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Remarks by Treasury Secretary Henry M. Paulson on the Competitiveness of U.S. Capital Markets Economic Club of New York New York, NY

Thank you, Barbara. It's good to be in New York City, the financial capital of the world. What happens in our financial markets is an indicator of the overall state of our economy. And I am pleased to report that our economy is strong.

We are experiencing sustained growth and low unemployment. The economy has added more than 6.8 million new jobs since August 2003. Productivity, an indicator of future growth, has grown at an annual rate of 3 percent since the first quarter of 2001. And, very importantly, this productivity is now translating into higher wages, so more Americans are sharing in our economic success. The U.S. economy is the envy of the world, and we must keep it that way.

Capital markets are the lifeblood of our economy. They connect those who need capital with those who invest or lend capital. They play a vital role in helping entrepreneurs implement new ideas and businesses expand operations, creating new jobs. They give our citizens the confidence to invest, earn higher returns on their savings, and reduce the cost of borrowing for student loans, mortgages, and consumer credit.

Our capital markets are the deepest, most efficient, and most transparent in the world. We are the world's leader and innovator in mergers and acquisitions advice, venture capital, private equity, hedge funds, derivatives, securitization skills, and Exchange Traded Funds. This expertise has made our leading financial institutions, many of them headquartered right here in New York, leaders in Asia, Europe, and Latin America. U.S. commercial and investment banks contribute greatly to economic success all around the globe.

Recent Past

Yet, our markets are not immune to challenges. After years of economic expansion and the excesses and exuberance of the late 1990s, we faced what some called the perfect storm: the technology and telecom bubble burst, the U.S. economy went into recession, terrorists attacked us on September 11, 2001, and a wave of corporate scandals undermined investor confidence.

We weathered the storm. The President, both parties in Congress, and regulators moved quickly to address the business scandals, which helped to restore investor confidence. And the President's economic policies and tax cuts laid a strong foundation for recovery.

In the United States, whenever there is a major problem in our capital markets, we shine a light on it and move quickly to clean it up. The vast majority of corporate leaders are honest people, but those executives who put their personal interest above the interests of their shareholders undermined confidence in our markets. That's not competing, that's cheating. And perpetrators are being punished.

We responded to the corporate scandals with the Sarbanes-Oxley Act of 2002, new listing rules for public companies, and regulatory and legal enforcement actions to alter certain business practices. These changes have been extensive and significant, so it is quite naturally taking time for companies to understand, process, and implement the new rules and requirements. Many of the results have been positive. At the same time, as corporations, financial institutions, and regulators continue to adapt, questions are being raised about the long-term impact of these changes. Our goal is to preserve the integrity of our markets while maintaining their competitiveness.

Recently, Mayor Bloomberg and Senator Schumer emphasized this point in a Wall Street Journal Op-Ed that was right on target. They highlighted a discussion that many in the financial community are having: Does the decline in initial public offerings in U.S. capital markets signal potentially broader challenges to our competitiveness?

An IPO occurs when a private company decides to sell its shares to the public. Our public markets provide the lowest-cost capital. Access to these markets – as it should – brings regulatory, governance, and disclosure responsibilities. Historically, the U.S. markets have represented the gold standard, and a significant number of premier foreign companies have willingly adhered to our standards in order to access our markets.

Yet recently, in the wake of new, heightened regulatory and listing requirements for all public companies in the U.S., we have witnessed changes in IPO activity. Despite our strong economy and stock market, IPO dollar volume in the U.S. is well below the historical trend and below the trend and activity level in a number of foreign markets.

Moreover, existing public companies in the U.S. are deciding to forgo their public status – with its attendant regulatory requirements – and go private. This is occurring in record numbers, at record volumes, and, as a percentage of overall public company M&A activity, is approaching levels we have not seen in almost 20 years. This development is being facilitated by ever-growing private pools of capital.

Given domestic trends, it is not surprising that the U.S. share of the total volume of foreign IPOs has also declined. Determining the causes and potential effects of these trends is more complicated. Are they temporary, harmless phenomena, or more like the coal miners' canary? What is the implication for America's investors and our existing public companies, which remain subject to the new regulatory standards? And what does this mean for America's economic competitiveness?

Let me begin by discussing the importance of regulation. Truly competitive capital markets must inspire investor confidence. They must be fair and they must be perceived to be fair. Of course, fairness does not guarantee success. Laws and regulation cannot prevent investors from losses, nor should they attempt to do so. We should not discourage risk taking, but we should make sure that investors have reliable information on which to base their decisions.

In a recent speech, former Treasury Secretary Bob Rubin said this about regulation: "Our society seems to have an increased tendency to want to eliminate or minimize risk, instead of making cost/benefit judgments on risk reduction in order to achieve optimal balances."

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.

Some observers cite the decline of foreign IPOs in the U.S. market as an indicator of the competitiveness of our capital markets. We should go beyond the numbers and examine some of the possible reasons for this decline. Several factors contribute to the recent trends, including public policies in other countries. But several other contributing factors offer a framework to assess our own capital markets. These include:

- The development of markets outside the U.S., particularly in London and Hong Kong – and the ability of U.S. investors to participate in these offerings;
- A legal system in the U.S. that exposes market participants to significant litigation risk;
- A complex and confusing regulatory structure and enforcement environment;
- And new accounting and governance rules which, while necessary, are being implemented in a way that may be creating unnecessary costs and introducing new risks to our economy.

Each of these warrants deeper discussion.

Foreign Market Development

First, let me say unequivocally, the development of competitive capital markets overseas is a positive. Efficient capital markets lower the cost of capital, creating more growth, more jobs, and higher living standards. And economic growth abroad creates markets for our products and jobs here at home.

In three weeks, I will travel to Beijing for the first session of our recently initiated Strategic Economic Dialogue with China. We will encourage China to open up their financial markets to competition in order to accelerate the development of those markets and support sustainable economic growth – growth that will bring benefits to both our nations.

A number of foreign markets have developed excellent standards and protocols. In some parts of the world, particularly Europe, public companies adhere to the International Financial Reporting Standards – an accounting system that differs from ours.

One important feature of the IFRS accounting system is that it is principles-based, rather than rules-based. By "principles-based," I mean that the system is organized around a relatively small number of ideas or concepts that provide a framework for thinking about specific issues. The advantage of a principles-based system is that it is flexible and sensible in dealing with new or special situations. A rules-based system typically gives more specific guidance than a principles-based system, but it can be too rigid and may lead to a "tick-the-box" approach. I will be talking about the difference between principles-based and rules-based systems in a number of contexts today.

International companies that list in the United States must reconcile their IFRS statements with U.S. Generally Accepted Accounting Principles, or GAAP. We should recognize that the time and cost that go into reconciling and restating IFRS statements may not be a worthwhile expense for a foreign company considering the U.S. market. Because of progress being made in converging accounting standards, the U.S. and EU have developed a "roadmap," with the goal of allowing listings in the U.S. market on the basis of statements prepared using IFRS, and likewise continuing to permit listings in the EU on the basis of statements prepared according to GAAP. These efforts are encouraging.

A number of foreign exchanges have also aggressively embraced technology and developed innovative business models that increase efficiencies and reduce costs to investors in their markets. These competitive forces have spurred responses in our country. In the most recent example, the Chicago Mercantile Exchange and Chicago Board of Trade announced plans to merge and offer investors a broader range of exchange-traded derivatives, with the goal of creating efficiencies in technology and operations.

Ten years ago, premier foreign companies seeking to raise attractively priced equity capital turned almost exclusively to the United States. That's no longer the case, as alternatives have developed around the world. But certain challenges to doing business in the U.S. market also are contributing to the recent trends, and these challenges merit a closer look.

Legal Burden

Let's begin with one challenge that will take a concerted effort over the long term to correct – the need for reform of our legal system. My own 32-year experience in the private sector – working in the capital markets with U.S. and foreign companies alike – has convinced me that legal reform is crucial to the long-term competitiveness of our economy.

A sophisticated legal structure – with property rights, contract law, mechanisms to resolve disputes, and a system for compensating injured parties – is necessary to protect investors, businesses, and consumers. But our legal system has gone beyond protection. In 2004, U.S. tort costs reached a record quarter-trillion dollars, which is approximately 2.2 percent of our GDP. This is twice the relative cost in Germany and Japan, and three times the level in the UK. The consulting firm Towers-Perrin found that the tort system is highly inefficient, with only 42 cents of every tort dollar going to compensate injured plaintiffs. The balance goes to administration, attorney's fees, and defense costs. Inefficient tort costs are effectively a tax paid by shareholders, employees, and consumers. Simply put, the broken tort system is an Achilles heel for our economy. This is not a political issue, it is a competitiveness issue and it must be addressed in a bipartisan fashion.

Regulatory Structure

Another issue to consider in assessing the competitiveness of our financial markets is regulation. Over the course of our nation's history, we have added multiple regulators to respond to the issues of the day. Our regulatory system has adapted to the changing market by expanding, but perhaps not always by focusing on the broader objective of regulatory efficiency.

For example, while the business of banking has converged over time, we still have four separate banking regulators. We have a similar dynamic with the securities and commodities markets, and their related self-regulatory structures. Each of these organizations has different statutory responsibilities and a number have different regulatory philosophies. We also have a dual federal-state regulatory system in the banking and securities markets – and the degree of federal preemption over state law in these areas varies greatly. Another large and important part of our financial sector, insurance, is regulated solely at the state level.

A consequence of our regulatory structure is an ever-expanding rulebook in which multiple regulators impose rule upon rule upon rule. Unless we carefully consider the cost/benefit tradeoff implicit in these rules, there is a danger of creating a thicket of regulation that impedes competitiveness.

Our rules-based regulatory system is prescriptive, and leads to a greater focus on compliance with specific rules. We should move toward a structure that gives regulators more flexibility to work with entities on compliance within the spirit of regulatory principles.

Rules by themselves cannot eliminate fraud. Wrongdoers will seek out loopholes or ways to circumvent the rules. For instance, in the recent business scandals, management at some companies remained technically within the rules while offering deceptive financial statements.

Some rules developed in the past have proved to be deficient in today's dynamic marketplace and some that are developed today are likely to be sub-optimal in a few years unless they are rooted in principles which will stand the test of time.

There is a growing awareness in the financial community of the desirability of streamlining the regulatory system. One example is the decision of the New York Stock Exchange and the NASDAQ to consolidate their regulatory operations. This is a positive development, and I encourage them to focus on achieving the right principled result as opposed to just combining the two rule books.

While no nation's regulatory structure is perfect, ours has served us very well for many years. It is second to none. And to ensure that it meets the challenges of the years ahead, we should be open to learning from our own experience and from the experience of others. We should ask ourselves: What changes are needed to make our regulatory structure more efficient and effective in today's world?

At times, our legal system and regulatory structure produce unintended consequences. Consider the area of enforcement. Over the last several years different regulators at the state and federal level have been focused on finding and prosecuting wrongdoing – a worthy, necessary, and successful effort. But when multiple jurisdictions and entities are involved, each with their own objectives and approaches, the enforcement environment can become inefficient and, to the regulated, can appear confusing and threatening.

Given the business scandals, this is understandable. And some violations from years ago are just coming to light. Almost every week we read about another act of corporate wrongdoing, many representing egregious violations of shareholder trust. Let's be clear: Those who commit corporate fraud are guilty of stealing from shareholders, employees, and consumers. That behavior can never be tolerated. Our challenge is to make sure the tools are in place to punish bad actors, while recognizing that the vast majority of business leaders are honest, capable, and focused on the interests of shareholders and employees.

Today, we have an opportunity to make the enforcement environment more constructive. In such an environment, public companies would be able to work with regulators to resolve ambiguities and make the right decisions. Such regulatory guidance should be easy, quick, and relatively costless to obtain. The combination of enforcement and guidance is likely to be more effective and more efficient than relying on enforcement alone, particularly in an environment in which there is a greater degree of trust between the regulators and the regulated.

In a sign of increasing openness to considering new approaches, the Justice Department has been seeking input from outside groups and is currently considering revisions to the "Thompson Memorandum," which deals with criminal prosecution of companies. If it appears that changes are warranted, in the public interest, and consistent with the need to safeguard the integrity of our economic system, I am confident the Justice Department will revise its policy.

Sarbanes-Oxley and Governance

When discussing the competitiveness of our markets, we should acknowledge that Sarbanes-Oxley and the related public company listing rules brought necessary reforms to our corporate governance and capital markets. These reforms are rooted in the basic principles that underpin a robust corporate governance system – accountability, transparency, and the need to identify and manage conflicts of interest.

These changes were necessary to rein in abuses. But significant changes always cause stress, and early implementation of new rules may produce uneven results. We must recognize the benefits of the new rules, and remain open-minded about how they affect the system, both positively and negatively. At this time, I do not believe we need new legislation to amend Sarbanes-Oxley. Instead, we need to implement the law in ways that better balance the benefits of the legislation with the very significant costs that it imposes, especially on small businesses.

By far the single biggest challenge with Sarbanes-Oxley is section 404, which requires management to assess the effectiveness of a company's internal controls and requires an auditor's attestation of that assessment. Companies should invest in strong internal controls and shareholders welcome this development because it is in their best interest. However, section 404 should be implemented in a more efficient and cost effective manner. It seems clear that a significant portion of the time, energy, and expense associated with implementing section 404 might have been better focused on direct business matters that create jobs and reward shareholders.

Businesses around the world are eager to see how we address this issue. The Chairman of the SEC, Chris Cox, recognizes the severity of this problem and is providing strong leadership to address it. He understands that it will take an aggressive forward-leaning approach to change the implementation of Section 404 and make it more efficient.

Mark Olson, the Chairman of the Public Company Accounting Oversight Board, shares Chris Cox's viewpoint. Collectively, they have responsibility for providing guidance on implementing Section 404. The SEC will soon seek comments on a new and much improved auditing standard aimed at ensuring that the internal control audit is top down, risk based, and focused on what truly matters to the integrity of a company's financial statements. This new guidance for both companies and their auditors should encourage common sense reliance on past work, and on the work of others. Moreover, the SEC and the PCAOB are going to provide tailored guidance for small companies that recognizes their specific characteristics and needs.

Overall, I believe our corporations are better governed today. Directors are more independent, more aware of real and perceived conflicts, more diligent about their fiduciary responsibilities, and they spend much more time engaged in compliance processes. But good corporate governance is a means to an end, not an end in itself. We do not need a process-oriented mentality to corporate governance. We need better managed, more competitive corporations that earn investor confidence through sound leadership, thoughtful governance, and outstanding performance. One important indicator of the effectiveness of corporate governance changes will be the ability of companies to attract experienced, competent board members who can add real value – and who are able to spend more time at board meetings overseeing the business and developing strategies, and less time on regulatory compliance.

We should remember that we cannot legislate or rule-make our way to ethical behavior, whether it be in the business world or any other endeavor. Proper corporate governance processes increase the likelihood that well-intentioned people will do the right thing. But they do not guarantee such an outcome – and they certainly do not guarantee that unethical people will do the right thing. In my judgment, we must rise above a rules-based mindset that asks, "Is this legal?" and adopt a more principles-based approach that asks, "Is this right?"

Several weeks ago, Warren Buffett offered a warning to his leadership team at Berkshire Hathaway when he wrote, "The five most dangerous words in business may be `Everybody else is doing it.'" As usual, Warren Buffett was right. The ability to avoid these pitfalls takes moral leadership, starting right at the top.

Accounting

The corporate scandals were, for the most part, accounting scandals, so it is not surprising that so much of the recent reform has focused on the accounting industry. Our accounting system is the lifeblood of our capital markets. And it has historically represented a very high standard. But it was abused in the corporate scandals by manipulation and smoothing of earnings.

Capital markets rely on trust, which is based on financial information presumed to be accurate and to reflect economic reality. The ultimate responsibility for accurate and transparent financial statements must rest with management. The role of the external auditor is to examine a company's financial statements in order to express an opinion that conveys reasonable, but not absolute, assurance as to the truth and fairness of the statements. Auditors do this by evaluating management's adherence to Generally Accepted Accounting Principles.

The Sarbanes-Oxley reforms were intended to increase the quality of corporate audits. They have had a significant effect on the accounting industry, fundamentally altering the interactions between auditors and corporate management and boards in a number of ways, some of which are not constructive. Also, we have been left with only four major accounting firms, each of which is exposed to potentially large legal liabilities.

This may not be healthy. The big four firms dominate the industry in terms of revenues and professional staff. The remaining accounting firms face significant barriers to competing with the big four, at a time when auditors are in real demand. The current situation forces us to ask questions about the industry's sustainability and effectiveness:

- Given the importance of accounting to our financial system, is there enough competition?
- Will our reformed accounting system produce the high-quality audits and attract the talented auditors we need?
- Do auditors seek detailed rules in order to focus on technical compliance rather than using professional judgment that could be second-guessed by the PCAOB or private litigants?

A common theme in my remarks today is the desirability, where practical, of moving toward a principles-based system. Nowhere is this issue more relevant than in the accounting system. Added complexity and more rules are not the answer for a system that needs to provide accurate and timely information to investors in a world where best of class companies are continually readjusting their business models to remain competitive.

Last year, approximately 1,200 publicly listed companies in the United States restated their financials. As of September 30 of this year, the number is more than 1,000. Some of these companies were involved in the business scandals. Many others were well-intentioned companies struggling to cope with a redefinition of rules in a complex system. These restatements draw time and attention away from other value-enhancing activities – and they represent an added cost to shareholders. Businesses and auditors are searching for something that doesn't exist in today's constantly changing world – a rules-based safe haven that still provides investors with an accurate portrayal of a company's financial performance.

Auditors should be able to focus on one fundamental objective – ensuring the integrity and economic substance of management's financial statements. To get there, we must recognize that accounting is not a science. It is a profession, requiring judgments that cannot be prescribed in a one-size-fits-all manner that undermines the usefulness of financial statements to investors.

The PWG, Derivatives, and Hedge Funds

In assessing the condition and competitiveness of our capital markets we have also initiated a broad review of recent changes, including the growth of derivatives and private pools of capital and their implications for the stability of the system. Credit derivatives have altered the financial landscape in many positive ways, most notably by dispersing the concentration of risk. They also pose potential risks themselves.

Hedge funds are among the largest users of derivatives. Over the past five years, the number of hedge funds has nearly doubled, while their assets under management have more than tripled. These investment managers engage in a wide variety of strategies, generate substantial transaction volumes, and introduce significant leverage into the system. They have also made our capital markets more efficient, facilitating the dispersion of risk. And hedge funds have developed an impressive global presence. Given their explosive growth, the instruments they trade, and the evolution of our financial marketplace, we must continually assess their actions and impact on the market.

The SEC, which has broad anti-fraud and civil liability authority over hedge funds, is well-positioned to focus on investor protection. Another group of regulators aims to minimize the potential for systemic risk by working with the regulated financial institutions that extend credit to and transact business with hedge funds. And the President's Working Group on Financial Markets – comprised of the Treasury Secretary and the Chairmen of the Federal Reserve Board, the SEC, and the CFTC – continues to review and monitor markets, assess issues related to the performance of derivatives, and study the activities of hedge funds in three broad areas: investor protection, operational risk, and potential for systemic risk. We have begun a series of educational meetings with a broad array of participants in the hedge fund community to gain insight as we move forward with our deliberations.

Conclusion

In conclusion, competitive capital markets will pave the way for continued economic growth that benefits all Americans. The issues I've outlined are crucial to ensuring that our capital markets remain the best in the world. And certain principles should guide us going forward.

First, it is necessary to take a global view. We don't operate in isolation, so it is very important to consider how changes we make affect the ability of our companies to compete globally and how these changes affect our interaction with markets and regulators around the world.

Second, our regulatory structure should be more agile and responsive to changes in today's marketplace.

Third, to stand the test of time, rules should be embedded in sound principles.

Fourth, regulators should take a risk-based approach to regulation, weighing the cost to shareholders against the benefits.

Fifth, our enforcement regime should punish and deter wrongdoing and encourage good behavior without hindering responsible risk-taking and innovation.

And, lastly, the best way our business leaders can protect the integrity and competitiveness of our markets is to exert moral leadership, where the threshold question is, "Is this right?" not "Do the rules allow us to do this?"

Our capital markets remain strong and competitive, but they face some significant challenges that do not lend themselves to easy answers or quick fixes. The Treasury Department plans to host a Conference on Capital Markets and Economic Competitiveness early next year. We will invite participants with a wide range of perspectives, particularly the investor perspective. The Conference will cover the three primary areas I have discussed today – our regulatory structure, our accounting system, and our legal system – all of which impact our capital markets and are critical to the overall economic competitiveness of our nation. Our objective will be to stimulate bipartisan discussion and to lay the groundwork for a long-term strategic examination of these issues.

In all that lies ahead, we must remember that the competitiveness of our capital markets depends to a large extent on our nation's overall economic competitiveness. We are fortunate that because our economy is so strong, we approach our challenges from a position of strength. And we should use this position of strength to tackle long-term challenges that will affect our economic competitiveness. We must:

- reform our entitlement programs;
- advance energy security;
- maintain and strengthen trade and investment policies that benefit American workers;
- focus on economic and educational policies that will add jobs, improve productivity, and result in tangible income growth for all Americans;
- and, of course, strengthen and maintain the competitiveness of our capital markets.

I came to Washington determined to accomplish as much as possible over the next two years. These challenges won't be easy, but I'm very grateful for the opportunity to work with the President and the other members of his economic team to help America keep its competitive edge in the 21st century.

Thank you very much.

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