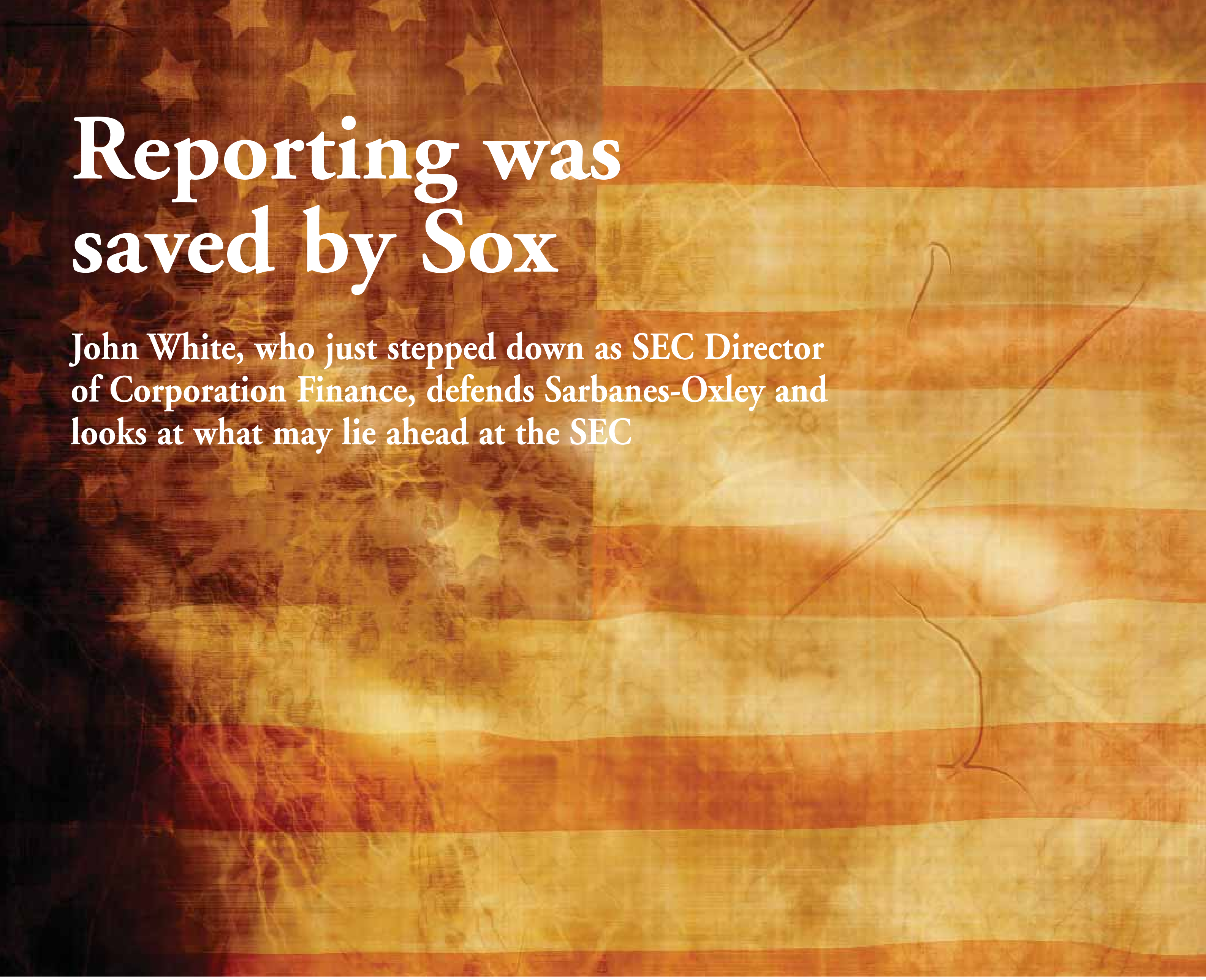

Reporting was saved by Sox

John White, who just stepped down as SEC Director of Corporation Finance, defends Sarbanes-Oxley and looks at what may lie ahead at the SEC

These last three years on the SEC staff have provided some of the most exciting and rewarding experiences of my professional life. And the last few months were just extraordinary. We have faced some of the most interesting and challenging securities issues of our time.

I want to start by going back to when I was here at this conference two years ago, in January 2007. The single biggest issue facing the Commission at that time was the perceived (or actual) erosion of US markets in favour of international markets. The US was perceived to be losing the global competitive battle – for companies, for markets and for investors – largely because of what was said (at the time) to be the inhospitable and onerous regulatory environment in the US. Three separate studies focused on the Sarbanes-Oxley Act of 2002 (Sox), concluding that over-regulation was causing a mass exodus from US markets. Companies were voting with their feet (or, more accurately, their listings), and investors were voting with their dollars. So, I actually used the opportunity of this conference that January to lay out the three-part agenda for 2007 in Corporation Finance.

Item one was the need to complete the revision of the deregistration process. The foreign issuer community had been decrying that our old rules were trapping them into continued US reporting. This initiative went quite smoothly. That March, the Commission adopted new rules to simplify the process for foreign private issuers to terminate their SEC reporting obligations. These were effective in June 2007, before the calendar year foreign issuers had to first file their 20-Fs containing those dreaded Sox 404 reports from management and auditors. Through the end of 2008, approximately 150 foreign private issuers have filed Form 15Fs to terminate their reporting obligations with the SEC. After the first rush of filings in mid-2007, the numbers leveled off and, more recently, have dropped to a trickle.

Sox and the credit crunch

Item two was completing the Sox 404 improvements. The dreaded provisions of Sox 404 were being held up as the biggest detriment to being a US reporting company. Chairman Cox told me, when I was hired, that this was his (and therefore my) biggest and most pressing challenge. Of course, little did any of us know what lay ahead in fall 2008! As an aside, despite all the hysteria of that period, I have always believed that fear of US private litigation has been a much bigger detriment to foreign private issuer listings than Sox, and also that the driving force behind the decline in US listings was simply the growing strength and depth of foreign markets as they matured.

In any event, during summer 2007, the Commission completed the adoption for the first time of guidelines for management's assessment of internal controls and approved a new PCAOB audit standard (AS 5) for auditing management's assessment of internal controls. These steps provided for a much more top-down, risk-based and, therefore, more efficient and less burdensome application of Sox 404. Largely, compliance with Sox has faded from public complaint.

As an aside, while I agree that these

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refinements in the implementation of Sox 404 were needed, I am a strong believer (both as a member of the private bar, as well as when I was a regulator) in the provisions of Sox, particularly the CEO/CFO certifications, the requirements for disclosure controls and procedures, the internal control assessments and audits and various corporate governance improvements. I believe that these processes collectively improve the quality and reliability of financial reporting (and that is a good thing) and a critical attribute of US markets. Don't forget, whatever it was about, the crisis last fall was not grounded in a failure of corporate reporting. It was about substantive regulation (or a lack or failure thereof) of financial institutions and complex financial products.

Item three was eliminating reconciliation to US Gaap for foreign issuers using IFRS. This project went at breakneck speed (by SEC standards at least) in 2007. Although affecting only a few hundred issuers initially, this was obviously a change of huge magnitude in the financial reporting world, and one that laid the groundwork for the next step – possibly moving to IFRS for US issuers as well.

As you likely know, last November the Commission published its proposed roadmap for required use of IFRS by US issuers, which includes suggested timing under which the Commission would make a decision in 2011 whether to implement mandatory IFRS, with implementation taking place as early as year-end 2014.

IFRS will win the day

Let me shift for a minute or so into a looking forward mode with a few thoughts on this. The use of IFRS by US issuers is a critically important initiative. It is also a proposed roadmap, seeking public comment, and the Commission (under Mary Schapiro) will have to finalise that timetable. In public forums, particularly the FASB roundtable in July, the resounding message from all the constituencies was: give us dates, give us a plan, so we can plan.

The roadmap (even when finalised) does not make the final decision. It merely sets up the final decision as a future Commission action, proposed to occur in 2011 (but subject to comment, as I said), with actual, required first use being at the end of 2014. And that decision in 2011 (or whenever), will look at three factors: quality and reliability of IFRS standards (convergence alone is not the focus), the independence and effectiveness of the IASB and the readiness of various constituencies (companies, preparers, auditors, academia, other regulators, investors).

With respect to timing, the Commission voted on the proposed roadmap timetable last August (prior to the extraordinary events of the past four months). It may be that the financial community's focus on other compelling matters during this period and in future months will require a resetting of the proposed timetable. That remains to be seen, of course, after the comment period and the Commission finalises the roadmap.

As my final thought on IFRS, if you listen to the initial reaction of many commentators, in the press in particular, you may become sceptical about the likelihood (or perhaps even the desirability) of reaching the end goal,

“My recommendation is to decouple other voting items from the access debate”

but I believe we need to keep that goal-a single set of high-quality, global accounting standards-in sight. In my view, the benefit of achieving comparability (as well as internal consistency for global enterprises) is truly compelling, and ultimately will carry the day. And in looking at that goal, I cannot imagine that US Gaap will be the ultimate survivor. Look around the globe. The EU, Australia and Israel have IFRS, Canada is moving there, and now so is Mexico, and many others. So in my mind, it really is not a question of if, but of when.

In getting there, the challenge for the Commission and its new Chairman, Mary Schapiro (and so also for my successor), will be to provide leadership and vision in the coming years, recognising that there are outstanding issues, but also recognising that the end result will almost certainly be IFRS. So concerns about readiness, and the state of IASB funding and governance (including the events of last October), should not deter us from pursuing the ultimate goal. Remember, the roadmap is looking to a Commission assessment of readiness and to a Commission decision in 2011 (or whenever), not in 2008. Long-term, forward-looking leadership will be critical.

Fire and mutual recognition

Anyway, back to history. That was 2007. When I was here last January, I again took the opportunity to lay out the Division’s agenda for the coming year (that being 2008). I was told by my colleagues on the staff that it was going to be a slow year. Pre-election. Nothing happens. It’s the opportunity to focus on long-term, less exciting, clean-up projects. So, with the three big competitiveness projects from 2007 successfully behind us, we in Corporation Finance stepped back and decided that updating our outdated international rules should be our priority. So, last January, again at this conference, I laid out a three-part agenda on the international front. You know the results: three proposals, two in February and one in May, and final Commission action on all three on August 27, during the last week of normalcy at the Commission.

The first of these, which we refer to by its acronym Fire, shortened the deadline for 20-Fs to four months, beginning with filings made in 2012. It also included a number of other revisions, including testing of FPI status on a single, annual date, instead of continuously. The second release substantially revised the Rule 12g3-2(b) exemption such that a foreign private issuer whose primary market is outside the US (and who posts information in English on its website) is provided with an automatic exemption from Exchange Act registration. And finally, the third release expanded and enhanced various exemptions relating to cross-border tender offers and rights offerings, all this being intended to encourage the inclusion of US security holders in M&A and other transactions involving foreign private issuer targets. Frankly, none of this was really very exciting, but it was important, as our rules (dating back to the sixties, in some cases) did need to reflect changes in technology, internationalisation and experience.

The other topic from last year’s conference that I spent some time on was possible Commission initiatives on mutual recognition of foreign securities regulatory regimes, which basically involves giving foreign brokers (and exchanges) greater access to US investors. If you recall, my Corporation Finance focus was looking at the standards that might be applicable to the foreign companies whose securities might be traded on a foreign exchange that was assessable to US investors. Actual Commission action on this front in 2008 was limited. In late August, a framework for a limited arrangement with Australia was announced, but that’s about it. So, that was it for 2008 (on the international rulemaking front).

So, what about 2009? Well, I can’t give that agenda speech any longer. I don’t have three international projects on the shelf again this year that I plan to deliver. Why? First, I am no longer on the staff (a slight hindrance). Second, that agenda hasn’t been set. We need a Chairman (Mary Schapiro, who has been selected, but not sworn in yet), and we need a new Director (who has not been selected yet). So, with the remainder of my time, let me do two things: First, give you the agenda I did leave behind. Then, talk about timing and priorities for the Commission in 2009.

With respect to an agenda, I did, while still in Washington, put out a possible Division agenda for 2009 (it’s on the SEC website, in a speech called Don’t Throw Out the Baby with the Bathwater). I was, of course, speaking without authority (or at least without the ability to implement), but I was leaving some suggestions for my successor. So, let me mention some of the items I identified (some of which have more international implications than others).

Proxy access: elephant in the room

The first item is IFRS, which I covered already and is a critical initiative. The roadmap needs to be finalised to provide the guidance everyone is asking for. A timetable is needed.

The second item is reviewing and implementing, where appropriate, the recommendations of the SEC Advisory

Committee on Improvements to Financial Reporting (so-called Cifir). Twenty-five recommendations were issued in August, focusing on accounting complexity and disclosure. (A Treasury committee also issued recommendations in September, focusing on auditors and auditing.) There is a lot in the 25 recommendations.

From an SEC prospective, there are two to focus on (and we were actively looking at these at the staff level, before market events this past fall): (i) correction of errors, which involved addressing the Commission rules on how and when to restate, or not, and (ii) professional judgment, which becomes particularly important with a move toward IFRS, and is also helpful in the fair value arena. I have one observation to make here: Some commentators have expressed scepticism about these projects, suggesting they are not in the best interests for investors (that's without seeing or understanding the proposals). The regulators need to stay the course here, and everyone needs to look at the recommendations before passing judgment. All in all, these are good ideas.

The third item, the elephant in the room, is the proxy access debate. This was the most challenging issue I grappled with on the staff (before the market events of this past fall, of course). A massive effort was put into review of the proxy process in 2007: With three roundtables, two rule proposals, 34,000 comment letters, and, finally, one rule adopted in November 2007. Despite all this effort, unfortunately, I found that there is little common ground in the proxy access debate. By that, I mean there is really no compromise position. On the one side is the view that shareholders are being shut out of the nomination and election process for board members by the current system (and thus forced to launch costly proxy contests in order to effect change at the companies in which they invest).

On the other side are concerns that proxy access would be disruptive to boards and result in special interest board members. So, after much effort, little concrete progress resulted, other than reconfirming the agency's pre-existing position permitting exclusion from proxies of shareholder proposals for election of directors (after the issue was opened up in 2006 by a court decision involving AIG).

The two points that I would like to make here are, first, that access is likely to be on the table again this year. It was actually included in early drafts of the bailout bill in September, for companies participating in the Trouble Assets Relief Program (although dropped in the final bill). It is likely to be back as a possible legislative matter with the new Congress or as an SEC matter, effectively with a new Commission. Note that four of the five Commissioners, including Chairman Schapiro, will be new to addressing this issue (they did not participate in the extensive debate of 2007). A different resolution than November 2007 is certainly possible. Also note that this is an issue bigger than an SEC staff recommendation; it is a fundamental Commission policy issue with, as I said earlier, little common ground.

My second point here is, putting aside what the right answer may be on access itself, which I won't express a view on today, there are many proxy-related issues that have been swept up in the policy debate here, and that I believe need to be addressed soon. These include: (i) the so-called non-objecting beneficial owner and objecting beneficial owner (Nobo/Obo) issues; (ii) NYSE Rule 452 relating to voting broker shares (where the underlying owners, usually retail, do not express a preference); (iii) direct company communications with shareholders; (iv) overvoting (a big company concern); (v) empty voting (the separation of beneficial ownership from voting); and (vi) ownership thresholds for shareholder proposals (very outdated). All this has been on hold for several years and needs to be addressed, and the Commission needs to be weighing in. My recommendation is to decouple these items from the access debate and begin to respond to investor and company needs.

The fourth item is beneficial ownership. The Corporation Finance staff has been in the early stages of evaluating (or re-evaluating) the beneficial ownership reporting regime in light of recent judicial and other developments, and considering possible recommendations, if any, to the Commission. In particular, I'm referring to the *CSX v Children's Investment Fund* case from last June regarding the treatment of equity swaps and other derivatives. In that case, which is on appeal, the court indicated that it was strongly inclined toward the view that a holder of long positions under cash-settled equity swaps beneficially owned the stock referenced by the swaps. There is a lot in this area for the staff to consider in terms of possible rulemaking recommendations to the Commission.

Repeal provisions on CDS

The fifth item is credit default swaps, which were a big topic during the crisis last fall. The Commission took action in December to facilitate the creation of central counterparty arrangements for over-the-counter credit default swaps. Hopefully this will provide greater transparency and stability to that market. But, the actions taken in December are only a first step. The use of a central

counterparty is only voluntary, not mandatory. There is still no regulation or oversight of trades that market participants do away from the central counterparty, which is where the fraudsters will likely still remain. The Commission does not have the statutory authority to regulate this market. In fact, no regulator has authority over this market. As Chairman Cox noted in his testimony to Congress (and in a later op-ed piece for *The New York Times*) last fall, the credit default swap market represents a regulatory hole, and he has urged that Congress grant the authority to regulate this market. Clearly, what to do in this market is one of the items early on the Congressional agenda for 2009.

An obvious fix, from an SEC perspective, is to repeal the provisions that exclude credit default swaps from the definition of securities (and take away SEC jurisdiction). Under that approach, the Commission would pick up jurisdiction over recordkeeping and disclosure and then provide appropriate exemptions when credit default swaps are traded on exchanges (or in central counterparty arrangements). So, assuming there is Congressional action (in response to this request for authority), this will be another agenda item for the Commission (and the Division) in 2009, and one that I assume will be acted on promptly, if the additional authority is given.

Finally, here are some other possible projects for 2009:

- Focusing on rating agency matters, including finalising the remaining securities ratings proposals (where ratings appear as reference points in the SEC rules);
- Final action on the Regulation D proposal (the sixth item in the private offering and small business capital raising reform package from 2007), regarding a new exemption (Rule 507) permitting limited general solicitation in private placements to a new category of large investors (having over $2.5 million of investments);
- Possible temporary, interim rulemaking concerning communications during capital raising (Rule 163); this would be for large companies that have not put equity shelfs in place, and are concerned about spooking the market with overhang if they do;
- Updates to Regulation AB covering asset-backed securities (obviously much in the news) – these rules are a few years old now; and
- Addressing the application of Section 5 to short sales and so-called Pipes (private investment in public equity) transactions. There have been some adverse, and wrong (in my view) court decisions.

So, those are some of the agenda items I left behind. You'll note that not many are international in focus, except IFRS of course.

Responding to crisis demands

With respect to timing and priorities generally for the Commission this year, there are quite a number of demands on the Commission's time. In the short run, the new Chairman (Mary Schapiro) needs to get on board herself, and to get her team in place. She also needs to set her own priorities in this highly charged environment. Other demands on the Commission include, first, reacting to the crisis (through the fall, it seemed like every weekend another institution was in trouble; this is obviously not the optimal way to allocate time, but a financial crisis can't be ignored when it's there, and emergency actions chew up a lot of time and focus).

Second, reacting to the Madoff scandal, and concerns with Enforcement and the Office of Compliance Inspections and Examinations (OCIE), will be very time consuming. The investigation by the inspector general will put big demands on the staff in responding. Also remember that a stepped up enforcement effort, which is likely, means stepped up demand on Commission time, as enforcement matters (600 plus per year) all come before, and are considered by, the Commission as a whole, at closed meetings. Third, reacting to possible regulatory restructuring, which is a big issue and a big priority. This is, again, very time consuming. Congressional hearings drain time (senior time), and, if and when reorganisation is enacted, implementation also takes time and senior effort.

So, what does all that mean to you? Well, the staff (particularly in Corporation Finance) keeps operating and responding. It continues to review filings on schedule, legal and accounting advice continues to flow and there are no delays in accessing markets, caused by the staff at least. This was a priority of mine all fall and I am sure it continues to be a priority of Shelley Parratt, the new Acting Director. So, your day-to-day contact with the Commission staff (and its responsiveness) is unaffected. But, realistically, when you begin to think about the rulemaking projects which many of you (and now I) focus on and care about in our everyday professional lives, including many of those I just mentioned as possible agenda items for 2009, there may be a different story. This is simply a bandwidth issue. The various demands on Commission time that I just mentioned will (and really should) take priority.

This is a long-winded way of saying that traditional rulemaking things may move at a more measured pace in 2009. Take, for example, where some of the Commission's international initiatives fit in, such as final action on the Rule 15a-6 proposal from last summer (which would liberalise activities by non-US broker dealers with US investors) or mutual recognition (carrying forward or expanding the exploratory arrangement with Australia from last August). Or even think about the timing on finalising the IFRS roadmap. Unfortunately, but understandably, many of the agenda items of the staff that I mentioned as leaving behind don't feel like first priorities. So, no promises, obviously, and no predictions this year.

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This is an extract from the keynote address at PLI's Eighth Annual Institute on Securities Regulation in Europe on January 12 2009. White was speaking only in his personal capacity as a member of the private bar