U.S. Securities and Exchange Commission

Speech by SEC Commissioner: Remarks before the European Parliamentary Financial Services Forum

by

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U.S. Securities and Exchange Commission

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It is an honor to be here with you today at the Financial Services Forum. Let me start by saying that the views that I express here are my own and do not necessarily represent those of the Securities and Exchange Commission or my fellow commissioners.

I applaud the Forum for its role in facilitating discussions between the European Parliament and the financial services industry and promoting cross-border integration of the financial services industry. I am pleased that you have not limited your focus to Europe, but have reached out to the U.S. also.

Frédéric Bastiat in his satirical "Pétition des fabricants de chandelles, bougies, lampes, chandeliers, réverb ères, mouchettes, éteignoirs, et des producteurs de suif, huile, résine, alcool, et gén éralement de tout ce qui concerne l'éclairage à MM. les Membres de la Chambre des Députés"[1] called for "a law requiring the closing of all windows, dormers, skylights, inside and outside shutters, curtains, casements, bull's-eyes, deadlights, and blinds -- in short, all openings, holes, chinks, and fissures through which the light of the sun is wont to enter houses."[2] In this way, the nation's lighting industry would prosper to the benefit of all except, of course, the consumer. Although written more than 150 years ago, we would do well to avoid the protectionist impulses that Bastiat's petition so colorfully illustrated. Instead, in both Europe and the U.S. we should throw open the windows and let the sunlight shine in.

In today's world of trading in complex financial products and services, the task of maintaining free and open competition is admittedly a more difficult task than lawmakers in Bastiat's day confronted when they considered how to deal with trade in goods. Nevertheless, the fundamental principles have not changed and the goal of fostering a global marketplace remains a worthy

one. I know that you are all committed to this goal, as is demonstrated by your presence here today.

It is my privilege to be here with you to discuss the ways in which we can work together to encourage global competition in the financial markets. Europeans and Americans benefit greatly from a market that allows for competition across borders, and as trading partners we are well matched. I am confident that we can craft solutions that recognize that we can have an integrated, global marketplace for capital, as well as for goods, without imposing a single set of uniform rules on all the participants in that marketplace. I intend to continue to work towards that end.

I am one member of the five-member Securities and Exchange Commission, all of whom are appointed by the President and confirmed by the Senate. The SEC is an "independent agency," which means that it performs a mix of executive, legislative and judicial functions. The SEC has civil (not criminal) enforcement powers against people who violate the securities laws and our rules; it has power to write rules pursuant to statute; and it acts like an appellate court in reviewing appeals from sanctions that the stock exchanges and the professional organization of brokers levy against their members. As you might have heard, the SEC recently underwent a change of leadership. Chairman Christopher Cox comes to the job as an insightful, engaged, and enthusiastic leader. He already has exhibited an appreciation for looking at both the costs and benefits of our actions.

An American economy that is encumbered by an unwieldy and unworkable web of regulations serves nobody's interests. That is why I was concerned to learn that, for the first time in its 11 year history, the "Index of Economic Freedom," published annually by the Wall Street Journal and the Heritage Foundation, an American think tank, no longer ranks the U.S. among the top ten "most free" countries.[3] Although it is wonderful to see other countries becoming more free, I do not like to see the U.S. losing its reputation for being a great place to do business. I also do not want American investors to be deprived of the opportunity to invest their capital in the ventures and places of their choosing.

Europeans and Americans need to work together to ensure that regulatory solutions are enhancing, not inhibiting, worldwide economic integration. Together, we must determine whether the measures that we have implemented are serving their intended purpose of protecting investors. Because investors ultimately bear the costs of regulation, they depend on us to identify and correct conflicts and duplication between regulatory frameworks. Only through cooperation with and, when appropriate, deference to other regulators can we address these conflicts. I am committed to ensuring that the voices of all affected parties, not only U.S. interests, are part of the debate that shapes, and, if necessary reshapes, American regulations.

It will be no surprise to you that one issue on which we need to continue to work together is accounting standards. European companies, as part of the

move towards the integration of the European economy, are beginning the costly, difficult process of transitioning to International Financial Reporting Standards. We at the SEC are watching with great interest. I applaud this effort towards greater transparency and ease of capital flows across national borders. I understand that European companies are concerned about continuing to bear the costs of reconciliation to U.S. GAAP on top of switching to IFRS. But, I am optimistic that Europeans and Americans can work together to eliminate this long-standing requirement in accordance with the "roadmap" laid out earlier this year, contemplating a 2007-2009 timeframe of mutual recognition. I am confident that the need for reconciliation will disappear as all of us gain experience with IFRS in practice. Because of differences in culture, legal systems, and especially liability regimes, true "equivalence" - however that term is defined - may be an illusory goal. Thus, I prefer to state our goal as one of mutual recognition. Investors need to know that published financial statements have integrity and have been prepared according to a set of high standards that are applied consistently. If investors know the standards under which the accounts are prepared, then they can make their own, informed investment judgment. We in the U.S. are keenly aware that unnecessary reconciliation only imposes costs on investors on both sides of the Atlantic.

For this reason, I am baffled at the suggestion by some that Europeans should begin to require U.S. companies to reconcile their U.S. GAAP financial statements to IFRS. This runs against the direction that we are taking in the United States and undermines our efforts towards mutual recognition. Some may assert that this is a useful bargaining chip to ensure that we Americans will recognize IFRS. But, I believe that it is counter-productive, ignores historical precedent and market practice, and diverts attention and energy from solving the real challenges before us. IFRS will stand or fall on its own merits. Our efforts should be focused on making sure that it succeeds.

The April recommendation of the Committee of European Securities Regulators (CESR) that companies using U.S. GAAP need to add significant disclosure, in both narrative and numeric form, comparing U.S. GAAP to IFRS has created uncertainty for U.S. companies. Audit firms and market participants have been interpreting this recommendation as requiring a full reconciliation of U.S. GAAP to IFRS, even though the proposal itself says that such a reconciliation is not needed. I hope that - and understand from my European counterparts that - this is a misunderstanding. I also am hopeful that the European Commission, when it makes the final decision with respect to reconciliation for issuers using U.S. GAAP, will not depart from historical precedent by imposing a reverse reconciliation requirement.

The non-U.S. corporate community has expressed concern over the tremendous cost of litigation in the U.S. Many within the U.S. are likewise calling for litigation reform. President Bush for years has been sensitive to this issue, first as governor of Texas and now as president of the United States, and has taken active steps to try to address it. Congress has also acted, and I expect that it will continue to work on this problem. It was decades in the making and is susceptible to no easy solutions. Regulators also need to be mindful that the disclosures that we require might someday

form the basis for litigation. It is incumbent upon us to give clear guidance about what companies must disclose so that they are not subjected to retroactively-imposed disclosure obligations through enforcement actions and private litigation.

The wrongdoings by U.S. and non-U.S. companies that have filled the newspaper pages over the past several years have raised the level of anxiety of market participants all over the world. Our legislative and regulatory responses also have had global outworkings. Simply put, some businesses lost their ethical compass, and the shadow of those few has fallen across the rest. Against this backdrop, it is not surprising that there have been heightened concerns about U.S. regulatory overreach.

The Sarbanes-Oxley Act has gained the most attention. There are many positive aspects to Sarbanes-Oxley Act and the SEC's implementation efforts over the past few years. Broadly speaking, it reflects goals shared by Europeans and Americans with respect to strengthening corporate governance - it does not generally dictate corporate behavior, but instead requires corporations to disclose information. The market is then charged with deciding how much weight to place on that disclosure. The Act acknowledges the importance of stockholder value as opposed to stakeholder value. Most importantly, it strengthens the role of directors as representatives of stockholders and reinforces the role of management as stewards of the stockholders' interest.

The most problematic aspect of the Act is Section 404, which requires management to complete an annual internal control report and requires the company's auditor to attest to, and report on, management's assessment. The problems have centered mostly around definition and cost. If we can find a cost-effective way for Section 404 to achieve its objectives, it could be one of the most valuable parts of the Act.

The emphasis on good controls over financial reporting is laudable. Section 404 makes management accountable for the integrity of financial information and gives shareholders insight into the credibility of the financial statements. Investors might step up their scrutiny of financial statements of a company that has been found to have "material weaknesses" in the internal controls around the processes that produce its financial statements.

It is indisputable that everyone greatly underestimated the costs involved in the 404 process. When the SEC first released its implementation rules for 404, we estimated that the aggregate costs would be about $1.24 billion or $94,000 per public company. Unfortunately, we missed...by quite a bit. Actual costs incurred for 404 compliance, according to surveys, were some TWENTY times higher than estimated costs. In the SEC's defense, we made this estimate before the Public Company Accounting Oversight Board released its 300-page Auditing Standard No. 2 to govern the 404 process.

I should explain that the PCAOB is a newly-created, non-governmental, nonprofit corporation. Its role is to oversee the public accounting firms that

audit issuers registered in the U.S. Non-U.S. accounting firms are not exempt. Because the PCAOB is subject to oversight by the SEC, non-U.S. accounting firms should not hesitate to raise with the SEC any concerns arising from their interactions with the PCAOB.

During 2005, through roundtables and other discussions, we have learned that the internal controls rule and the PCAOB standard are being applied in an overly-prescriptive manner, not in a top-down, risk-based way. Recently, the CFO of a large European company told me that his company determined that it had 500 key controls, but when the company brought in its outside auditor, the auditor asserted that the company has 20,000 key internal controls. I have heard many similar stories from American companies, with even bigger numbers. Do the costs and burdens to audit and document tens or hundreds of thousands of controls provide commensurate benefits? How can they? How can this possibly be consistent with the definition of "key internal control" in the first place?

The good news for foreign private issuers is that the SEC has recognized the difficulties that section 404 may pose, particularly in combination with the migration to the new International Financial Reporting Standards. In March, therefore, we extended the 404 compliance date for foreign private issuers for another year: they need to comply with section 404 for their first fiscal year ending on or after July 15, 2006. Last month, we extended the compliance deadline for smaller public companies, including smaller foreign private issuers. These companies will have to comply with the Section 404 requirements for their first fiscal year ending on or after July 15, 2007. This is consistent with other accommodations that we have made for non-U.S. issuers since we first started to implement Sarbanes-Oxley, such as recognizing other governance systems, including the German Mitbestimmung, and allowing individuals who might not qualify as "independent" under our definition (such as leitende Angestellten) to serve as members of a company's audit or supervisory board. I anticipate that the SEC will continue to be receptive to similar requests for accommodation.

To help contain the costs of Section 404, I believe that the SEC should review whether the PCAOB's Auditing Standard Number 2, which has been the focus of most of the criticism of the Section 404 process, is a workable standard. The sheer length and tone of this standard, combined with a fear by accountants and companies that their professional judgment will be second-guessed and that they will thus be subject to increased liability for those judgments, have contributed to an excess of caution and an emphasis on needless detail. We and the PCAOB in May issued clarifications that the standard of "reasonableness" really does mean reasonable -- it does not mean absolute or certain or perfect.

Neither the Sarbanes-Oxley Act nor the implementing rules should dissuade a foreign company from considering a U.S. listing, yet there are some reports that this might be happening. Foreign listings not only benefit U.S. investors in the form of greater investment choices and diversification, but also provide foreign issuers with access to the U.S. capital markets and greater potential for making acquisitions in the U.S. As of the end of 2004, approximately

1,240 non-U.S. corporations from 57 countries filed reports with the SEC. This number is up by eight from the year before. Does that mean that we should not worry? Have there been, in fact, companies who have decided to forego a U.S. listing? I have heard stories to that effect, but definitive evidence is, of course, hard to obtain.

We need to take the concerns of foreign companies seriously. The press is also full of stories that Sarbanes-Oxley encourages some foreign companies to contemplate shedding their American listings and deregistering. This summer, the Rank Group, owner of the Hard Rock Café, announced its decision to deregister and cited the board's belief "that the burden and expense of complying with SEC reporting and other applicable U.S. obligations is out of proportion to the benefits obtained by the Company and its shareholders as a whole."[4]

Deregistration, of course, can be an uncertain, complicated, and costly process for foreign issuers. The SEC staff is looking at ways to modify the process. While the immediate prospect of losing registrants may be unattractive, a longer-term view suggests that non-U.S. companies are more likely to register with us if they know it is not an eternal commitment. We must recognize that conditions change for individual registrants. We should allow for as much flexibility as possible, without sacrificing the expectations of and fairness to American equity investors.

I would like to turn briefly to another area in which the SEC has been implementing new regulatory requirements. You all no doubt have heard about our new rule, set to go into effect early next year, requiring hedge funds to register with the SEC. This rule is the subject of a legal challenge, which will be heard by the court in December. My colleague Cynthia Glassman and I voted against this rule. I am happy to say that we were not alone in our opposition to the rule. Many others outside the Commission, including Congressmen and representatives of fellow regulators such as the Federal Reserve Board, the Treasury, and the CFTC, also expressed concerns. The rule was adopted notwithstanding the opposition. I opposed it mainly because (1) the SEC does not have the resources to properly implement it; (2) it will divert resources from areas more critical to our central mission (hedge funds serve fewer than 200,000 investors, while mutual funds serve over 90 million); (3) the statute under which these funds will register is not a device that will give us any special, up-to-date information regarding risks to the financial system that their investment activities may pose; (4) it will mislead investors to think that the mark of "SEC registered adviser" means more than it does; and (5) we did not consult in any meaningful way with our fellow regulators to try to fashion a regulatory system that could make the best use of taxpayer resources, elicit useful information, and be the least economically burdensome.

Most importantly with respect to this rule, I worry about the effect on investors. The peculiar provisions of this hedge fund registration requirement decrease the liquidity of hedge fund investors and constrain their choices by discouraging offshore investment advisers from serving American clients.

The majority in adopting this rule rejected calls to exempt offshore advisers who are regulated in their home countries. Non-U.S. advisers of regulated, publicly offered funds do not have to register with the SEC, but advisors of private offshore funds do have to register, even if these private funds are registered abroad. My colleagues who adopted the rule acknowledged that E. U. regulation might be an alternative, but they nevertheless concluded that evaluating the regulatory frameworks of other countries "would tax our resources."[5] Of course, this reason should have dissuaded them from adopting the hedge fund adviser registration requirement altogether!

The registration requirement applies if a non-U.S. adviser has 15 U.S. resident advisory clients within the previous twelve months, regardless of the amount of the adviser's assets under management. The SEC majority rejected suggestions that offshore advisers be required to look through their private funds only if more than 25 percent of the fund was held by U.S. investors. In my colleagues' view, this would have exempted too many offshore advisers.

Advisers that hit the magic number of 15 U.S. clients generally are required to register, but are exempt from compliance with certain substantive requirements under the Act, such as some governance and reporting requirements and rules by which U.S. advisors have to keep custody of client assets. They will still be subject to our books and records requirements and will be subject to examination by SEC staff. When it adopted the rule, the SEC acknowledged that "as a practical matter, U.S. investors may be precluded from an investment opportunity in offshore funds if their participation resulted in the full application of the Advisers Act and our rules."[6] I have heard reports that even this modified form of registration is causing foreign advisers to reject U.S. investors from their funds. The result: we have hurt U.S. investors by effectively decreasing their investment options.

The SEC's actions that I have described suggest that more government action may not always be the ideal solution to problems that we see in the marketplace. In the U.S., we love to take polls of public opinion on a wide range of issues. When pollsters ask people to rate professions, teachers, firemen, and police consistently rank in the 80s out of a perfect 100. Corporate executives have fallen from ratings in the 60s in the late 1990s to the 20s today, to join lawyers, reporters and politicians. These, of course, are the very people crafting the new rules! The MEPs in the audience should not worry - remember, these polls only ask about Americans about American politicians.

We cannot legislate morality and ethics in any profession, but at the same time, we cannot have a successful, sustainable free market system without morality and ethics. The culture of a firm - especially the tone from the top - conveys a great deal throughout the organization as to whether ethical misdeeds will be tolerated.

For those of you from the private sector, to the extent that you think changes

in your corporation or industry are necessary, do not wait for a regulator to tell you to make them. I would encourage you to work with your colleagues to design efficient, effective solutions and preventive measures of your own. As a supporter of the free market, it distresses me when business people do not react to perceived problems using a principle-based approach to guide the conduct of their organization and the industry. Too often, however, it seems that market participants look instead to regulatory solutions, which they can manipulate to their benefit and the detriment of their competitors.

Finally, lawmakers and regulators cannot be faulted for missing important issues if they were not brought to their attention when the laws and regulations are drafted. Please participate in our consultation process on rules - the SEC is legally bound to take comments into account and explain why we accept or reject them. We take this obligation seriously and look to investors, regulators, and corporations outside the U.S. for information and insights about unique challenges that our rules may pose for them. By representing your own interests effectively, you help us to protect U.S. investors and maximize their opportunities to participate in the global economy.

With your assistance, we can work to address some of your persistent concerns about recent regulatory reforms in the U.S. We can also work to shape future regulatory initiatives so that they fulfill their intended function of protecting investors without imposing unnecessary burdens in the U.S. and abroad. I am confident that international cooperation in these regulatory matters will benefit all of us in the long run.

Thank you for your attention. I am looking forward to our discussion.

Endnotes

[1] "Petition on behalf of the Manufacturers of Candles, Tapers, Lanterns... [and] Generally of Everything Connected with Lighting," Les Sophismes Économiques, Chap. VII (First Series, 1845).

[2] Nous demandons qu'il vous plaise de faire une loi qui ordonne la fermeture de toutes fenêtres, lucarnes, abat-jour, contre-vents, volets, rideaux, vasistas, oeils-de-boeuf, stores, en un mot, de toutes ouvertures, trous, fentes et fissures par lesquelles la lumière du soleil a coutume de pénétrer dans les maisons, au préjudice des belles industries dont nous nous flattons d'avoir doté le pays, qui ne saurait sans ingratitude nous abandonner aujourd'hui à une lutte si inégale. . . . Et d'abord, si vous fermez, autant que possible, tout accès à la lumière naturelle, si vous créez ainsi le besoin de lumière artificielle, quelle est en France l'industrie qui, de proche en proche, ne sera pas encourageée?

[3] Heritage Foundation, Economic Liberty Is On The March In Most Regions, 2005 "Index Of Economic Freedom" Shows (Jan. 4, 2005) (available at:

http://www.heritage.org/research/features/index/pressReleases/2005%20Index%20Overview%20Release.doc).

[4] Rank Group, News Release (July 1, 2005) (available at: http://www.rank.com/rank_site/downloads/press_releases/Intention%20to%20Delist%20from%20NASDAQ%20and%20Terminate%20ADR%20Programme%20and%20SEC%20Registration%20%2001.07.05.pdf).

[5] Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004) ("Hedge Fund Adopting Release"), at text preceding note 200.

[6] Hedge Fund Adopting Release at n. 213.

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