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ECONOMIC VIEWPOINT

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Five Steps to Make Wall Street Safer for Investors

If trust in corporations isn't restored, the U.S. will see growth, innovation, and its role as a global economic leader wither away

What worries me about the stench coming from Corporate America is not its impact on the economy, because America's resiliency is awesome. It isn't that scandals may be causing the dollar to sink, because the greenback was overvalued anyway. Nor am I concerned that errant CEOs will escape punishment, since the feds are finally on the case.

No, what bothers me most is something not so easily fixed--the erosion of the equity-based culture that emerged in recent years. There were several components to it. First, Americans came to rely on equity markets for an ever-increasing amount of their personal financial security. By the end of the 1990s, for example, investment in mutual funds reached \$4 trillion, a sixteenfold increase during the decade, with nearly 80 million individuals owning stock directly or through these funds. Individual self-reliance was in. Government paternalism was out.

Second, most companies had turned to stock-based incentives for top management and employees to drive productivity and innovation, with positive results for the economy. Third, from Seville to Shanghai, the expansion of equity markets around the world facilitated the breakup and privatization of state-owned monopolies, enhancing both customer choice and service. In addition, America's position on the world scene was enhanced by the great success of its model of a market-based equity culture.

This equity culture rested on the trust that markets reflected the real value of underlying companies--trust that is now shattered. It assumed that regulators could spot and contain transgressions--a faulty assumption, as we now know. Shareholders, employees, and the public at large believed that CEOs and their boards were effective fiduciaries for their interests. This faith has too often proven to be misplaced.

Growing popular disillusionment is reflected in the 13.4% fall of the Standard & Poor's 500-stock index in the second quarter; in opinion polls that show collapsing confidence in business leaders, recently society's heroes; in the drop in foreign capital coming into the

U.S., once a mecca for equity investors; and in conversations about how the markets are rigged that are taking place in barbershops, restaurants, and other everyday meeting places.

The alternative to equity culture is heavyhanded government that saps growth, innovation, and economic freedom. Yet given the extent of corporate malfeasance, the only way to restore investor confidence is for both CEOs and Washington to push for reforms as sweeping as those instituted at the turn of the century and in the 1930s. Most of the necessary elements are contained in the proposals coming from the New York Stock Exchange, the Securities & Exchange Commission, Congress, and various business groups. Here are some key imperatives:

-- **Regulate auditors.** A new oversight body must be established, reporting to the SEC. It should set auditing standards, license auditors, and have power to punish transgressors. To guarantee its independence and resources, it should be funded by every publicly listed company.

-- **Revamp CEO compensation.** The magnitude of stock options--and the fact that they were not treated as a company expense--gave execs too much incentive to cut corners to pump up stock prices in the short term. In the future, options should not be exercisable for five years, and not unless company performance exceeds the S&P 500. They should also be charged against corporate income when they are cashed in. Better yet, executives should be rewarded in stock that must be held for a number of years so CEOs can win and lose with the rest of long-term shareholders.

-- **Make CEOs and boards accountable.** The SEC should endorse national guidelines for all publicly listed companies doing business in the U.S. Among the provisions: CEOs and CFOs must personally warrant that financial statements paint a full and accurate picture of their companies' positions, including critical underlying trends. Not only must boards be more independent but also audit, compensation, and governance committees ought to be held more clearly accountable for the basic policies of the companies they represent.

-- **Keep up pressure on Wall Street.** Among the most egregious conflicts of interest has been the way analysts have been pressured and paid to recommend stocks simply to curry favor with the issuing companies. Until it's clearer how effectively Wall Street will police itself, the SEC should issue public progress reports on investment banks' moves to eliminate conflicts.

-- **Modernize accounting.** Designed for a simpler Industrial Age, accounting needs to deal with a global, financially complex, knowledge-based economy, including derivatives, off-balance-sheet assets, and intangible assets such as research-and-development capabilities. The best ideas from around the world must be combined into one high-grade set of international standards.

No one can guarantee that these measures can save equity culture. But can we afford anything less than a Herculean effort?