U.S. Capital Markets in the Post-Sarbanes-Oxley World:
Why Our Markets Should Matter to Foreign Issuers

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As Chairman of the Securities and Exchange Commission, I am obligated to tell you that the views I express here are my own and do not necessarily represent those of the Commission or its staff. With that formality aside, let me begin with an observation that is sometimes heard in discussions about liberalizing international commerce. Feelings about free trade, it's said, are the same as those about heaven – everyone wants to get there, but just not too quickly!

I want to thank Howard Davies and the London School of Economics and Political Science for hosting this event, and for giving me the opportunity to speak today. It is an honor and a pleasure to be at an institution with such a rich and varied history, serving as a place of study or research for 13 Nobel Prize winners, including Friedrich von Hayek; more than two dozen heads of state, including John F. Kennedy; and one former student in a category of his own: Mick Jagger!

We are all familiar with the dramatic expansion of global business and foreign direct investment in recent years. But less well understood is how national regulation impacts the world's securities markets, and the importance of regulatory coordination and cooperation among the world's securities regulators. Given the substantial amount of cross-border holdings, capital flows, and transactions such as mergers and acquisitions, all regulators have much to learn from their foreign counterparts.

Indeed, while the SEC is proud of the regulatory system in the United States and the work we do to maintain and constantly improve it, I am the first to acknowledge we don't have all the answers. We are anxious to listen to, and learn from, ideas advanced by other regulators, which is one reason why the SEC is an active member of IOSCO, the International Organization of Securities Commissions. In the same vein, we also seek to hear from all manner of interested parties, to advance a constructive dialogue and to maintain strong and vibrant capital markets – in the United States, in Europe, and throughout the world.

In that spirit I'd like to talk today about a number of pressing issues facing securities markets throughout the world, with an emphasis on the comprehensive U.S. corporate-reform law of 2002, the Sarbanes-Oxley Act – looking at how it's working, how it affects foreign issuers, and what we're doing to ensure a level playing field in the U.S. market for all issuers, regardless of country of origin.

For the past few years, much of the media coverage of business has revolved around financial scandals at some prominent, once-respected companies. You all know the list: Enron, WorldCom, Adelphia, Health South, Tyco, Global Crossing, Cendant and others. In the beginning, these financial scandals appeared to be primarily an American phenomenon — perhaps a result of overheated U.S. stock markets, excessive greed, and a winner-take-all business mindset. More recently, however, it has become clear that U.S. companies were not alone when it came to scandals. Over the past 18 months, we have seen many non-U.S. companies – Parmalat,

Vivendi, Hollinger, Ahold, Adecco, TV Azteca, Royal Dutch Shell, Seibu, China Aviation, and others – accused of managerial fraud, accounting irregularities and other governance abuses.

Related to these disclosures of alleged gross corporate malfeasance, there was also a more widespread erosion of standards throughout our markets, with questionable practices becoming accepted and ethical corners being cut on a too frequent basis. The net effect has been to undermine the faith investors have in the integrity of the world's capital markets. When investors buy shares in a company or purchase its debt securities, they must have faith that the company's financial statements have been prepared using high-quality accounting standards designed to accurately reflect the company's financial condition. If investors don't have this faith, they will insist on a risk premium for their investment. The cost of capital will increase for these companies, with the obviously negative impact on investment and employment decisions.

As it becomes extremely time-consuming for investors to distinguish the good from the bad, they will tend to invest in other markets or perhaps not invest at all. This is of particular concern in the U.S., at a time when more than half of all our households have some equity ownership, and investment decisions on the deployment of retirement funds are increasingly being delegated to individual beneficiaries. It must also be of concern for investors, businesses, and regulators throughout the world.

Different countries have responded differently to the problems in the world's securities markets, but what's significant is that there has been a global recognition of the need for reforms. This is critical, because simply fixing problems in only one market can result in their reappearance in other markets. Through multilateral cooperation we can not just learn from each other, but also raise standards throughout our markets, and ensure that investors everywhere have the protections they need and deserve.

The Sarbanes-Oxley Act

The American response to the problems I've just outlined came in 2002, when the U.S. Congress and President Bush enacted the law which became known as Sarbanes-Oxley. The Act is the most significant piece of securities legislation passed since the securities acts of 1933 and '34, the latter of which created the Securities and Exchange Commission itself. Sarbanes-Oxley created a new Public Company Accounting Oversight Board to oversee the audit profession. It created new rules to protect auditor independence and address conflicts of interest faced by securities analysts. It increased the penalties for financial fraud and gave the SEC additional resources. The act also instituted other important safeguards, such as requiring issuer CEOs and CFOs to certify the company's financial statements, and mandating that auditors certify the adequacy of the issuer's internal controls.

Now, two-and-a-half years later, some critics claim the Sarbanes-Oxley Act goes too far. In particular, these critics charge that requiring certification of internal controls — the so-called Section 404 provision of Sarbanes-Oxley — is too expensive and unnecessary. Section 404 has even led some foreign issuers to declare that they may wish to leave America's capital markets altogether rather than have their internal controls certified.

It is easy for an individual issuer to look at the cost of compliance with U.S. federal securities laws and balk. But the cost of capital also comes with benefits. U.S. capital markets are deep and liquid. Nearly half of all the world's equity shares, by market capitalization, trade in the United States. And non-U.S. investors have approximately $4.5 trillion invested in U.S. stock markets.

Since the 1930s, the U.S. has required some of the most extensive financial disclosures, backed up by one of the most robust enforcement regimes of any jurisdiction in the world. As a result, the average person in the United States who saves even a little money doesn't feel that the only realistic investment opportunity is a government-insured savings account. Educated investors recognize that investing in the stock market entails risk, but the U.S. government has worked to ensure there is a range of investor protections and a level playing field. These laws, regulations, and enforcement activities make the U.S. capital markets attractive to foreign investors.

A First-Class Market

The requirements of Sarbanes-Oxley cannot be evaluated in a vacuum. They are important because they have produced, and will produce, improvements that help to restore and reinforce investor confidence in our markets, and lower the cost of capital to issuers. Section 404, for example, reaffirms that U.S. legislators are serious about internal control requirements. It is already clear that Section 404 is helping to strengthen the business operations of those U.S. and foreign issuers who have seized the opportunity to use the internal controls assessment as a managerial opportunity and not simply a compliance exercise.

The disclosures that have been, and will be, made under Section 404 involve facts that investors should know about a company when making an investment decision. But these are also facts that management and the board of directors should know about the companies for which they have responsibility.

This discussion of Section 404 is a reminder of the need for high standards in securities markets throughout the world. The overwhelming majority of investors – regardless of their nationality and regardless of where they're investing – demand honesty and integrity. They demand that boards of directors take their fiduciary duties seriously. They demand that companies have the internal controls they need in order to ensure the accuracy of their financial disclosures. And when there is fraud or where securities laws or regulations are violated, investors rightly expect regulatory authorities to aggressively pursue enforcement action.

All capital markets talk of honesty and integrity. Full, accurate, and timely disclosure of material information is a "core principle" of IOSCO. Strong fiduciary obligations for corporate managers and directors are now enshrined within the OECD's Principles for Corporate Governance.

These measures are helping to raise standards throughout the world, but I still believe there are distinct benefits to listing on a U.S. exchange and registering with the Commission. I'd like to explain why by drawing a parallel to the U.S. Marine Corps, which shares some characteristics with the Royal Marines here in Great Britain. Of all the U.S. armed services, the Marine Corps has the longest and most intensive basic training for both its officers and enlisted personnel. The Corps is upfront about its grueling physical and mental drill. But it has no problem meeting its recruitment goals. The reason is simple: the Marines are an elite – the best of the best.

That is what we want the U.S. market to represent as well. We want listing and registration in the United States, with its extensive requirements, to signal that the issuer is committed to the highest standards. We also seek to have a listing in the U.S. signify to investors throughout the world that this company is willing to make the investment needed to meet these standards. Companies who choose not to come to the United States may meet those same standards – but our registrants have taken the extra step of telling the world that they are up to the challenges that accompany a U.S. listing.

It is entirely consistent with the principles underpinning Sarbanes-Oxley reforms to also evaluate whether the rules and regulations we write to implement these principles are effective and appropriate. Have rules been implemented the right way? What are the relative costs and benefits? Are there certain situations in which rules should not apply? Or where old rules have been outmoded or are in need of revision? For instance, we have recently proposed reforms to the rules governing the "quiet period" in the weeks preceding initial public offerings, reflecting the advances made in modern communications methods, such as the Internet. There are many other areas where we have acknowledged the need for updating and modifying rules, and there are also examples related to non-U.S. issuers.

Going Forward

In this same vein, the SEC has worked from its earliest days to accommodate foreign issuers, and to facilitate their access to our markets. In 1935, just one year after the SEC's creation, the Commission issued a rule exempting foreign companies from our rules governing both proxy statements and reports by insiders of transactions in their company's securities. More recently, many issuers have raised excellent points and real concerns about how Sarbanes-Oxley will be implemented in practice, and how this implementation may affect those who are listed in more than one jurisdiction and who operate under more than one set of rules.

The SEC remains committed to a level playing field for all its issuers, foreign and domestic alike. But we recognize that cross-border listings frequently entail issuers having to navigate duplicative or even contradictory regulations in different jurisdictions. While the SEC is unwilling to compromise where investor protections are concerned, some duplicative or contradictory regulations can compromise those protections and place an unnecessary burden on issuers, firms and investors.

I want to emphasize that the SEC is determined to avoid such situations, where possible. We have demonstrated our willingness to work with foreign regulators and market participants to reduce the likelihood of this occurring and continuing uncorrected. One recent example is the SEC's rule regarding the composition of audit committees of listed issuers. Sarbanes-Oxley required the SEC to pass a rule mandating that all members of audit committees be independent directors. But the corporate governance laws and regulations in Germany for instance, and a few other countries with dual board systems, require corporate audit committees to include a labor representative. SEC rules do not, however, consider employees of an issuer "independent" for fear that an unscrupulous corporate officer could appoint employees to the board who were beholden to the company's management.

Following a dialogue with the European Union and others, the SEC was reassured that in those jurisdictions with dual boards, the mandatory labor representatives on issuer audit committees were firmly independent of the company's management. The resulting final rule relating to audit committees contained an exception for these jurisdictions that would allow employees who are not officers of a company to sit on the audit committee. This enables the affected issuers to comply with both sets of law. And it preserves the intent of Sarbanes-Oxley – to ensure that independent directors can communicate directly with auditors without management interference.

Another example of the SEC seeking to accommodate the special circumstances of foreign issuers came with our rules related to the publication of financial information presented in ways not strictly in compliance with U.S. Generally Accepted Accounting Principles, or GAAP. In this area, we included an exemption for

non-GAAP communications outside the U.S., even where those communications reach the U.S. We took this action because we did not want to interfere with the regular practices governing how foreign companies communicated with investors in non-U.S. markets.

A third example of accommodation is our work with the new Public Company Accounting Oversight Board to iron out some issues regarding oversight of foreign audit firms. Under the Sarbanes-Oxley Act, all audit firms, including non-US audit firms, providing significant audit services for issuers listed in the United States, are required to be registered and inspected by the PCAOB. Because of potential conflicts with foreign privacy laws and blocking statutes, the PCAOB has made some adjustments in the information requested of foreign firms during the registration process. In addition, the PCAOB is seeking a collaborative approach to developing its oversight role vis-à-vis non-U.S. audit firms, working with counterparts in Europe and elsewhere.

We welcome continued input from the foreign issuer community as well as from our regulatory counterparts in other jurisdictions. In the short term, I expect several initiatives that should ease some of the concerns that foreign private issuers may have about the reforms now being implemented in U.S. markets.

First, I expect the SEC to consider whether there should be a new approach to the deregistration process for foreign private issuers if they do not feel prepared to meet the U.S. requirements. U.S. federal securities laws and regulations on this issue were designed many years ago, before there was much in the way of cross-border listings. While the rules were designed to protect investors, we should seek a solution that will preserve investor protections without inappropriately designing the U.S. capital market as one with no exit. We recognize that issuer circumstances change, and that foreign private issuers should have the flexibility to respond to these changes.

Second, the Commission also recognizes the seismic change that conversion to IFRS represents for many European countries. We appreciate the European Union's efforts in this area because we value the EU's willingness to require the use of a single set of high quality accounting standards. This approach enhances investor understanding. We also understand that conversion to IFRS, while undoubtedly beneficial in the long run, could be difficult and expensive for some to implement in the immediate term. Consequently, the Commission has proposed amendments to our reporting requirements that would facilitate foreign private issuers' conversion to IFRS. For those foreign issuers also listed on U.S. exchanges, the SEC has long allowed these companies to use IFRS, provided the financial figures were reconciled to U.S. Generally Accepted Accounting Principles over a three-year period. Within the next few months, I fully expect the Commission will consider adopting a proposal to allow first-time users of IFRS to reconcile their financial statements to U.S. GAAP for only two years, and I am of the firm view that this would be a step in the right direction.

Third, the SEC recently extended the deadline for smaller accelerated filers – issuers in the United States with market capitalization between 75 and $700 million – to come into compliance with SEC rules implementing Section 404 of Sarbanes-Oxley. We pursued this course of action because we understand there are limited resources available to comply with these internal control requirements, which may be disproportionately expensive for companies with fewer resources to devote to compliance and their internal controls.

Though the Sarbanes-Oxley Act does not provide an exemption for foreign private issuers, we will continue to be sensitive to the need to accommodate unique foreign structures and requirements. Many non-U.S. companies and their auditors are well on their way to completing the processes necessary to report on

internal controls. Of all the reforms contained in the Act, getting these processes right is likely to have the greatest long-term impact on enhancing the reliability of financial reporting. However, many companies outside the U.S., especially in Europe, face additional challenges in the near term that go above and beyond those faced by U.S. companies as European companies adopt international financial reporting standards for the first time in 2005.

To address these burdens, I have asked the staff of the Commission to consider whether to recommend that we delay the effective date of the internal control on financial reporting requirements for non-U.S. companies. We will continue to monitor progress in these areas and we are prepared to reach out and engage in an open dialogue to address concerns regarding reporting on internal controls.

Conclusion

There are, of course, many other important issues looming on the international landscape, but the fundamental issue for everyone involved in financial markets today, regardless of company or country, must be to maintain high standards – legal, regulatory, and ethical – that breed trust and confidence. This becomes increasingly important at a time when money managers can move capital around the globe with a few clicks on a computer. Capital will flee environments that are unstable or unpredictable – whether that's a function of lax corporate governance, ineffective accounting standards, a lack of transparency, or a weak enforcement regime. Investors must see for themselves that companies are living up to their obligations and embracing the spirit underpinning all securities laws. Only then will the place of the world's securities markets as an engine of prosperity be assured – in America, in Europe, and throughout the world.

Thank you.