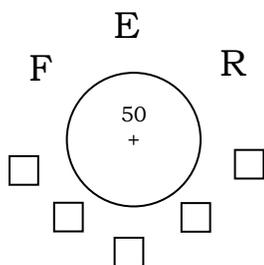


FINANCIAL ECONOMISTS ROUNDTABLE

For Release
September 7, 2007



STATEMENT ON “THE INTERNATIONAL COMPETITIVENESS OF U.S. CAPITAL MARKETS”

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The Financial Economists Roundtable (FER) is a group of senior financial economists, who have made significant contributions to the finance literature and seek to apply their knowledge to current policy debates. The Roundtable focuses on microeconomic issues in investments, corporate finance, and financial institutions and markets, both in the U.S. and internationally. Its major objective is to create a forum for intellectual interaction that promotes in-depth analyses of current policy issues in order to raise the level of public and private policy debate and improve the quality of policy decision.

FER was founded in 1993 and meets annually. Members attending a FER meeting discuss specific policy issues on which statements may be adopted. When a statement is issued, it reflects a consensus among the majority of the attending members and is signed by all members supporting it. The statements are intended to increase the awareness and understanding of public policy makers, the financial economics profession, the communications media, and the general public. FER statements are distributed to relevant policy makers and the media.

The following statement on “The International Competitiveness of U.S. Capital Markets” is the result of a discussion at FER’s annual meeting on July 15 – 16, 2007 in San Diego, California. A list of members approving the statement and their current or most recent affiliation is attached.

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Statement of the Financial Economists Roundtable
On
**The International Competitiveness
of U.S. Capital Markets**
September 7, 2007

The Committee on Capital Markets Regulation (better known as the “Paulson Committee”) issued an Interim Report (the “Report”) on November 30, 2006, concluding that “the United States is losing its leading competitive position as compared to stock markets and financial centers abroad.”¹ This report was quickly followed by a study commissioned by New York Mayor Michael Bloomberg and Senator Charles Schumer and prepared by McKinsey & Co., which reached similar conclusions.² At its July 2007 annual meeting the Financial Economists Roundtable (FER) discussed the Report and the issues raised by it. This statement represents a consensus of the views of a majority of the FER members on several issues raised by that report.

The Report

As evidence in support of its conclusion that “the U.S. is losing its leading competitive position,” the Report cites the decline in the U.S.’s share of global IPOs, the migration of trading volume to less intensively regulated securities markets (London and Hong Kong in particular), and the increasing preference of foreign firms to raise capital in the United States in private rather than public markets (thereby avoiding most of the SEC’s mandated disclosure requirements and their accompanying liability potential).³ While the Report acknowledges that there are many factors responsible for the loss of U.S. competitiveness (such as the increased integrity and trust in competing foreign markets, the increase in liquidity in foreign and private markets, and improvements in technology that make it easier for all investors to use foreign markets), the focus of the report is on legal and regulatory conditions in the U.S. that make U.S. capital markets less attractive to investors.⁴ In the words of the Report: “There is little public policy can do to reverse the impact of the first three factors There are opportunities, however, to make adjustments to our regulatory and litigation framework so that public markets are less burdensome.”⁵

The Report finds that a major reason for the loss of U.S. competitiveness is the “shift of regulatory intensity balance” towards what might be deemed “excessive” regulation of U.S. markets, and “concludes that the solution to the competitive problem of U.S. capital markets lies, on the one hand, in reducing the burden of litigation and

¹ p. ix.

² McKinsey & Co, “Sustaining New York’s and the US’ Global Financial Services Leadership”, The City of New York Office of the Mayor (January 2007)

³ p. x.

⁴ pp. 4-5.

⁵ Id.

regulation and, on the other hand, in increasing shareholder rights.”⁶ To redress this imbalance the Report makes no less than 32 specific recommendations on how to change the regulatory and enforcement system in four areas: regulatory process, the public and private enforcement system, shareholder rights, and implementation of the Sarbanes-Oxley Act of 2002 (SOX), especially §404.

Critics of the Report have rightly noted the lack of a clear connection between the measures of the loss of U.S. competitiveness cited by the Report and the importance it attaches to “regulatory and litigation burdens” as explanations or causes of these trends. We do not believe it would be useful to add still another voice to those pointing out the failure of the Report to make specific causal connections between the international competitiveness problems it identifies and the “regulatory and legal” changes it proposes as a solution to these problems, or the failure of the Report to even consider the potential benefits of some of the regulations it would either eliminate or significantly alter.

Indeed, we are skeptical even about the relevance of the measures of competitiveness that the Report relies on to buttress its argument that the United States has a significant competitive problem. For example, the Report makes much of its contention that new foreign listings on U.S. exchanges have fallen in recent years, while foreign listings in London have increased significantly, allegedly because of “overregulation” in the United States. But in the opinion of the FER, the Report does not demonstrate any causation between “overregulation” and the decline of foreign listings. Recent listing patterns appear to be driven by factors other than “overregulation,” and in particular by changes in the characteristics of firms that seek an international listing. In addition, there is evidence that foreign corporations that list in the United States receive a higher valuation premium compared to similar firms that do not cross-list in the U.S., and that this valuation premium has not declined since passage of SOX.⁷ While there also are academic studies that do find a decline in cross-listing premia after the adoption of SOX, they too recognize the difficulty of concluding that SOX is the cause of this decline.⁸ Thus, even the measures of competitive erosion that the Report points to do not unequivocally support its contention that “overregulation” in the U.S. subsequent to the passage of SOX has been the cause of a significant competitive erosion of U.S. stock markets.

Notwithstanding the Report’s shortcomings, its specific recommendations do serve the purpose of focusing attention on regulatory and enforcement mechanisms in U.S. securities markets that may not be working as anticipated and may need improvement. The FER identified four such mechanisms: litigation costs imposed on firms raising capital in the U.S. because of securities class action suits; audit costs associated with the implementation of §404 of Sarbanes-Oxley Act (SOX); requirements imposed on foreign companies wishing to issue and have their securities traded on U.S.

⁶ p. xii.

⁷ Craig Doidge, G. Andrew Karolyi, and Rene M. Stulz, “Has New York become less competitive in global markets? Evaluating foreign listing choices over time,” European Corporate Governance Institute Working Paper 173/2007 (June 2007).

⁸See, for example, Kate Litvak, “Long-Term Effects of Sarbanes-Oxley on Cross-Listing Premia,” U. of Texas Law School, June 2007, at p. 6, available at <http://ssrn.com/abstract=994583>

exchanges; and shareholder rights with respect to the adoption of poison pills as a takeover defense.

The starting point of an analysis of these issues should be to clarify the purpose or goal of capital market regulation in all countries. The FER believes that the goal of such regulation should be to increase the economic efficiency of global capital markets, rather than to protect certain financial institutions or markets in any particular country from legitimate global competitive forces. Improvements in technology and the development of the infrastructure of capital markets in other countries inevitably create new competitive conditions for both financial institutions and individual countries and have ramifications for the regulatory and legal structures of individual countries. In addressing these issues, the principle of what is best for investors in general should guide each country, rather than considerations about what is best for specific financial institutions or markets.

Maintaining or enhancing the leading global competitive position of a particular country's institutions or markets should not by itself be a justification for adopting new regulations and laws. For example, we view the alleged migration of foreign issuers to non-U.S. markets rather differently than does the Report. (Indeed, one interpretation of the often dismal performance of new foreign listings in London is that U.S. listing and reporting standards may have had the beneficial effect of discouraging dubious foreign issuers from listing in the United States.) The policy recommendations of the FER that follow are based on the assessment that their adoption will benefit not only investors in U.S. capital markets but also will enhance the efficiency of global capital markets, by either increasing competition or reducing operating costs.

Securities Class Action Suits.

Prominent among the concerns often mentioned by foreign issuers in deciding not to sell or list securities in the United States is the extent of potential liability they may incur under U.S. securities laws and class action procedures – in particular, class action suits alleging a violation of Rule 10b-5, usually attributed to some material misrepresentation or omission in a company's financial statements. U.S. issuers share this concern as well. Securities class action (SCA) settlements reached \$10 billion in 2006, not even counting the \$7 billion Enron settlement.⁹ An earlier study found that SCA settlements were paid 68.2% by insurers, 31.4% by the corporation, and 0.4% by others.¹⁰ But shareholders of the corporation actually incur almost all of the settlement costs because the insurance premiums paid by the corporation reflect the amounts insurance companies pay out plus their capital, litigation and administrative costs.

Class actions can serve as a useful and effective civil enforcement device when there are many plaintiffs with relatively small individual claims, as in many defective product or environmental pollution cases. They afford a mechanism, not dependent on government, for internalizing to the enterprise costs that its operation imposes on outsiders. But SCAs present different issues.

⁹L. Simmons & E. Ryan, *Securities Class Action Settlements: 2006 Review and Analysis*, p. 2, Cornerstone Research (2007).

¹⁰F. Dunbar et al., *What Explains Settlements in Shareholder Class Actions*, p. 9, Nat'l Econ. Res. Assoc. (1995).

It is important to distinguish two categories of SCAs – (1) those arising out of security purchases and sales in the secondary trading market among outside shareholders, and (2) those where the company itself or its insiders (officers and directors) are transacting to their own benefit. In the first category, the allegation is that the market price was distorted (usually, inflated) by misleading information from the company, so that one party lost and the other gained (as compared to what would have occurred had the price reflected accurate information). But the remedy is not that the winner makes restitution to the loser, but that the corporation pays the losers, though it was not a party to, and derived no benefit from, the transaction. Consequently, the great bulk of non-trading innocent shareholders of the corporation pay the equally innocent losers, since it is the continuing shareholders who bear the burden of what the company pays, either directly or indirectly through insurance premiums.

Over time, diversified or long-term shareholders, trading infrequently, are more likely to be losers than winners, so that the net expected effect on their wealth would be negative even if such wealth transfers were costless. But they are far from costless. Plaintiffs' attorneys take about 25-35% of what the company pays, and the company's defense costs (paid directly or through higher insurance premiums if covered by its insurance) are about the same magnitude.

Public shareholders would be better off if there were no potential for class action recovery in these secondary market situations, therefore, because they would avoid the deadweight loss from litigation costs and ex ante they are as likely to be on one side as the other. But that is not the case in category (2), where the company or its insiders are taking money from outside shareholders on the basis of securities fraud (assuming the allegations are proven). Here liability could serve the useful purposes of both deterrence and compensation.

The Report (at p.79) recognizes the distinction, as have academics,¹¹ but does not follow its implications. Instead, it merely recommends that some of the required elements – materiality, scienter (intent) and reliance – of a rule 10b-5 cause of action be clarified in the light of conflicting lower court decisions. Reducing legal uncertainty and cutting back on interpretive creep have merit but do not go to the heart of the matter. The FER recommends that the SEC abolish (as it has the clear power to do) enterprise liability under rule 10b-5 in category (1) situations, while retaining managerial and firm liability in category (2) transactions. Both domestic and foreign issuers would be relieved of an intimidating but ill-founded liability, and our capital markets would be made more attractive for all issuers.

Shareholder Rights: The Market for Corporate Control and Takeover Defenses.

The Report concludes that shareholders of publicly traded U.S. firms have fewer rights than their counterparts in many other countries, and that it would be in the interest of the United States to strengthen shareholder rights.¹² We concur. Stronger shareholder rights can reduce agency costs associated with the potential divergence of interests between professional managers and dispersed shareholders, the typical corporate ownership structure in the United States. In particular, the Report supports majority, rather than plurality, voting for corporate directors, and commends efforts now underway

¹¹ See, for example, J. Coffee, *Reforming the Securities Class Action*, 106 Colum. L. Rev. 1534 (2006).

¹² pp. 93, 100-101.

to give shareholders greater access to the director nomination process, but offers no concrete recommendations on exactly what shape these reforms should take.¹³ The FER agrees with the Report's sentiments in these areas, but would have liked to see specific recommendations as to how to achieve these goals.

In many other countries, such as the United Kingdom, if shareholders believe that the management and board of a company they own are not performing adequately, they can call a special shareholder meeting at which they can nominate and elect an entirely new board of directors.¹⁴ Under the current governance system in the United States, it is in practice impossible for dispersed shareholders to oust incompetent boards and elect a new board. Giving shareholders greater rights to oust poorly performing boards, in their entirety if need be, by electing new boards would have important side benefits. It would eliminate the entrenchment use of "staggered boards" (where only a minority of the board is up for election each year), and serve to increase the incentive of corporate managers to be more responsive to shareholder concerns. Discussions between institutional shareholders, in particular, and corporate managers and boards would obviously take on a more cogent character if managers and boards knew that shareholders had the ability to call for a special meeting to vote on removing them if they failed to respond adequately to shareholder concerns. Another suggested reform has been to give shareholders under certain limited circumstances the right to nominate and place on the company's proxy statement some directors in competition with the management slate. The SEC has been deeply divided on this change, and recently proposed for comment two diametrically opposed rules to permit or bar shareholder nominations.

Until major governance reforms are adopted, however, the only effective mechanism in the United States for removing poorly performing boards remains an effective market for corporate control – via hostile takeovers. The FER agrees with the Report that "shareholder rights plans" (the so-called "poison pills" which dilute a hostile purchaser's equity holdings) are a prohibitive defense against hostile takeovers. When coupled with a staggered board it is almost impossible for shareholders to replace boards who refuse to remove such poison pill defenses. Its effect is to deprive shareholders of a say (or vote) in whether or not to accept a hostile bid, effectively eliminating hostile takeovers as a market mechanism for disciplining ineffective managers.

The Report recommends that U.S. companies with staggered boards should be required to obtain shareholder authorization (by majority vote presumably) prior to the adoption of a poison pill, unless the company is the target of a takeover attempt, in which case the firm might adopt a poison pill subject to obtaining shareholder approval within three months of its adoption.¹⁵

The FER would go further, and require shareholder approval of poison pills for all companies, regardless of whether they have staggered boards. This would conform to the broad principle that the board of any company should not be able to deny its shareholders of the opportunity to decide on the merits of a takeover bid, and would be consistent with UK policy of prohibiting the use of poison pills entirely.¹⁶ It would also restore the

¹³ pp. xii-xiii

¹⁴ See U.K. Companies Act of 1985, section 303.

¹⁵ p. 102.

¹⁶ See General Principal 3 of the City Code on Takeovers and Mergers, and City Code Rule 21.

market for corporate control as an effective disciplinary mechanism for self-enriching or poorly performing boards and managers.

Cost Burdens of SOX Section 404.

The Report devotes an entire section to an analysis of the compliance costs associated with implementation of §404, concluding that these costs have been excessive and have significantly reduced the competitiveness of U.S. capital markets. The aim of §404 is to increase the accuracy of companies' financial statements and to reassure investors that companies are maintaining effective controls over financial reporting. But §404 implementation costs have been high. The Report estimates that these costs for issuers totaled between \$15 and \$20 billion in 2004, more than 35 times higher than the SEC's original cost estimate.¹⁷ It recommends a number of changes aimed at reducing the costs of §404 implementation, in particular, a redefinition of the scope and materiality standards of the current audit requirements, and enhanced guidance by the Public Company Accounting Oversight Board (PCAOB) and the SEC for external auditors in carrying out their assessment and attestation responsibilities under §404.¹⁸

The §404 controversy over implementation costs comes down to the precise accounting and auditing standards that companies and external auditors must use in assessing the effectiveness of a company's internal controls. Section 404 requires that the corporation management shall assess in the corporation's annual report "the effectiveness of the internal control structure and procedures of the issuer for financial reporting" and that "management must state whether the controls are effective and note any significant deficiencies or material weaknesses in internal controls." In addition, it requires that the company's external auditor "attest to, and report on, the assessment made by the management of the issuer"

Subsequently, the PCAOB issued Auditing Standard No. 2 (AS2) which required auditors to provide "reasonable assurance" that no "material weaknesses exist" in a company's internal controls over financial reporting.¹⁹ A "material weakness" was defined as "more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected ..."

The Report is concerned that this high standard has resulted in excessive compliance costs. Thus, the main thrust of the Report's recommendations is to relax or moderate the high standards that have been adopted by the PCAOB and the SEC in the implementation of §404. In particular, it would change the "probability threshold for the detection of control weakness from AS2's existing 'more than remote likelihood' standards to 'reasonably possible' that a material misstatement could occur."²⁰ Furthermore, this assessment would be required only for annual statements. Both the SEC and PCAOB (in AS5) subsequently made the change to a "reasonable possibility" standard.²¹

¹⁷ p. 126. See also I. Zhang, "The Economic Consequences of the Sarbanes-Oxley Act of 2002", Carlson School of Management working paper, University of Minnesota (February 2007).

¹⁸ p. 131-32

¹⁹ PCAOB Standards and Related Rules – Auditing Standard No. 2, as of May 12, 2006.

²⁰ p. 19.

²¹ PCAOB Standards and Related Rules – Auditing Standard No. 5, effective for fiscal years ending on or after November 15, 2007.

We agree that this change is desirable and should serve to reduce costs. However, the Report gives little reason to believe that, even then, the benefits of §404 will exceed the costs. Consequently, the FER recommends a statutory amendment to make it optional for a company to adopt the §404 procedure for a management assessment and auditor attestation of the effectiveness of its internal controls, with the requirement that if it chose not to comply, it would have to explain why in its financial statements. The market will assess a company's explanation for non-compliance and will value the company accordingly. Indeed, recent evidence suggests that the market both appreciates and rewards 'good' explanations and can punish perfunctory explanations.²² Presumably, if non-compliance is viewed as a material reduction in the transparency or reliability of a company's financial statements, investors will put a lower value on a company that does not comply, providing an incentive for that company to meet §404 requirements if the expense is worthwhile.

Maintaining Open Markets: Listing Requirements for Foreign Issuers.

The Report argues for the United States to maintain open markets and remove impediments both to foreign firms listing in the United States and U.S. firms listing on foreign markets.²³ Eliminating such impediments would arguably create a more competitive marketplace for listings and allow individual firms to choose which country's regulatory and governance structure best suits the needs of their shareholders. The Report stops short, however, of endorsing this as a general policy approach, and instead singles out the difficulty that foreign firms already listed in the United States have in exiting the U.S. marketplace (deregistering) as a significant impediment that the U.S. should relax.

Until recently, foreign companies already listed in the United States could not exit the United States as long as they had 300 or more U.S. shareholders. Relaxing this impediment, the Report argues, will encourage foreign companies to come to the United States in the first instance because they will know that they can later leave if they wish. The Report recommends that the SEC "loosen these capital controls, at least for foreign issuers," and "exclude ... [large] institutional investors from the calculation of the U.S. shareholder base."²⁴ The SEC adopted instead a rule to permit a foreign issuer also to delist and stop reporting when its U.S. daily trading volume is below 5% of its worldwide average daily trading volume.²⁵ In our view this was a sensible addition.

But the FER believes that the Report fails to address what may be the most important impediment to the development of open markets for foreign cross-listings: the duplicative reporting standards for foreign firms. The SEC requires all listed foreign corporations to report in conformity with Generally Accepted Accounting Principles (US GAAP), or to reconcile International Financial Reporting Standards (IFRS) with US GAAP if they use IFRS, as do many foreign-chartered corporations and all EU-based

²² S. Arcot and V. Bruno, "One Size Does Not Fit All, After All: Evidence from Corporate Governance", Financial Markets Group, London School of Economics WP (April 2007).

²³ p. 49.

²⁴ p. 50.

²⁵ SEC Release No. 34-55540 (March 27, 2007) available at <http://www.sec.gov/rules/final/2007/34-55540.pdf>.

corporations. As a consequence, foreign firms that list in the United States must bear significant additional reporting or reconciliation costs.

The SEC recently proposed that foreign issuers be allowed to file financial statements prepared in accordance with IFRS, without any reconciliation with US GAAP, and has issued a “concept release” on allowing US firms to do the same.²⁶ The FER supports allowing *both* foreign and U.S. firms to choose to report in conformity with either IFRS or US GAAP.

There are still some significant differences between these reporting standards.²⁷ In particular, US GAAP provides more comparability across reporting entities than does IFRS because IFRS provides less specific guidance as to how to account for specific transactions. Nonetheless, in our view both IFRS and US GAAP provide reasonable foundations for financial reporting for investors. Allowing firms to adopt whichever of these standards they believe to be the most cost-effective provides an opportunity for the market and investors themselves to sort out which reporting standard best serves their interests. We recognize that management may choose the accounting rules that best serve their personal benefit, as many believe was the explanation for much of the heated opposition to expensing stock options. But if investors judge IFRS as inferior to US GAAP, we expect the result would be a discount on the valuations of companies that use IFRS, providing an incentive for such companies to adopt US GAAP, and *vice versa*. The FER believes it likely that the potential benefits of allowing greater competition between the different reporting regimes would outweigh the potential costs associated with less comparability and possible abuse of the discretion to choose.

A potential problem is that jurisdictions that allow or require their constituents to use IFRS currently may modify, and do not uniformly enforce, the IFRS, which can result in non-comparability across firms. The FER suggests that, to mitigate this potential problem, the description accompanying IFRS financial statements should always say that management prepared such statements “in conformity with IFRS as adopted by [name of jurisdiction, such as EU].” Although there has been little enforcement of IFRS standards in most of the world, we expect that if SEC registrants were to use IFRS, their auditors would check compliance with IFRS just as auditors now do for compliance with US GAAP.

Recommendations

1) Securities class action suits -- *Abolish enterprise liability under rule 10b-5 in situations arising out of security purchases and sales in the secondary trading market among outside shareholders, while retaining managerial and firm liability where the company itself or its insiders (officers and directors) transact to their own benefit.* Imposing massive liability on a company that is not a party to the securities transactions and does not benefit from the fraud does not serve a targeted deterrence function because it is the continuing shareholders of the corporation who bear the burden of what the

²⁶ SEC Concept Release “Allowing U.S. Issuers to Prepare Financial Statements in Accordance With International Financial Reporting Standards,” Release No. 33-8831 (August 7, 2007) available at <http://www.sec.gov/rules/concept/2007/33-8831.pdf>.

²⁷ PricewaterhouseCoopers, “Similarity and Differences: A Comparison of IFRS and US GAAP.” (October, 2006). For example, US GAAP provides better information about the de-recognition of financial assets, while IFRS provides better treatment of potential and contingent liabilities.

company must pay if found guilty, either directly or indirectly through insurance premiums. Public shareholders would as a whole be better off if there were no such liability. On the other hand, retaining liability for insiders and firms that trade in the secondary market and directly benefit from a fraud on the market requires the wrongdoers to make restitution and serves a significant deterrence function.

2) Shareholder rights -- *Require all corporations to obtain shareholder approval to adopt a poison pill, regardless of whether a company has a staggered board.* “Poison pills” are a prohibitive corporate defense against hostile takeovers and can prevent the removal of poorly performing boards and management through the market for corporate control. Requiring shareholder approval for the adoption of a poison pill would conform to the broad principle that the board of any company should not be able to deny its shareholders of the opportunity to decide on the merits of a takeover bid, and it would help restore the market for corporate control as an effective disciplinary mechanism for poorly performing boards and managers.

3) Compliance costs associated with SOX §404 -- *Adopt a statutory amendment that makes it optional for a company to follow the §404 procedures for a management assessment and auditor attestation of the effectiveness of its internal controls, with the requirement that if the company chooses not to comply it must explain why in its financial statements.* §404 is highly controversial because of sharp disagreement about its relative costs and benefits. Costs are much higher than expected and benefits are difficult to identify and quantify. Consequently, the FER recommends that the market be allowed to determine the value of §404 compliance. If a company chooses not to comply, the market will assess its explanation for non-compliance and will value the company accordingly. Presumably, if non-compliance is viewed as a material reduction in the transparency or reliability of a company’s financial statements, investors will put a lower value on a company that does not comply, providing an incentive for that company to meet §404 requirements if the expense is worthwhile.

4) Maintaining open markets -- *Allow both foreign and U.S. firms to choose to report in conformity with either IFRS or US GAAP.* The SEC requires all listed foreign corporations to report in conformity with Generally Accepted Accounting Principles (US GAAP), or to reconcile International Financial Reporting Standards (IFRS) with US GAAP if they use IFRS, as do many foreign-chartered corporations and all EU-based corporations. Consequently, foreign firms that list in the United States must bear significant additional reporting or reconciliation costs. The FER believes that both IFRS and US GAAP are high quality accounting standards that provide reasonable foundations for financial reporting for investors. Allowing both foreign and U.S. firms to adopt whichever of these standards they believe to be the most cost-effective provides an opportunity for the market and investors themselves to sort out which reporting standard best serves their interests.

FINANCIAL ECONOMISTS ROUNDTABLE

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