The Changing Dynamics of Global Capital Markets

James S. Turley
Chairman and CEO
Ernst & Young

Global Capital Markets Summit
U.S. Chamber of Commerce
Washington, D.C.

March 26, 2008

Good afternoon, and thank you to the Chamber of Commerce for the invitation today.

As we all think about the future of global capital markets, we do so while doing our best to navigate some really choppy waters. Today's turbulence provides a daily reminder that while financial markets—and the assets that underlie them—offer extraordinary opportunities for growth, they can also be extremely volatile. Similarly, just as the globalization of markets offers more opportunities to more people in more parts of the world, it also means that the risks that go along with those opportunities can spread very, very quickly.

The fallout from the ongoing liquidity and credit crises underscores the growing interconnectivity of capital markets—but it also demonstrates how complex both business transactions and financial instruments have become. In turn, this interconnectivity and complexity have strengthened the demand for information regarding the nature of the risks associated with such transactions and instruments, and how such risks can best be managed.

Today, what I'd like to do is highlight three principles that will give investors more complete information about companies—principles which, when embraced, could set a foundation for higher levels of investor confidence. These aren't dramatic, new ideas—but instead are principles whose time has certainly come for full implementation.

First, is the need for greater transparency and disclosure, given how globalized and complex the markets have become.

Second, is the importance of companies—and regulators—placing greater emphasis on internal controls, and other elements of risk management.

And third, is the value of common standards and practices uniting capital markets—both those in developed markets and in emerging markets.

The New Market Landscape

I'd like to start by taking a minute to describe how the profile of capital markets today is very different than it was when I was appointed Chairman of Ernst & Young in the summer of 2001. For one thing, that was just a few months before Enron and WorldCom. (Yes, I know—timing is everything!)

For starters, market opportunities today are much more global. One way of driving this point home is to consider the countries which housed the largest IPOs last year. The companies were headquartered in Russia, Kazakhstan, China, Japan, the United Arab Emirates, Spain, the United States, and Brazil—literally spanning the globe.

A closer look at these IPOs also paints a picture of the shift that is occurring in global capital flows from developed to emerging markets. The Ernst & Young Global IPO Survey shows that companies based in emerging markets accounted for 57 percent of all the funds raised through IPOs last year—up from 37 percent in 2002. There has also been a dramatic increase in the funds raised in emerging markets IPOs—$163 billion last year, up from $24 billion in 2002.

But IPOs are only one measure of the changes taking place. According to one estimate, net private capital flows into emerging market economies were an estimated $782 billion last year, up from $113 billion in 2002—a nearly seven-fold increase over five years. And according to Deutsche Bank, emerging market and developing countries last year contributed almost 70% to global economic growth. China added more than twice as much to growth as the U.S., while India accounted for as much growth as the entire euro area.

Now, this remarkable expansion throughout the world is being driven by a number of things, including deeper pools of capital, and the success of a number of countries in developing the financial and regulatory infrastructure that supports the development of their financial markets. While this means heightened competition for some established economies, like the U.S., the development of market-based economies and a bigger global economic pie translates into heightened demand for a wide range of goods and services, and means more economic opportunity for individuals the world over. We shouldn't forget that this has been the objective of Western policymakers for decades.

But just as markets have become more global, they've also become more complex. We have seen a proliferation of financial instruments that are highly technical and, as we are learning, not always well understood. Consider that at the end of 2006 the outstanding value of derivatives was $286 trillion—that is *trillion,* with a "t".

And we've also seen that new types of unregulated investors are taking a more prominent role in the global economy. Hedge funds and private equity firms continue to be important players. And of course sovereign wealth funds are getting a lot of attention these days, especially as they are providing much-needed liquidity to the world's financial system. The IMF projects that sovereign wealth funds could have $12 trillion in assets by 2012, four times the nearly $3 trillion they have today. (There's that "t" word again.)

Transparency

To me, all these changes point to the need for more transparency.

But before I get into that, I want to really be clear about what I mean by transparency, because saying that you are for transparency is like saying you are for motherhood or apple pie.

When I speak of transparency I am thinking in terms of the need for information and disclosures that are relevant to a particular audience. Let me say that again: the need for information and disclosures that are relevant to a particular audience.

My point is this: if the markets have a need to know something in order to operate efficiently and fairly, then there should be transparency around that information to the market participants. On the flip side, if there is information that regulators or standard setters need to do their job effectively, then there should be transparency around that information to the regulators themselves.

Right now, I'd like to talk about the importance of transparency, starting with publicly-traded companies, and then with respect to auditing firms like Ernst & Young.

As we look at the increasing complexity and interconnectivity of global capital markets, and the tremendous shifts in capital flows—from west to east, from public to private markets, and from regulated to unregulated—the need for transparent, reliable, and understandable information becomes greater and more evident than ever before.

People need information about the companies in which they are thinking of investing, and about the transactions in which those companies are engaging. They need information so that they can make their own assessments and decisions about the opportunities with which they are presented, the level of risks such opportunities entail, and the possibilities that exist for mitigating those risks. And they need this information in a way they can access it and understand it.

Much of the information in the marketplace reminds me of when my fellow Missourian Mark Twain wrote to a friend, saying, "I apologize for such a long letter, I didn't have time to write a short one." The length and complexity of some of the disclosures today hinders communication in many ways, instead of enhancing it. Transparency is the very foundation of investor confidence, but I think much needs to be done to ensure the users of the information are getting what they need.

But it is not just companies and their business transactions that need to be more transparent. We in the audit profession recognize that we too need to be more transparent.

By being open and transparent about our commitment to audit quality, and about the processes and practices we employ to deliver on that commitment, we can give the public greater confidence in our ability to maintain the public trust. And frankly, too often we as a profession have relied on our private partnership status, and haven't in the past been as transparent as we need to be in the future.

Last December, when I testified before the Treasury Advisory Committee on the Auditing Profession, I called for the Committee to recommend that the transparency of audit firms be enhanced. Specifically, I suggested that the PCAOB require registered audit firms to publish a transparency report, consistent with the requirements of the EU Eighth Directive, which would provide increased public insight into a firm's processes and commitment to audit quality. I still believe this is a good idea today.

We also believe that regulators and policymakers should have a clear view of the health of the private sector public company auditing function. Needless to say, a failure of a major audit firm and the resulting profession-wide repercussions would have a big impact on audit quality and a big impact on the capital markets. And many believe, as I do, that regulators and policymakers have reason to be concerned about that.

So I think it is important for someone, other than the audit firms themselves—someone in a position of authority—to monitor potential sources of catastrophic risk faced by firms. This obviously requires the firms to provide the relevant information to an appropriate authority, which hasn't been the historic practice of either the firms or the regulators. This increased level of transparency between firms and regulators is consistent with a preliminary recommendation from within the Treasury Advisory Committee. And I strongly support regulators accessing auditing firms' financial and risk-related information and utilizing their understanding to inform public policy considerations in order to protect markets and investors and maintain audit quality.

Risk Management and Internal Controls

While transparency can bring sunlight to the way companies operate and how financial transactions are structured, that is good, but by itself is not enough. Around the world, there is a pressing need for better identification of and management of risk. An organization has to be cognizant of its own risks, mitigation plans, and triggering events that could cause harm.

This is a broad charge and is a real challenge to many boards—and it will require them to continue to devote more attention and resources to it—if they are to fully comprehend the risks in the businesses they serve.

In this context, risk management covers a broad universe. But one key element is the importance of strong internal controls. Internal controls cover operational as well as financial aspects of an enterprise, and with more and more information of relevance to the market coming outside of the traditional audited financial statements, the importance of internal controls to reliable information is likely to increase.

Clearly, with all the attention and time that was devoted to internal controls in the first years of implementation of Section 404, internal controls have become a real flashpoint.

Yet despite this, around the world an increased appreciation for the importance of internal controls is emerging, and many countries are adopting their own corporate governance laws that emphasize internal controls. But we are still a long way from global consensus.

In my view, we need to elevate the discussion about internal controls to one that is worldwide and involves a range of stakeholders: investors, regulators, auditors, financial institutions, and preparers.

We need to face the fact that, going forward, companies are going to be able to produce—and investors are going to be more and more interested in receiving—a wider range of information on a nearly as-needed basis. Much of this information may not be directly connected to financial reporting, and much of it may not be subject to auditing either.

Building trust in the reliability of such information will be a challenge, and perhaps the only way of building such trust will be for companies to maintain rigorous internal controls. We can start the process of institutionalizing these internal controls as part of a broader risk management program by having a

robust debate about just what controls should look like, and how they can be implemented, and, indeed, the circumstances under which there should or should not be a role for auditors in attesting to them.

Some may accuse me of trying to export Section 404 to the rest of the world. But that is not the point. The point is that there is real value to investors, companies, and markets from a strong organizational focus on internal controls and risk.

And I hope we can move beyond motives, and have a global debate about what management should be saying about its controls, what auditors should be saying about them, if anything, and reach some global consensus so that investors, companies, and the markets can be better served.

In my view, the strength of a company's internal controls, both operational and financial, will become more important in the future because of likely changes in information flows to investors. But even if others don't agree, I think we need to seek global consensus for the good of investors.

Need for Common Standards

That takes me right to the need for common standards and practices across the world's capital markets, in a wide range of areas—a development that would benefit all markets, and emerging markets in particular.

I come to this discussion as someone who oversees the Ernst & Young global network with over 130,000 people working in over 140 countries. And as I see it, Ernst & Young's promise to deliver seamless, consistent, high-quality service worldwide is mismatched against the fractured, inconsistent, and overlapping regulatory environment in which we and our clients operate around the world.

In an environment marked by growing numbers of businesses operating in multiple countries, and rising levels of capital moving across borders, there is a need for common benchmark standards that will promote the delivery of reliable, consistent, and comparable information.

While regulatory and policy decisions in all countries must, of course, fit within national legal frameworks, when these decisions affect global business, global investment, and global markets, policymakers must increasingly look to the prospect of international collaboration rather than stand-alone national approaches.

One particularly bright line of divergence between the U.S. and the rest of the world is the use of U.S. Generally Accepted Accounting Principles versus International Financial Reporting Standards, or IFRS. Indeed, more than 100 countries either require or permit IFRS. Many countries are shifting to IFRS this year, like Israel. Canada shifts in 2011, with early adoption in 2009—while Brazil, Chile, India, and Korea are among the countries that have also set a date to move to IFRS.

In my opinion, the U.S. cannot afford to be an outlier. I have called for the SEC to set a date certain for a shift to IFRS from U.S. GAAP for U.S. companies. Establishing a date certain would enable U.S. companies and universities to begin preparing now, and would provide the impetus to confront the many legal and regulatory changes that would need to accompany the shift. We have seen this movie before—and based on the first hundred countries to adopt, there was little or no preparation taking place until that date certain was set.

I do want to be clear on something, though. It is not that IFRS cannot still be improved—because it can and will improve. But were the U.S. to establish a date certain for a shift to IFRS, it would promote

similar moves by other jurisdictions to embrace these international standards and would encourage everyone to focus their resources on improving IFRS and the International Accounting Standards Board governance process, instead of on modifying the standards for local use. And that is critically important. In order for the full benefit of IFRS to be realized, it is essential that countries or regions abide by the same IFRS principles. If IFRS is adapted for a range of different jurisdictions, we will not have a single reporting language, and IFRS will be a single standard in name only.

Often, when people talk about IFRS and U.S. GAAP, they talk about convergence or harmonization.

I want to be clear about something. The way I see it, convergence and harmonization of a variety of standards and regulatory approaches is a process that is necessary and inevitable as globalization occurs and we learn from one another. However, there is an end point to the convergence timeline, and that end point comes when moving to adoption of a common global standard is best for business, markets, investors, and regulators. So it is really a process of converge, converge, converge, converge, and then at some point, adopt.

In my view, we have reached the endpoint on accounting standards. If we look at international standards of auditing, or internal controls over financial reporting as I spoke of earlier, or corporate governance measures, or even other shareholder rights, they are all at various stages of convergence. Again, I see all of them leading to a point at which the capital markets will be best served by ultimately adopting a common global approach.

Conclusion

As I get ready to conclude, I'd like to close with a proposal for taking the ideas I've talked about and turning them into action. At the most basic level, I think there should be some mechanism, or some organization, or some collective agreement to facilitate ongoing global discussion of what's happening in the markets. Having a market input structure like this in place—call it a "Global Capital Markets Working Group"—will help all of us identify issues around transparency, around risk management, and standards, guidance, and best practices; and will also help foster common understandings, common approaches, and—where needed—improvements.

I think it is vital that such an effort should not just be governments and regulators talking to each other—the involvement of issuers, auditors, and investors is critical as well. In that way, we can listen to one another and benefit from each other's differing knowledge and experience. The fact is—and I say this as an auditor—one plus one can add up to more than two—at least when it involves bringing together different perspectives.

The global Financial Stability Forum provides a great example of the value of bringing perspectives together across the globe, but it is principally government-oriented organizations.

Another good effort is the auditing profession's recent series of stakeholder meetings in financial centers across the globe. From Mumbai, to Cape Town, to Tokyo, to New York, to Santiago, to Paris, participants included preparers and users of financial statements, regulators, standard-setters, corporate governance experts, and audit professionals—all gathered in a robust dialogue on a number of critical issues confronting global capital markets. But these meetings were ad hoc.

With the interconnected, complex, and dynamic nature of today's markets, I think there is a real need to formalize or institutionalize an effort that is along the lines of what I have just described.

By talking to each other, by listening to each other, we can actually learn, and begin to change how we think. And given all of the dynamics in the global capital markets, I am convinced we all may need to think a little differently.

So I'm hopeful that we can build momentum for the launch of a sustained multi-party dialogue like I've described, because I believe such a mechanism can be the vehicle through which we turn our rhetoric into reality.

Because truly, in many ways global capital market activity has outstripped the reach and constraints of national regulators functioning on their own. This reality can certainly be difficult for many regulators and elected officials to accept. And while the statutory responsibility for market governance will surely remain a local matter, there is clear value in aligning standard setting, regulatory mindsets, and identification of best practices with the realities of the global market.

Thank you to the Chamber of Commerce for hosting this important event at this important time. Today's gathering, I hope, provides a valuable opportunity to help jumpstart this new way of thinking.