**STATEMENT OF**

**FORMER SPEAKER OF THE HOUSE NEWT GINGRICH**

**BEFORE THE**

**HOUSE COMMITTEE ON FINANCIAL SERVICES**

**SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND**

**GOVERNMENT SPONSORED ENTERPRISES**

**WEDNESDAY, APRIL 26, 2006**

Chairman Baker, Ranking Member Kanjorski, and members of the subcommittee:

Thank you for inviting me to appear before you today to testify on the global competitiveness of America's capital markets.

America's ability to win -- and not just compete -- in the global economy depends in part on our having the world's most efficient capital markets. Substantial reforms in this area will be required for America to continue to be the most successful economy in the world and the best source of high paying jobs and enough economic growth to sustain the Baby Boomers and their children when they retire.

Last year, the London Stock Exchange recorded 129 new listings by companies from 29 different countries. In the United States, NASDAQ gained a net of fourteen and the New York Stock Exchange a net of six. In a press report by the London Stock Exchange on the reasons for its success, it cited that "about 38 percent of the international companies surveyed said they had considered floating in the United States. Of those, 90 percent said the onerous demands of the new Sarbanes-Oxley corporate governance law had made London listing more attractive."

Recently, New York Stock Exchange CEO John Thain told the Senate that last year that not a single top ten initial public offering (IPO) (by size of

market capitalization) was registered in the U.S., and that 23 out of the top 25 largest IPOs in the world were registered outside the U.S. last year. This is contrast to the year 2000, when nine out of every ten dollars raised by foreign companies was raised in the U.S.

These are only a few indications that the very nature of our times will give the United States no choice but to transform or decay. We must make the bold changes required to enable our capital markets to flourish and our economy to win in the global marketplace or we will cede our leadership position to others.

For over a century, the pace of progress in America has been driven by the discoveries of scientists and technologists, brought to the marketplace by entrepreneurs in the form of products and services. We have flourished and lead the world because we have adapted to the opportunities created by science and technology. Countries that have ignored these opportunities have fallen behind in standards of living and quality of life.

America is facing a serious challenge to our economic superiority for the first time since we surpassed Great Britain around 1840. Over the last 150 years we have been the most dynamic economy in the world. While Germany and Japan could challenge us in some areas, they were simply not big enough to compete with America in everything.

Now we are faced with the economic rise of China and India, countries whose populations are larger than our own. Americans will have to be four times as productive just to match them in overall economic activity (since there will be four times as many Chinese and over three times as many Indians as Americans). Historically, we have achieved far more than this level of productivity advantage. But as other countries study us and learn what we do, they will learn to be better competitors.

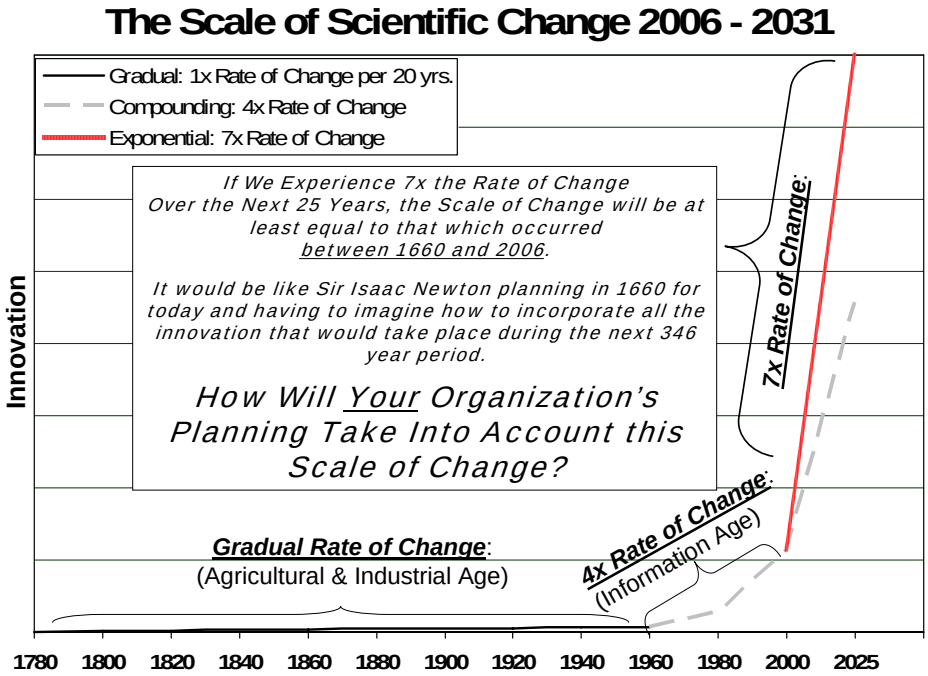
In scientific knowledge and advancement, we are experiencing today a rate of change that is four times greater than what we did during the last 25 years—making the scale of change we will experience in the 25 year period 2006-2031 at least equivalent to what we experienced in the 100 year period 1906-2006.

More scientists are alive today than in all of previous human history combined. Furthermore, instead of sharing knowledge at the rate of the printing press and mail delivery, scientists are sharing knowledge through the Internet and the cell phone. This explosion of knowledge is moved from laboratory to market by a venture capital-licensing-royalty system of unprecedented power and ability.

Drivers of change fueled by Moore's Law will increase knowledge and productivity on a world wide basis—virtually guaranteeing continuous down-ward pricing pressures: information technology; communications; nano-scale science and technology; quantum mechanics; and biology.

In terms of productivity improvement, this is much like the period of 1873 to 1896 when there were advancements in steel, electricity, electric light, steam ships and the telephone. For example, the introduction of commercial refrigerator cars for railroad and ships meant that you could deliver Texas beef anywhere—collapsing food prices. The constant and steady explosion of productivity will continue to drive prices downward.

The scale of scientific change we will experience in the next 25 years is suggested by the following diagram.



We are in the early stages of a revolution in knowledge that will transform the way we live, learn, and do business.

This scale of change means that there are enormous economic opportunities for the United States in the coming years.

Having strong capital markets is a key to continuing the entrepreneurial creativity that has made us the most successful and prosperous economy in the world for over 160 years. Strong U.S. capital markets will also ensure that America can capture the rewards of a rapidly innovating scientific and entrepreneurially based economy.

When you examine this scale of change and combine it with the rise of massive new centers of low cost production in China, India, and elsewhere, you are in a transformed world. Yet, our government has not adapted nearly fast enough, in its function and policies, to this changing world.

The following are a set of recommendations for this subcommittee to consider as it continues its important work of ensuring that the United States has the most efficient and productive capital markets in the world:

1. **Fundamental Overhaul of Sarbanes-Oxley**. With three years experience of the Sarbanes-Oxley regulatory regime, it has become plainly evident that this law requires a fundamental overhaul. The good intentions of Congress have met with the law of unintended consequences. The explicit and implicit costs of Sarbanes-Oxley compliance are staggeringly high and far exceed the benefits. The costs are disproportionately large for small businesses, which on a percentage of revenue basis are estimated to be 11 times that of larger companies. Congress clearly did not intend this. The Securities and Exchange Commission's (SEC) original estimate of $91,000 per company on average was wildly optimistic and probably undercounts compliance costs by a factor of 40 to 50. There is also the future cost associated with the litigation "time bomb" set in motion by Sarbanes-Oxley. This refers to the onslaught of lawsuits that can be expected in any future market or industry downturn owing to the new causes of action created by Sarbanes-Oxley and also by the apparent ease in which liability can be shown by tracing decline in market price to a shortcoming in internal financial controls. With such compliance costs, it is little wonder that so

many new listings chose the London Stock Exchange over a U.S. exchange. Moreover, judging from what we have learned from the Rudman Report on Fannie Mae, it appears that the reliance that Sarbanes-Oxley puts on audit committees and boards of directors were insufficient to prevent the financial deception by management in this high profile case. It is examples like this one that makes it possible to question whether the cost associated with Sarbanes-Oxley compliance is not simply a deadweight loss to the economy.

Alex Pollock and Peter Wallison of the American Enterprise Institute are two of the most thoughtful observers I know on Sarbanes-Oxley. I am attaching to this statement as **Appendix A** recent Congressional testimony by Pollock on the unintended burdens of the Act. In particular, Pollock sets forth a number of recommendations that this subcommittee should consider, which I reproduce here:

a. Enact the provisions of HR 1641, introduced last year by Congressman Jeff Flake of Arizona. HR 1641 would make Section 404 of Sarbanes-Oxley voluntary, as opposed to mandatory. This approach would be well suited to a market economy and a free society.

   If investors actually want the kind of heavy internal control documentation 404 demands, then the companies will do it because investors will demand it. Investors will punish those companies which opt out.

   If, on the other hand, investors conclude that resources would be better spent elsewhere-- on research, or introducing new products, or customer service, for example-- then companies will do that and the investors will react accordingly.

b. If a totally voluntary approach be viewed as politically impossible, at a minimum make Section 404 voluntary for smaller public companies. Exemption from these requirements for these companies is recommended by the SEC's Advisory Committee on Smaller Public Companies.

[Pollock] believe[s] that “voluntary with disclosure and explanation” would be a better concept than simple “exemption.” The company should decide what approach it will take to internal control certification and explain to its investors why it has so chosen. Investors can consider the company’s logic and make up their own mind.

c. Instruct the Public Company Accounting Oversight Board (PCAOB) to change its review standard from “other than a remote likelihood” to “a material risk of loss or fraud.” [Pollock] think[s] this is essential to improve the implementation behavior of the accounting firms.

d. State clearly that Congress does not have the naïve belief that accounting is something objective, but rather understands, as every financial professional does, that accounting is full of more or less subjective judgments, estimates of the unknowable future, and debatable competing theories. As the saying goes, it is art, and by no means science.

   Therefore the express instruction of Congress should be that consultation, judgment and professional advice on the application of accounting standards is expected and demanded of accounting firms.

e. Instruct the PCAOB to require a Section 404 regime for the public accounting firms themselves, as a condition of their public trust, on the same standards as apply to public companies.

f. Mandate a report from the SEC and the GAO comparing the British principles-based Turnbull Guidance on corporate risk controls to the approach taken by Sarbanes-Oxley implementation.

g. Bring the PCAOB under Congressional authority as a regulatory agency should be, subject to appropriations, oversight and a normal appointments process, and move PCAOB assessments, as they are for any other regulator, to the regulated entities.

h. Finally, enact a sunset or reauthorization requirement for Section 404 of Sarbanes-Oxley five years from now. That would be 2011, a decade after the scandals which gave it birth, with correspondingly greater experience, knowledge and perspective for all concerned.

2. **Reign in State Attorneys-General**. We must have a uniform national set of securities regulations. To the extent that state Attorneys-General are encroaching in this rule-making area, then the Congress should direct the SEC to preempt such state action.

   In recent years, the actions of some state Attorneys-General are eliciting serious questions about the fair treatment of corporations and threatening the rule of law. A competitive environment has evolved in which "activism" is the norm and generating media headlines an ever present goal as Attorneys-General crusade against one industry after another. Further, Attorneys-General have reaped publicity and political advantages through their pursuit of multi-state litigation targeting the tobacco, pharmaceutical, software and financial services industries. A few Attorneys-General have gained national attention by speaking to the media during the pendency of investigations.

   Also disconcerting is the alliance between Attorneys-General and members of the plaintiffs' bar, who are often awarded contingency fee contracts for state work. These attorneys are also major campaign contributors of the elected Attorneys-General, raising significant concerns about conflict of interest and fairness in prosecutions and civil litigation.

   As trial lawyers ratchet-up their shopping of litigation concepts to state Attorneys-General, there needs to be legislation to address the problem of Attorneys-General hiring plaintiffs' attorneys on a contingency fee basis. The Private Attorney Retention Sunshine Act calls for increased government oversight and greater transparency when Attorneys-General seek to forge contingency fee deals with outside counsel. The Sunshine bill has already been enacted in seven states, and its adoption is being championed in others this year, including West Virginia and Florida.

Christopher DeMuth of the American Enterprise Institute has written about the dangers of unchecked interference by state Attorneys-General:

*Even more striking are the new coast-to-coast regimes being constructed by state officials like New York Attorney General Eliot Spitzer. He candidly admits that his mission is the wholesale restructuring of entire industries on a nationwide scale. The agreements he has imposed on Merrill Lynch and other financial services firms make detailed requirements of how the firms are to be managed in the future. This has created, thanks to collaboration with officials in other states, new national regulatory programs established entirely outside the legislative process and outside the public rule-making procedures of regulatory agencies. Instead, the deals are cut in lawyers' offices. The results are policy cartels with no exit for any firm or customer, no policy competition or experimentation, no federalism.*

*The emerging phenomenon is one of multiplying special-purpose national governments operating in parallel with the official national government and without any coterminous political accountability. This has come to pass because of the desuetude of several Constitutional provisions, none more important than the Compact Clause, which provides that "no State shall, without the Consent of Congress, enter into any Agreement…with another State." The requirement of Congressional approval is unqualified and it is fundamental. For a gang of states to go off on their own and set up independent governing regimes is, politically, a form of partial secession. Yet this protection has lapsed through judicial neglect.*

*Here the big innovation was the 1998 settlement agreement among most of the states and the leading tobacco companies. The agreement established a national regime for the marketing of tobacco products, including a de facto national excise tax on cigarettes designed to raise $246 billion over 25 years, a range of spending programs funded by the revenues, entry controls to limit competition from new manufacturers, and a host of other regulatory requirements. The states have become so addicted to the tobacco revenue windfall that the decline in cigarette smoking is now a serious fiscal worry.*

*The tobacco program was followed by the Spitzer-led initiatives for regulating investment firms. The pharmaceutical industry—already heavily regulated by the official federal government—is next. Attorney General activists are already closely coordinating a variety of cases in courts across the nation.*[1]

This blackmail model of Attorneys-General championed by New York's Eliot Spitzer, which mugs companies without going to court, is a job killer. These practices must be stopped.

The Congress should also take decisive action to halt any inter State agreements that are being made in violation of the Compact Clause. The Constitution is clear that the federal government sets the framework for the national economy. Congress and the Executive Branch have a constitutional duty to protect that role from encroachment by states.

3. **Litigation Reform**. Edwards Deming once warned that litigation was one of the greatest threats to the American economy. Prior to 1963, civil justice suits were a reasonable part of making America work. Only in the last forty years has the prospect of litigation emerged as a self-enriching industry for a narrow group of lawyers—the personal injury attorneys. Today, entire law firms exist solely to file such lawsuits. The scale of lawyer enrichment has grown to a point that some of the wealthiest persons in America are personal injury lawyers who participated in the tobacco settlement. Money that should have gone to those injured by smoking instead went to lawyers who now fly their own private airplanes and buy baseball teams.

   There are other major consequences of this explosion of litigation. Laws are being changed from an instrument of justice into an instrument of revenge and redistribution. Americans are learning to treat litigation as a lottery, to sue rather than settle, and to turn American civil life into one of conflict and suspicion.

   Investment decisions about creating new drugs, jobs, and trying new services are being made riskier by defense lawyers who warn about the litigation that has unpredictable and possibly bankrupting costs. This endangers the entrepreneurial character of our economy.

[1] Christopher DeMuth, "Unlimited Government," *The American Enterprise*, Jan-Feb, 2006

Such an environment makes America a less and less desirable place to do business for companies that increasingly have choices of where to locate in a global economy. Securities litigation also affects where new companies decide to seek capital financing.

Potential investors, looking at the litigation risks in America compared to the rest of the world, are beginning to shift investments to less risky countries.

We need to fix this. The following are a set of recommendations to reform our litigation system:

a. Arbitration Preferable to Litigation. Everyone should know that rapid, inexpensive arbitration is preferable to litigation. Cases involving technical knowledge should go first to panels of experts (health courts in the case of medical malpractice), but plaintiffs should be able to appeal to a court if they feel cheated. They should, however, have to carry the result of the expert panel with them into the litigation.

b. Losers Pay. Losers should be at risk for costs, and if the judge finds that the loser filed a case without substance, triple damages should be payable by the loser, and the personal injury lawyer should be required to pay court costs for having willfully brought a case without merit.

c. Fixing Percentage of Recovery for Injured Party. The injured party should be guaranteed 85 percent of the settlement while the personal injury lawyers should be limited to no more than 15 percent.

d. Prohibit Law Firms from Bringing Class Action Lawsuits. It should be illegal for a law firm to form a class action lawsuit for its own enrichment. The injured parties should originate the lawsuits and hire the law firm. The judge should have the option of opening the class action lawsuit to competitive bidding to find the least expensive law firm for the injured parties.

e. Ban Lawyer Advertising. We should return to a world in which lawyers do not advertise. There are profound reasons why society has historically held that lawyers should not publicly seek cases. The damage done by constant thirty-second reminders of the right to sue and the right to feel injured and trespassed upon is incalculable. It actively harms American society, the American economy, and the stature and prestige of the legal profession. The profession-enhancing rationale behind anti– ambulance chasing laws was right. The reduction of the law into a commercial venture is wrong. It is time to reverse that decision and make the law once again above the profit motive.

f. Securities Litigation Reform. Despite enactment in 1995 of the Private Securities Litigation Reform Act, claims are growing larger and cases are frequently settled for massive amounts of money. Securities class action settlements have increased on an inflation–adjusted basis from $150 million in 1997 to $9.6 billion in 2005. There needs to be reform of the system to ensure that companies are not burdened by excessive, costly litigation which fails to compensate truly injured parties. The Congress should also assess how to preempt any Sarbanes-Oxley litigation "time bomb" from swamping the courts and harming investors. In October 2005, the U.S. Chamber Institute for Legal Reform released an economic study directed by a world-renowned securities scholar and companion research paper that provide a detailed overview of who benefits most from securities class actions and how these cases impact the business community and the U.S. economy. The study is the first of its kind and reveals that most institutional investors don't simply break even from securities class action settlements; many of them benefit, accumulating the gains of stock prices inflated by alleged fraud and also receiving compensation for losses suffered as a result of allegations of fraud. The companion research paper draws significant conclusions about the economic consequences of securities lawsuits, including the alarming conjecture that the mere filing of a securities class action lawsuit on average results in a 3.5 percent drop in the defendant company's equity value.

The current system is not working as intended and it was created in a very different environment. The SEC has now increased its enforcement resources and is able to bring more cases. For example, in 1986 the SEC's annual budget was $106.4 million and in 2005 its annual budget was $961.3 million. We need fundamental reform of this system given the new regulatory environment and given that the current system clearly does not work well as the economic studies reveal.

g. Fixing the Fraud and Abuse in Mass Tort Litigation. The crux of the trial lawyers' mass tort business model is the medical screening process in which lawyers, doctors and screening companies ally to mass produce claims. This assembly-line process has enabled trial lawyers to quickly and inexpensively generate such a high volume of plaintiffs that most defendants opt to settle, rather than risk time and money on a trial. The end result is a multi-million dollar payday for plaintiffs' lawyers, who leverage their windfall to finance more mass screening operations that will yield more questionable claims to serve as the basis for more litigation against American employers.

To clean up the screening process once and for all, there needs to be significant legislative and regulatory reforms of the system. Possible solutions include:

- Legislation at the federal or state level that would set standards for diagnoses, requiring that diagnoses state the disease is caused by exposure to the product in question and rule out alternative causes; proof of a doctor-patient relationship; and a medical indication that a test is needed before it is prescribed.

- Creation of uniform procedures for medical and legal personnel involved in medical screening.

- Furthermore, National Institute of Organizational Safety and Health (NIOSH) needs to be urged to strengthen a proposed code of ethics for B-Readers, physicians specially certified to diagnose diseases like silicosis and asbestosis by reading x-

rays. To make sure these doctors are held accountable, NIOSH needs to audit and decertify B-Readers who depart dramatically from industry best practices in making their diagnoses.

4. **Fully Fund the XBRL Project**. The Congress should fully fund the development of the XBRL project championed by SEC Chairman Cox so that U.S. companies can take advantage of this financial reporting system that allows investors and analysts to compare company performance. I understand that this project is estimated to cost approximately $3.5 million to complete. Given the dramatic economic benefits that will accrue to the U.S. from the comparatively small cost of this project as well as the long term enhancement of the competitiveness of our capital markets, supporting this effort with federal dollars is well justified. Set forth as **Appendix B** is an essay by Peter Wallison that describes what is at stake.

5. **Transform the SEC into the Model Federal Agency of 21st Century Entrepreneurial Government**. It is an objective fact that government today is incapable of moving at the speed of the Information age.

   There is a practical reason government cannot function at the speed of the information age. Modern government as we know it is an intellectual product of the civil service reform movement of the 1880s.

   Think of the implications of that reality.

   A movement that matured over 120 years ago was a movement developed in a period when male clerks used quill pens and dipped them into ink bottles.

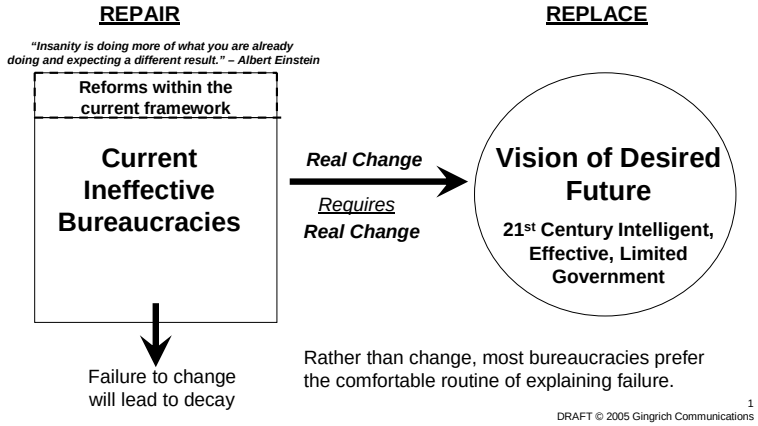
   The processes, checklists, and speed appropriate to a pre-telephone, pre-typewriter era of government bureaucracy are clearly hopelessly obsolete.

   Yet the unseen mental assumptions of modern bureaucracy are fully as out of date and obsolete, fully as hopeless at keeping up with the modern world as that office would be.

It is simply impossible for the SEC to meet the challenges of the 21st century with the industrial era regulatory paperwork and process focused system. The SEC must become a real time, transparent, self policing market focused system.

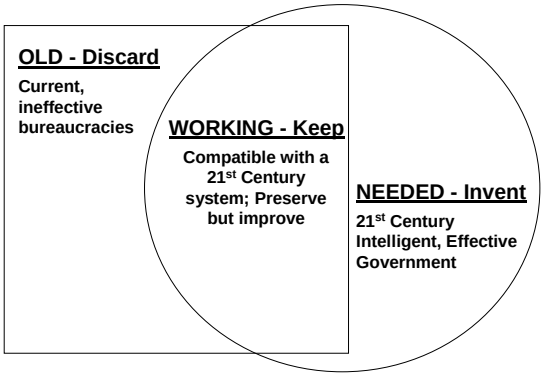
The difference in orientation between what we are currently focused on and where we should be going can be illustrated vividly.

**Building a 21st Century Intelligent, Effective, Limited Government Versus Marginally Reforming Current Ineffective Bureaucracies**




Of course, it is not possible to reach the desired future in one step. It will involve a series of transitions, which can also be illustrated.

**Transitioning to a 21st Century Intelligent, Effective, Limited Government Will Necessarily Mix the Old and the New**



Congress can help speed this transformation of the SEC by helping to define the metrics by which it will measure whether the SEC is meeting its goals.

A good place to start looking for ideas on how to reform the SEC is a paper by Peter Wallison and Cameron Smith dated October 5, 2005 and entitled "The Responsibility of the Securities and Exchange Commission for Efficiency, Competition and Capital Formation: Reforms for the First 1000 Days." It is a wealth of ideas for guiding the improvement of the SEC.

6. **Examine Stock Options**. The Congress should revisit the decision by the Federal Accounting Standards Board (FASB) to require the expensing of employee stock options (ESOs) by firms that issue options to their employees. A way should be found for startups and small companies to revert to the older model of stock options. The subcommittee should consider the approach outlined by Charles Calomiris in an August 5, 2005 AEI Working Paper entitled "Expensing Employee Stock Options". In it, Calomiris states:

   *It would be better to require that firms estimate expected dilution from existing ESOs on an ongoing basis, and include those estimates in the denominator of a constantly updated calculation of earnings per share. That statistic could be given a prominent place in the public reports of the firm, and would be available as an important source of information for investors.*

   *The computation of expected dilution (that is, the estimate of the number of shares granted that are expected to be converted in the future) would, of course, be subject to the same measurement errors noted in Sections 6-10 [of this paper]. But the consequences of those errors would not be the same. First, there would be no double counting of dilution costs. Second, there would not be any potential for confusion on the part of investors about the actual expenses of the firm, or the warranted value of the firm. Third, avoiding expensing would eliminate the incorporation of unreliable and misleading measures of "cost" in the firms accounting earnings. Fourth, expected dilution costs could be updated on an ongoing basis, so that*

*changes in stock prices and volatility could be reflected in forward looking estimates of dilution.*

*This forward-looking approach to measuring dilution would allow stockholders to take account of dilution before it occurs (an improvement on the current system of measuring earnings per share), and would provide a more accurate measure of future dilution than expensing, since FASB's proposal would fix the magnitude of expensing at the grant date and not update it.*

7. **Transform Math and Science Learning**. Winning the challenge of China and India will require profound domestic transformations, especially in math and science education, for America to continue to be the most successful economy in the world. The collapse of math and science education in the United States and the relative decline of investment in basic research is an enormous strategic threat to American national security. This is a strategically disappearing advantage. There is a grave danger that the United States will find itself collapsing in scientific and technological capabilities in our lifetime. In fact, the 14 bipartisan members of the Hart-Rudman Commission on national security unanimously agreed that the failure of math and science education is a greater threat than any conceivable conventional war in the next 25 years. The Commission went on to assert that only a nuclear or biological weapon going off in an American city was a greater threat.

   Improving math and science education is the single greatest challenge to our continued economic and national security leadership. Without a profound improvement in math and science learning, America will simply not be able to sustain its national security nor compete for high value jobs in the world market.

   This is among the most important decisions our generation will make about our country's future and our children's future. For the last twenty years, we have tried to improve education while accepting the fundamental principles of a failed system, guarded by the education bureaucrats and teachers unions. We must now transform math and science education or fall behind. It really is that simple.

Senator Alexander has shown tremendous leadership on this issue and has recently put forward an education reform bill that this subcommittee should review.

Set forth below are an additional set of ideas:

a. Getting students to study math and science may be done through incentives. We should experiment with paying students for taking difficult subjects in math and science. In this world of immediate gratification, many young people in poorer neighborhoods look to athletes and musicians as their future and drugs and violence become their reality when their hopes inevitably most often fail. The long and difficult road to becoming a PhD. in math or chemistry has virtually no support in these neighborhoods nor is it presented as an attractive way out. But, if as early as seventh grade there were some economic reward for learning math and science, which competes head to head with McDonalds, the signal sent would be immediate and dramatic. If the rewards went up as the classes grew more difficult we would have students pouring into math and science instead of fleeing it.

   We should therefore conduct a pilot project to see if this approach can be successful. And we should begin by targeting a poor inner city district where the potential for sending a strong signal is perhaps strongest.

   As a Congressman, I invented a program called “Earning by Learning.” I gave my speech money to pay poor children in public housing $2 a book for every book they read in the summer. The first year, a young girl in Villa Rica, Georgia read eighty-three books and earned $166. That was big money for a fourth grader in Villa Rica public housing. That fall, she got into trouble when she went back to school because she was too used to reading and kept doing more than the curriculum permitted. She wanted to learn so much that she was considered a troublemaker. Everywhere we tried “Earning by Learning” it worked.

b. We should set a goal of eliminating fifty percent of the education bureaucracy outside the classroom and the laboratory and

dedicate the savings to financing the improvements in math and science education.

There has been a steady growth in the amount of money spent on red tape, bureaucracy, and supervision. We now have curriculum specialists who consult with curriculum consultants, who work with curriculum supervisors, who manage curriculum department heads, who occasionally meet with teachers. The more we seem to spend on education, the smaller the share we spend on inspiring and rewarding those actually doing the educating.

c. Students must have informed, enthusiastic, and confident teachers guiding them in difficult subjects. We therefore need to foster and encourage teacher specialists who have mastered a subject matter, such as engineers and mathematicians. They should be allowed to teach after taking only one course on the fundamentals of teaching. They should be allowed to teach part-time so that more professionals can have the opportunity to share their knowledge and experience in the classroom. Moreover, every state should pass a law establishing an absolute preference for part-time specialists with real knowledge over full-time teachers who do not know the subject. Finally, by the 2008 school year, no one should be allowed to teach math and science that is not competent in the subject matter.

d. We should apply the free enterprise system to our education system by introducing competition among schools, administrators, and teachers. Our educators should be paid based on their performance and held accountable based on clear standards with real consequences.

e. Graduates willing to stay in math and science fields should pay zero interest on their student loans until their incomes reach four times the national average income. This would encourage students to stay in these needed fields and continue to pursue knowledge.

f. We should reward the best and brightest high school graduates and fully fund their further education. Norman Augustine, the

former Chairman and CEO of Lockheed Martin and former Undersecretary of the Army, recently testified before the Hose Committee on Education and the Workforce. He recommended an America's Scholars Program to fully find the undergraduate and graduate education on the physical sciences, math, biosciences, or engineering of the top 1,000 high school seniors each year. These scholarships would be based on academic success and ability to maintain the highest degree of excellence throughout the remainder of their education.

g. We should reward and encourage private sector participation in math and science education. We should provide a tax credit to corporations that fund basic research in science and technology at our nation's universities.

h. Congressman Frank Wolf was exactly right in a letter he sent to President Bush last May in which he cited the urgent national security need to triple the federal budget allocation for innovation – basic science research and development -- over the next decade. America must act to rebuild our core strength in basic science research and development so that America can maintain its global position long into the 21st Century.

Our past achievements in science, technology, and economic growth will disappear if we fail to transform our system of math and science education and make more investments in basic research. The ability to provide jobs and the American way of life in the 21st century depends on our competitiveness with China and India, which in turn, depends on our success in leading the world in math and science education and continuing to be the world leader in innovation.

These ideas are designed to stimulate thinking beyond the timid "let's do more of the same" that has greeted every call for rethinking math and science education. If the future and safety of our country really are at stake in the areas of math, science, and engineering (and I believe they are), then we can do no less than respond with an appropriate intensity and scale.

American Enterprise Institute for Public Policy Research

# Addressing the Unintended Burdens of the Sarbanes-Oxley Act

By Alex J. Pollock
Posted: Monday, April 3, 2006

TESTIMONY
Committee on Government Reform (United States House of Representatives)
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**Implementation Bureaucracy**

This hearing is important and timely. With more than three years of national experience with Sarbanes-Oxley implementation to consider, Congress can now easily see that its good intentions have resulted in notable adverse consequences. I am sure you have heard a lot about this from the businesses in your own districts.

Let us start with the most obvious unintended results. Sarbanes-Oxley implementation activities, particularly the Section 404 certifications which have become notorious, have created a tremendously expensive amount of paperwork and bureaucracy.

The explicit costs alone are extremely high and disproportionately high for smaller companies. The implicit costs of employee and management time and effort are high. In addition, there are the opportunity costs of diversion of management focus from playing offense to playing defense.

The total costs far outweigh the benefits which are likely to arise from them, especially for smaller companies.

This is especially true because the testimony of history is quite clear on the reliable regularity with which frauds and scandals accompany investment booms and bubbles. In my opinion, the detailed rules, bureaucratic overhead, and mechanical requirements which characterize Sarbanes-Oxley implementation will not prevent fraud and scandal during the next boom when it comes.

In a typical view of its Sarbanes-Oxley experience, frankly expressed, one smaller company's letter to the SEC describes the following: "concentration on minutia…redundant and inefficient…adversarial

relationship with audit firm…form over function…unrealistic requirements on small and developing companies." It further points out that the cost of all this, which far exceeded the estimates, is of course money taken away from its shareholders.

A letter from the British Confederation of Industry correctly observes that "Dealing with risks on the basis of a remote likelihood," which is the Sarbanes-Oxley implementation approach, "not only imposes huge costs but also makes this a nitpicking process."

An American trade association letter describes, "An atmosphere of near paranoia…the public accounting firms have increased their aversion to risk to an extreme degree."

On the disproportionate negative impact on smaller companies, the SEC's Advisory Committee on Smaller Public Companies has recently concluded: "The result is a cost/benefit equation that, many believe, diminishes shareholder value, makes smaller public companies less attractive as investment opportunities and impedes their ability to compete…. We believe Section 404 represents a clear problem for smaller public companies and their investors, one for which relief is urgently needed."

Another commentator, Eliot Spitzer, has described Sarbanes-Oxley implementation as an "unbelievable burden on small companies."

Congress clearly did not intend all this. The SEC did not intend it either, nor did it know what the effects of its regulation would be. This is apparent from the initial SEC estimate of a cost of $91,000 per company on average, an estimate which appears to be low by a factor of 50 or so. Either the SEC staff had very little understanding of what their regulation actually required, or interpretation of the regulation morphed in ways never imagined. Indeed, the SEC and the PCAOB subsequently criticized the accounting firms quite sharply for what Sarbanes-Oxley implementation has become.

In short, no one intended the outcome we've got. I believe it's time to fix it.

**Effects on Accounting Firms**

The flip side of the enormous expense and distraction for companies is that for the large public accounting firms, Sarbanes-Oxley implementation has been a revenue and profit bonanza. One journalist called it the greatest wealth transfer of modern times, from shareholders of companies to partners of accounting firms.

This is especially ironic since Congress was quite clear that this was not its intent. The Senate Committee Report on Section 404 was specific: “The Committee does not intend that the auditor’s evaluation be the subject of a separate engagement or the basis for increased charges or fees”! (emphasis added). Nevertheless, virtually every audit committee in the country has helplessly watched its audit fees escalate dramatically, unable to exercise any judgment about whether the expensive routines make sense for their shareholders. A second irony is that the implementation of an act dedicated to controlling conflicts of interest has created an obvious

conflict of interest for the accounting firms themselves. The more massive the Sarbanes-Oxley routines, the more memos, procedures and risk control descriptions which are generated, the more often they are reviewed and revised, the more meetings, the more interviews of managers, the more time it all takes, the more profitable the accounting firms become. No wonder they take out advertisements praising Sarbanes-Oxley!

In response to these developments, the “Pollock Proposal” is to expand Sarbanes-Oxley internal control requirements to cover the accounting firms themselves. Since they impose huge costs and nitpicking procedures on everybody else, they should have to go through the same Section 404 routines as a prerequisite to practicing on other people. I expect that, first, they would fail the reviews, and second, their views and reviews of others would become more reasonable.

Another perverse effect of Sarbanes-Oxley implementation is that, as another company wrote to the SEC, “External auditors are reluctant to give advice with regard to interpretation and application of complex accounting rules to avoid possible criticism from the PCAOB in regards to their independence.” A related comment: “Almost every significant audit-related decision is now being referred to the firm’s national offices rather than being addressed at the practice level.”

In other words, the PCAOB environment has made public accountants afraid to carry out the core function which defines a profession: exercising judgment. I consider this the reduction to absurdity of the effects of Sarbanes-Oxley implementation on accounting behavior--and a striking disservice to the companies trying to cope with the ever more convoluted accounting rules propounded by the FASB. Note that this issue suggests that we also need to review the PCAOB.

**Reform of Sarbanes-Oxley Implementation**

Learning from unambiguous experience, Congress now has the

opportunity to correct the expensive morass of problems resulting from the implementation of Sarbanes-Oxley in ways neither it nor anyone else ever intended, and to bring the costs to shareholders and the benefit to shareholders into balance.

Here's what I believe Congress should do:

1. Enact the provisions of HR 1641, introduced last year by Congressman Jeff Flake of Arizona. HR 1641 would make Section 404 of Sarbanes-Oxley voluntary, as opposed to mandatory. This approach would be well suited to a market economy and a free society.

If investors actually want the kind of heavy internal control documentation 404 demands, then the companies will do it because investors will demand it. Investors will punish those companies which opt out.

If, on the other hand, investors conclude that resources would be better spent elsewhere-- on research, or introducing new products, or customer service, for example-- then companies will do that and the investors will react accordingly.

2. If a totally voluntary approach be viewed as politically impossible, at a minimum make Section 404 voluntary for smaller public companies. Exemption from these requirements for these companies is recommended by the SEC's Advisory Committee on Smaller Public Companies.

I believe that "voluntary with disclosure and explanation" would be a better concept than simple "exemption." The company should decide what approach it will take to internal control certification and explain to its investors why it has so chosen. Investors can consider the company's logic and make up their own mind.

3. Instruct the PCAOB to change its review standard from "other than a remote likelihood" to "a material risk of loss or fraud." I think this is essential to improve the implementation behavior of the accounting firms.

4. State clearly that Congress does not have the naïve belief that accounting is something objective, but rather understands, as every financial professional does, that accounting is full of more or less subjective judgments, estimates of the unknowable future, and debatable competing theories. As the saying goes, it is art, and by no means science.

Therefore the express instruction of Congress should be that

consultation, judgment and professional advice on the application of accounting standards is expected and demanded of accounting firms.

5. Instruct the PCAOB to require a Section 404 regime for the public accounting firms themselves, as a condition of their public trust, on the same standards as apply to public companies.

6. Mandate a report from the SEC and the GAO comparing the British principles-based Turnbull Guidance on corporate risk controls to the approach taken by Sarbanes-Oxley implementation.

7. Bring the PCAOB under Congressional authority as a regulatory agency should be, subject to appropriations, oversight and a normal appointments process, and move PCAOB assessments, as they are for any other regulator, to the regulated entities.

8. Finally, enact a sunset or reauthorization requirement for Section 404 of Sarbanes-Oxley five years from now. That would be 2011, a decade after the scandals which gave it birth, with correspondingly greater experience, knowledge and perspective for all concerned.

I believe these steps would bring under control the unintended effects, which have proved so remarkably costly, bureaucratic and inefficient, caused by the way Sarbanes-Oxley has been implemented.

Thank you again for the chance to be here today.

American Enterprise Institute for Public Policy Research

# XBRL and U.S. Financial Market Leadership

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*To remain competitive internationally, U.S. companies need to accelerate the development and use of XBRL, a financial reporting system that enables investors and analysts to compare company performance.*

In December, the London Stock Exchange celebrated a record year for foreign company new issues, with 129 new listings by companies from twenty-nine different countries. In contrast, the New York Stock Exchange registered a net gain of six foreign listings (a gain of nineteen and a loss of thirteen) in 2005, and NASDAQ gained a net of fourteen. According to a press report by the London Stock Exchange on its success, “about 38 per cent of the international companies surveyed said they had considered floating in the United States. Of those, 90 per cent said the onerous demands of the new Sarbanes-Oxley corporate governance law had made London listing more attractive.” By now, it is well-known what harm Sarbanes-Oxley has done to the attractiveness of the U.S. securities markets, but what is not well-known is that the lack of resources available to a relatively obscure accounting group--engaged in the development of a technical-sounding disclosure system called XBRL--may also threaten not only the current primacy of the U.S. financial markets, but also the future competitiveness of U.S. companies.

Since 1998, the American Institute of Certified Public Accountants (AICPA) and a few other organizations have sponsored the

development of a taxonomy for extensible business reporting language (XBRL), a derivation of the computer language XML that has the ability to tag individual words and numbers so that they can be understood in a particular context. The tagging facility permits financial statements, and even text such as footnotes, to be translated into a common language that can be read by computer applications. Thus, an analyst or investor who is interested in comparing, for example, the oil reserves of all publicly reporting energy companies would be able--using XBRL--to search a database containing the financial statements or 10K reports of these companies and pull out the relevant data in seconds. Because XBRL tags each term with contextual meaning, it allows the search engine to ignore “reserves” for bad debts or other purposes and to extract only the data on oil reserves. Without this facility, the same information would have to be developed through a time-consuming page-by-page search through the disclosure materials filed with the Securities and Exchange Commission (SEC).

XBRL represents a huge advance in the information potentially available to investors and analysts, and its significance has not been lost on the new chairman of the SEC, Christopher Cox. Since taking office, Cox has made the implementation of XBRL--which he calls “interactive data” in order to avoid the techie connotation of XBRL--one of his key priorities, devoting attention to it in almost a third of all his public speeches. Under his prodding, the SEC is doing what it can to encourage the use of XBRL by public companies, most recently offering expedited review of securities registrations for those companies that file in the interactive data format.

But there is a problem. The development of the XBRL taxonomy--the definitions and classifications that enable contextual tags to be applied to every item in a company’s financial statements--is going slowly. As Cox explains, “the development of taxonomies lacks resources. Believe it or not, the awesome global challenge of fashioning a new way for billions of people to exchange financial data is currently dependent on the success of one solitary man who labors in anonymity at XBRL-US,” the coalition of U.S. firms that has overall responsibility for developing the XBRL taxonomy. Indeed, it’s true: only one person is currently employed full time on this task; the others are volunteers who believe in the value of XBRL but are employed elsewhere and help out when they can. This bizarre situation--in which the chairman of the SEC sees great value in a technological advance that is limping along in a state of resource privation--is the result of the traditional American view that the private sector, and not the government, ought to lead in the development of market innovations. But this approach, ordinarily so successful, does not work when no private sector company or group sees an immediate economic benefit from an

investment. Up to now, the AICPA has mostly been footing the bill, and the organization deserves applause for doing so, but even the accounting industry cannot afford to devote substantial resources to the development of a disclosure system that will mostly be of use to analysts. It is likely, in fact, that the XBRL project will separate from the AICPA this year.

And why is this a problem? For the same reason that the growth of the London Stock Exchange is a problem. The EU is also aware of the power and significance of XBRL, but its officials have not relegated it to a private, voluntary initiative. In typical European fashion, the governments have funded and pushed XBRL through to completion. Now, the EU's new common financial reporting system, known as International Financial Reporting Standards (IFRS), can be stated fully in XBRL. The United States lags behind. Before Chairman Cox, the SEC would not even acknowledge the significance of XBRL, and its development has been slow and uneven. Now that the value of the system has been officially recognized, it is far behind in its development.

Here, then, we come to the crux of the issue: in the future, companies that want their financial statements to be more accessible to investors and analysts will have another reason, apart from Sarbanes-Oxley, to offer their securities in the EU, particularly London, and to report their financial results in IFRS. And, even worse, in the globalized capital market of today, capital will flow to the companies whose financial statements are most easily analyzed and understood, giving those companies that state their financials in IFRS an important competitive advantage over the U.S. companies that use generally accepted accounting principles (U.S.-GAAP).

To be sure, at the moment, the U.S. financial reporting system is the preferred financial reporting system for most businesses, but IFRS is not far behind. According to the latest data available, U.S.-GAAP is used by companies comprising 53 percent of the capitalization of all markets, while IFRS is used by 35 percent. The balance, 12 percent, use other financial reporting systems but will likely convert to either U.S.-GAAP or IFRS as the capital markets continue to globalize. As shown by the growth of the London stock market, however, and the corresponding decline in foreign listings on the U.S. markets, IFRS is closing the gap and will continue to do so.

So what we have is a competition in two distinct areas, all revolving around the development of XBRL. The first is competition between the U.S. and EU securities markets for dominance in the global financial markets of the future. The EU, which has now put in place the XBRL

taxonomies that are necessary to make financial reports stated in IFRS more accessible to investors and analysts than those stated in U.S.-GAAP, is in a position to take advantage of this resource in attracting new listings and encouraging the use of IFRS. But the second area of competition may be even more important in the long run. Unless the XBRL taxonomies can be completed soon, U.S. companies that report in U.S.-GAAP may find themselves at a disadvantage in attracting capital vis-à-vis foreign competitors that use IFRS. The long-run consequences for the competitiveness of the U.S. economy as a whole could thus be adversely affected.

What to do? Now that XBRL has the full endorsement of the SEC, there can be no reason for U.S. companies to hold back. XBRL is coming--the only question is whether it will be sooner or later. The competition between the United States and the EU for financial dominance and the competition among companies for scarce capital argue strongly for the U.S. financial and industrial communities to get behind the XBRL effort. This means providing the financial resources to increase the personnel available to the XBRL-US consortium. It does not take much to join (www.xbrl.org/us), and there is a lot at stake.

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