different regulatory and tax laws as well as distinct litigation systems. Corporations are now able to select what country to operate in so that

[1] Roundtable participants were: Robert Steel, Treasury Under Secretary for Domestic Finance; Former Secretary of Commerce Don Evans, President of Financial Services Forum; Former Chairman of the Council of Economic Advisors Glenn Hubbard, Dean of Columbia Business School; Former U.S. Senator Don Nickles, Chairman and CEO of the Nickles Group; Marc Lackritz, President of Securities Industry and Financial Markets Association; Ted Schlein, Partner of Kleiner Perkins Caufield & Byers and Chairman of the National Venture Capital Association; Bill Harrison, Chairman Emeritus of the Board of JP Morgan Chase. The views represented in this RPC paper are not necessarily of any participating Senator.

they can minimize the cost of doing business. Consequently, U.S. laws and business practices play a critical role in maintaining the attractiveness of doing business in the United States.

Today, America's economy is the strongest in the world—but this lead is declining. Other countries have begun to transform their legal, regulatory, and tax systems to be more flexible and less burdensome for businesses. In response, Congress should adopt policies that keep America's competitive advantage. In short, that would include making permanent 2001 and 2003 tax relief, reducing burdensome regulations, and reforming our litigation system.

The capital markets industry is one sector of the economy that has witnessed increasing global competitiveness—and relative declining competitiveness in the United States—in recent years. Focusing primarily on capital markets, the roundtable participants discussed how America's markets could preserve their preeminence in the world for both investors and borrowers.

The Problem: U.S. Capital Markets Under Increasing Strain

In the past year, three separate highly publicized private-sector reports concluded that the competitiveness of America's capital markets is under increasing pressure.[2] U.S. capital markets' competitiveness is being challenged not only by external factors (such as developing markets and growing pools of equity around the world) but also by some self-inflicted (i.e., domestically imposed) challenges.

The three reports each make three similar observations and findings with respect to the current condition of our capital markets.

1. **Capital markets are a crucial component of the U.S. economy.** They account for 5 percent of total private-sector employment and enable entrepreneurs and small businesses to borrow capital to grow their businesses. Accounting for approximately 8 percent of GDP, this sector is the third-largest component of the U.S. economy, behind manufacturing (14 percent) and real estate (12 percent).

2. **Recent data suggest that U.S. capital markets are losing competitiveness.** In 2005, 24 of the 25 largest initial public offerings (IPOs) were offered in markets outside of the United States, and in 2006, that was the case for 23 of the 25 largest IPOs. In the past three years, London has increased its share of the global IPO market from 5 percent to almost 25 percent.[3]

3. **Regulatory and litigation burdens are two major drivers of declining competitiveness for capital markets.** In a large survey of industry leaders, McKinsey &

[2] The three reports were: 1) Interim Report of the Committee on Capital Markets Regulation by an independent, bipartisan committee composed of 22 corporate and financial leaders, November 2006; 2) Sustaining New York's and the US' Global Financial Services Leadership by McKinsey and Company, at the request of Mayor Bloomberg and Senator Schumer, January 2007; and 3) Commission on the Regulation of U.S. Capital Markets in the 21st Century by a bipartisan independent commission created by the U.S. Chamber of Commerce, March 2007.
[3] Interim Report of the Committee on Capital Markets Regulation, p. 3.

Company, a premier management consulting firm, found that about two-fifths of CEOs surveyed expected that New York City—and by extension the United States—would become less attractive as a place to do business. McKinsey found that what clearly dominated these views were fears that two factors would not be present: 1) a fair and predictable legal environment and 2) a strong but responsive regulatory environment.[4]

These reports concluded that U.S. regulators and Congress could take specific steps to improve the attractiveness of U.S. capital markets while maintaining sound investor protections.

The roundtable participants largely agreed with the conclusions of these three recent reports, and they also discussed the consequences of over-taxation on that industry.

Litigation Reform

One of the most commonly cited challenges to doing business in the United States is its unpredictable and costly litigation system. In 2005, Towers Perrin, a global risk and financial management firm, found that U.S. tort costs totaled $261 billion, more than the amount that every household spent on gas and electricity that year. This study also found that U.S. tort costs in 2005 amounted to 2.09 percent of GDP. Also, in 2005, public companies paid more than $3.5 billion to settle securities class-action lawsuits, not including settlements incurred by WorldCom. One recent survey on litigation trends found that companies with $1 billion or more in annual revenues spent an average of $31.5 million on their legal matters.[5]

Perhaps, the most troubling type of litigation is class-action securities litigation because of its fundamental difference from other types of litigation. In securities class-action lawsuits, different owners of a single corporate entity are essentially litigating against each other. In effect, shareholders of the same corporate entity are on both sides of a case with the right hand paying the left hand, minus costs to the trial bar. Securities class actions recover about 3 percent of losses, yet 25-35 percent of recovery goes to the attorneys. A recent National Economic Research Association study found that the average public company in the United States had nearly a 10-percent probability of facing at least one shareholder class-action lawsuit over the course of a five-year period.

Three ideas raised at the roundtable to reduce excessive lawsuits while maintaining investor protections were: 1) implementing a “loser pays” system; 2) enacting liability limits; and 3) reforming joint and several liability. In a loser pays system, also known as the “English Rules System,” the loser of a lawsuit is required to pay a portion of the legal fees and expenses of the winner. Another idea to reform the U.S. legal environment would be to limit punitive damages to a multiple of actual damages. Alternatively, another way to limit liability would be to enhance a judge’s ability to limit exorbitant awards. Not only would this reduce the direct costs on companies, but the improved predictability would allow companies to purchase insurance and engage in far more efficient legal risk management. Finally, joint and several liability is the idea that each defendant in a legal action is responsible for the entire amount of damages that a plaintiff is seeking, regardless of his or her degree of fault. One possible solution

[4] Sustaining New York’s and the US’ Global Financial Services Leadership, pp. 14-17.
[5] Third Annual Litigation Trends Survey Findings, Fulbright and Jaworski, LLP, p. 15.

to the joint and several liability problem is to adopt reasonable limits that apportion liability more in accordance with fault.

Auditor Liability: A Threat to the Accounting Industry

While securities class-action lawsuits unduly burden U.S. companies, gatekeepers for capital markets—particularly auditors—face unique challenges that threaten the entire industry, particularly the Big Four firms.[6] The accounting industry is highly concentrated as a result of a series of mergers over the past 20 years, with four firms auditing well over 95 percent of the firms listed on the U.S. exchanges. Because many public companies are multinational organizations, their auditors must also be sufficiently large to perform an audit. Furthermore, investment banks, which launch IPOs, strongly encourage companies to use a Big Four accounting firm. As a result of market dynamics, the Big Four have become a gatekeeper for capital markets. However, there is a wide consensus among industry experts that the demise of one of the remaining Big Four could have extremely adverse consequences for all audited companies and their shareholders. In May 2006, Japan's financial regulator suspended PriceWaterhouseCooper's Japanese network firm, following an accounting scandal with one of its clients. The two-month suspension forced 2,300 companies to find a new or temporary auditor which ultimately resulted in a loss of approximately 20 percent of its Japanese clients.[7]

While the number of securities class actions against accounting firms is relatively small, pending lawsuits involve tens of billions of dollars in potential claims. This exposure exceeds the combined partner capital of all Big Four firms. Furthermore, the case of Arthur Andersen (which saw its demise as a result of accounting practices in part relating to Enron) underscores the accounting profession's approach to auditing. One report suggested that "because audit firms are exposed to financial ruin by liability lawsuits, they may understandably err on the side of caution. In practical terms, this means that auditors have incentives to engage in 'defensive auditing.'"[8] Accounting firms, especially the Big Four, have become extremely conservative in their auditing practices for one very rational reason—the threat of litigation. As a result, companies pay enormous auditing fees, which adversely impact the shareholder.

The Treasury Department has begun to examine this issue by establishing a nonpartisan, public federal advisory committee that will make specific proposals for creating a strong, sustainable auditing profession.[9]

Congress has various policy options to limit the liability to auditing firms without comprising investor protection. Congress could address the problem by setting a cap on auditor liability in certain circumstances, an approach already taken by some European countries. To qualify for such a cap, auditing firms would be required to satisfy some minimum capital level.

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[6] Following the demise of Arthur Andersen, the four remaining accounting firms are PriceWaterhouseCoopers, Deloitte and Touche, Ernst and Young, and KPMG, LLP.
[7] Interim Report of the Committee on Capital Markets Regulation, p. 87.
[8] Interim Report of the Committee on Capital Markets Regulation, p. 88.
[9] The Committee, to be co-chaired by former SEC Chairman Arthur Levitt and former SEC Chief Accountant Donald Nicolaisen, will begin meetings in the fall to solicit a broad range of views from the auditing profession, public companies, investor community, and other financial market participants.

By creating a system that could limit damages, accounting firms would likely be able to purchase insurance against catastrophic loss from litigation.

In addition to legislative action, the Chamber of Commerce report (one of the three mentioned above) recommended steps to increase competition in the auditing profession. Specifically, the SEC and the U.S. stock exchanges should encourage public companies to conduct a periodic review of their audit firm choices. It also recommended that companies, investors, analysts, bankers, and attorneys open the door to more audit firm choices.

A view that was widely shared by the panelists was that the criminal prosecution of the entire firm of Arthur Andersen was excessive and a mistake. Some panelists suggested that rather than indicting an entire company, the Justice Department should have limited its prosecution to those individuals who perpetrated a crime. One of the previously cited reports made the similar recommendation to indict entire firms only in exceptional circumstances.[10] Echoing this idea, some panelists recommended that the Justice Department revise its prosecutorial guidelines.

Sarbanes-Oxley Section 404

Another separate issue related to the accounting industry that is frequently raised when discussing capital markets competitiveness is the impact of the Sarbanes-Oxley Act, particularly Section 404, which requires public companies to annually assess the effectiveness of their internal controls over financial reporting.[11] Numerous reports, including the SEC's Advisory Committee on Smaller Public Companies, found that Section 404 disproportionately hurts small businesses. Furthermore, research indicates that Section 404 may be lengthening the time that it takes for companies to get to the public markets and even compelling some companies to choose foreign markets or private placements.

On May 23 and 24, the SEC and the Public Company Accounting Oversight Board issued new management guidance to ensure that Section 404 audits focus on significant, material weaknesses. Treasury officials believe that it can alleviate the compliance costs of SOX 404 through regulation. However, some panelists suggested that the SEC and PCAOB are not moving quickly enough and that the proposed guidance will likely not have its desired effect.[12]

Principles-based Versus Rules-based Regulation

The goal of any financial regulatory system should be to balance investor protection, market integrity, and systemic risk. However, the current system has evolved over many decades with new laws placed upon old laws. Today, the system is a hodgepodge, composed of a series of individual regulations designed in response to a specific circumstance at a specific point in time. These laws and regulations are not being subjected to major reviews or revisions.

[10] Interim Report of the Committee on Capital Markets Regulation, p. 13.
[11] Sarbanes-Oxley Act of 2002, P.L. 107-204.
[12] Congress recently voted to table an amendment (Roll Call Vote Number 139) that would have eased the burdens of Section 404 on small and mid-sized companies.

Consequently, the current regulatory environment has made it increasingly difficult and costly for businesses to operate in the United States. Securities firms reported on average almost one regulatory inquiry, or an official request from a regulator, per trading day. SIFMA reports that the cost of compliance had reached $25 billion in the securities industry alone in 2005. With seven major federal financial regulators, state banking commissioners, state insurance commissioners, state securities commissioners, and self-regulatory organizations (such as the National Association of Securities Dealers), large financial institutions may be regulated by well over 150 entities. Companies face duplicate examinations, inconsistent supervisory actions, and a lack of clear guidance from U.S. regulators.

Alternatively, many firms believe that there are real advantages to Financial Services Authority (FSA), the United Kingdom's single-regulator model, which is based upon 11 Principles for Businesses. The FSA was created in 1997 by combining nine regulatory bodies into a single, principles-based regulator.[13] Principles-based regulation means placing reliance on high-level, overarching principles that are focused on outcomes. This approach seeks to improve the relationship between the regulator and the regulated through regular dialogue so that problems are detected and addressed earlier. This is juxtaposed with the U.S. model of a rules-based approach that is largely backward-looking with a traditionally more adversarial relationship between the regulator and the regulated.

Some have pointed out that Treasury and the Federal Reserve officials have both talked about moving towards a principles-based regulatory regime. However, officials from both agencies point out that even the FSA has 8,000 pages of specific guidance on how to meet the 11 principles. Moreover, some experts believe that the discussion of a rules-based or principles-based approach oversimplifies the complexity of the issue of financial regulatory reform. In fact, Treasury has talked about balancing both rules and principles in a modernized approach that would recognize guiding principles at a high level but would maintain specific-rules and regulations, particularly to assure strong investor protections.

Treasury officials believe that the financial regulatory system should be both principles-based and rules-based with the following three key elements: 1) rigorous benefit-burden analysis; 2) materiality; and 3) constructive engagement. These three elements, discussed below, were widely embraced by all panelists as critical components of a better regulatory environment. The first element is that all regulations should undergo a strict benefit-burden analysis. Securities regulation is one of the few areas of law that is not subject to a strict cost-benefit analysis. Even though Chairman Cox has been moving the SEC in this direction, the FSA is widely perceived as performing a rigorous cost-benefit analysis of all its regulations. The second element is materiality, meaning that regulators and auditors need to focus on issues that are material to investors and consumers. Information should not be collected and reviewed for its own sake; rather, regulators should have to ensure that the information being collected is appropriate and useful. Finally, Treasury argues that a third aspect for an effective structure is constructive engagement between regulators and the regulated. A clear process for businesses to engage with their regulators would ease ambiguities and reduce uncertainty.

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[13] The FSA is sometimes referred to as a prudential regulator as opposed to the United State's enforcement-based regulator.

Over-taxation: A Looming Threat in 2010

In addition to litigation and regulation, tax policy also plays an important role in keeping our markets competitive. In 2003, Congress passed a major tax relief measure, which, among other key changes, reduced the tax rate on capital gains and dividends to 15 percent. Many economists argue that this rate should be zero, and in fact, some countries have zero tax on capital gains. However, the budget resolution passed earlier this year created new enforcement tools that are designed to make it extremely difficult to extend the 2003 tax cuts. Under the FY08 Budget Resolution, a supermajority (60 votes) in the Senate is required to extend current rates on corporate dividends and capital gains beyond their expiration date of 2010. With the current budget resolution in place, it is likely that taxes on dividends and capital gains will increase, causing great damage to our economy.

The United States has the second highest corporate taxes in the world at 35 percent. Compare that with the European Union's average corporate tax rate of 26 percent at the end of 2006. The United Kingdom recently lowered its top corporate tax to 28 percent. Ireland, whose economy has grown at more than three times the rate of the euro-zone over the past decade, traces its success to the lowering of their corporate tax rate from 47 percent in 1998 to 12.5 percent—the lowest in the developed world. Furthermore, recent research has found that corporate taxes are largely borne by the corporation's workers and consumers.

The success of the 2001 and 2003 tax cuts have been undeniable.[14] Since 2003, over 8 million jobs have been created. There has been positive economic growth for every quarter, averaging nearly three percent. Federal revenues have been growing in the 11-13 percent range, and the budget deficit has been improving far ahead of any estimate.

Conclusion

The declining competitiveness of the United States' capital markets may be a canary in the coal mine of a much deeper problem. The trends of excessive regulation, litigation, and taxation in our capital markets are being replicated in other parts of our economy. Unless Congress, the Administration, and the business community create a clear and unified blueprint for maintaining our nation's competitiveness, capital and jobs will continue to move overseas.

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[14] For more information see: RPC Policy Paper: Marking the 4th Anniversary of the 2003 Tax Relief Law: A Boon to Taxpayers, Tax Receipts, and the Economy; May 15, 2007.