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Statement of the Shadow Financial Regulatory Committee on

## The Competitiveness of U.S. Securities Markets

February 12, 2007

Within the last few months two widely publicized reports have suggested that excessive regulation and litigation in the United States are causing financial transactions that used to take place in the United States to move to foreign markets, particularly London. The Interim Report of the Committee on Capital Markets Regulation, a group of respected financial executives and academics, and another report by New York Mayor Michael Bloomberg and New York Senator Charles Schumer both concluded that regulatory and litigation reform was necessary to create a more hospitable environment for financial transactions in the United States.

The Shadow Financial Regulatory Committee does not believe that the issue should be framed narrowly as a question of where financial transactions should take place. The Committee believes that the increasing maturity of securities and capital markets in other countries and the globalization of financial transactions are something to applaud. The fact that foreign markets are competing with ours is a good development, and will benefit both our markets and U.S. companies.

Still, the rapid decline in listings on U.S. exchanges, the growth in privatizations by U.S. companies, the expansion of private equity funds, and the fact that foreign companies are coming to the U.S. to raise funds privately but not publicly, all suggest that something is wrong. Excessive regulation and large and arbitrary litigation risks appear to be hindering this country's ability

to compete. The right balance of regulation and enforcement enhances investor confidence and makes our markets attractive; when regulation and litigation risk get out of balance, they impose unwarranted costs on American investors and reduce the attractiveness of our capital markets.

The two recent reports are comprehensive, addressing many factors that affect the attractiveness of U.S. markets. The Committee on Capital Markets, for example, covered U.S. international competitiveness, shareholder rights, SEC regulatory policies, section 404 of the Sarbanes-Oxley Act, and enforcement of the securities laws. The Bloomberg-Schumer report was also comprehensive. In this statement, however, the Shadow Committee will focus on only one of these issues—the litigation risk faced by public companies in the United States. We believe that exposure to unpredictable and expensive litigation is one of the key reasons that foreign companies are reluctant to enter the U.S. public markets and that U.S. companies are finding that the costs of being a public company outweighs the benefits.

It is very difficult to maintain that the benefits of private class actions under the SEC's Rule 10b-5 outweigh the costs. In these class actions, one group of innocent shareholders is often required to pay another group of shareholders—who purchased their shares in the market rather than from the company—for errors, omissions or even fraud that are the responsibility of company managements. Often, companies settle class actions because the expense in management time is too great, even when the management did nothing wrong. In 2005, U.S. public companies paid more than $3.5 billion to settle securities class actions, not including the large settlements in Enron and WorldCom. Even apart from the settlements in Enron and WorldCom, the average settlement was $71 million in 2005, up 156 percent from the $27.8 million average settlement in 2004. The rate for Directors and Officers (D&O) liability insurance is six times higher in the United States than in Europe.

It is doubtful that the benefits of this system approach its costs. The deterrent value of private class actions is small, since the settlements are paid in effect by the shareholders of the defendant companies or their insurers and not by the managers actually responsible. A study by the National Economic Research Association found that the ratio of settlements to investor losses in 2002 through 2004 averaged only 2.7 percent. The losses to companies in defense costs are difficult to estimate, but one study puts these in the same range as the fees of plaintiffs' counsel—about 25 to 35 percent of the total recovery. When the costs of business disruption and D&O insurance are added, there does not appear to be any positive recovery for anyone other than the lawyers.

This costly, arbitrary and unpredictable private litigation system exists side-by-side with an SEC enforcement system that could do a better job of punishing wrongdoers and deterring financial manipulation and fraud at much less cost. The SEC has the authority to bring civil and recommend criminal proceedings against corporate managers who engage in manipulative or fraudulent activity. These enforcement steps by the SEC would have a far greater impact in preventing wrongdoing than private class actions, and would not impose on public companies the major costs that are probably deterring companies from public offerings in the United States.

This is not to say that private securities class actions should not exist. Courts have long found liability where corporate insiders violate their fiduciary duties by trading on inside information, or corporations themselves buy or sell shares while in possession of material information that that is not generally known in the market. In this case, shareholders who suffer losses should be able to recover damages from the insiders or the company itself.

Accordingly, the Committee recommends that Congress adopt legislation that limits private securities class actions to those cases where insider trading has occurred, but otherwise requires 10b-5 to be enforced against companies solely by the SEC.