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

Executive Summary

Commission on the regulation of U.S. Capital Markets in the 21st Century

Executive Summary

March 2007

Overview

The U.S. capital markets have long provided tremendous advantages to our economy. They have supplied 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 have 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 from 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 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.
- Convince public companies to stop issuing earnings guidance or, alternatively, move away from quarterly earnings 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. The 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.

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, 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 APA for significant changes in policy.

The Commission believes that the protection of investors and the promotion of capital formation are 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 it 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 related issues.

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 earnings 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 earnings per share (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 are different 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.

Background and Scope

For more than 70 years, the United States has been home to the most fair, efficient, and sophisticated capital markets worldwide. This has brought unmatched prosperity to our nation and the world. The continued effective operation of these markets directly affects all aspects of our economy. Fair and efficient capital markets channel needed investment at competitive prices to large and small enterprises, encourage entrepreneurs, facilitate growth, create jobs, and foster innovation, while providing attractive opportunities for investors to preserve and increase savings and mitigate risk.

With the rapid expansion of global capital pools and the dramatic rise in new financial products over the last decade, it has become increasingly clear that the United States lacks an overall vision for how its legal and regulatory framework should respond to these new market developments. In recent years, the U.S. has experienced a steady decline in its share of global capital markets activity as international financial centers have grown to challenge this historical dominance.

A number of factors can be cited. In part, this is a reflection of natural economic and market forces that cannot, and should not, be reversed. Foreign countries have developed deep, vibrant local securities markets with advanced technological platforms, and the lower costs of transmitting information have reduced transaction costs associated with trading in multiple financial centers. But other factors within the United States advance these trends that contribute to the relative decline in the efficiency and competitiveness of America's capital markets. A number of these internal factors can and should be changed; legislators, regulators, and market participants have the power to make those changes.

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

In February 2006, the U.S. Chamber of Commerce launched the Commission on the Regulation of the U.S. Capital Markets in the 21st Century to evaluate the current legal and regulatory framework of the U.S. capital markets and to recommend changes designed to ensure the health of these markets through the 21st century. By design, the Commission's membership is bipartisan and independent, and it reflects a broad range of experience and affiliations.

The Commission's Co-Chairs A.B. Culvahouse (left) and Bill Daley (center) work with Commission Executive Director Mike Ryan (right) to focus the group's recommendations.

Recognizing the breadth and complexity of its charter, the Commission organized four working groups:

- U.S. Capital Markets in the Global Marketplace
- Accumulated Savings and Investor Education
- Challenges Confronting Issuers and Auditors
- Challenges Facing the Financial Services Industry

The Commission started with the premise that its recommendations needed to strike the right balance between two statutory mandates: protecting investors and promoting capital formation. If there is too much or too little emphasis on either mandate, the performance of America's capital markets—and more broadly, our economy—will be undermined. If investors do not have the confidence that they will be treated fairly, they will not invest and market performance will suffer. Similarly, if it is too difficult for issuers to attract capital, they will not seek additional capital through public markets and market performance will suffer. Thus, protecting investors and promoting capital formation are mutually reinforcing goals to a substantial degree.

During a year of study and discussion, the Commission conducted four public "town halls" in Chicago, New York, Washington, DC, and San Francisco and held a roundtable discussion in London. At these meetings, it received the views of many commentators, including academics, institutional investors, former regulators, venture capitalists, investment bankers, labor leaders, exchange officials, and entrepreneurs. The Commission met formally and informally with current and former regulators, members of the 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.

Since this Commission began its work, several positive steps have been taken to improve the functioning of America's capital markets. Some steps have been taken by Congress and others by regulators, such as the SEC and the Public Company Accounting Oversight

NATIONAL CHAMBER FOUNDATION

Board (PCAOB). While welcoming these actions, this Commission determined early in its deliberations not to focus on areas in which it appeared that meaningful progress was already being made.

In addition, others have examined the issue of America's capital market competitiveness and have 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.

Commissioners convene at the U.S. Chamber of Commerce to discuss the challenges facing America's capital markets.

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.

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 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 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 PCAOB work with their international counterparts and the International Auditing and Assurance Standards Board (ISAAB) toward the 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," which 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 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 (this 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 account retirement savings vehicles, 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 a 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 (DOJ) 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 DOJ or any other federal agency (including the SEC) from considering waiver as a cooperation credit factor.

3. The Commission believes that the DOJ 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 DOJ 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 DOJ 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.

Without a well-functioning capital markets system, Microsoft in 1978 may not have become the Microsoft we know today.

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 DOJ 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 Group of Eight (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 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 to 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 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 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 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 the SEC's Chief Accountant adhere to APA rule-making 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 (*e.g.*, 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 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, derivative and hybrid products, as well as pooled products like mutual finds, common trust funds, commodity pools, and others.

6. Congress should consider legislation that would transfer from the Commodity Futures Trading Commission (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.

To join in the fight to protect the competitiveness of America's capital markets, visit **www.uschamber.com** or call 202-463-5500. To learn more about the Commission or to read its full report, visit **www.CapitalMarketsCommission.com**.

National Chamber Foundation®
1615 H Street, NW
Washington, DC 20062
www.uschamber.com
Tel 202-463-5500
Fax 202-463-3129