U.S. Securities and Exchange Commission

Speech by SEC Chairman: Opening Remarks at the SEC Open Meeting

by

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U.S. Securities and Exchange Commission

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Item 1: Approval of AS 5; Adoption of definition of "significant deficiency"

Good morning. This is a meeting of the Securities and Exchange Commission conducted under the Government in the Sunshine Act on July 25, 2007.

Today's meeting is going to cover three vitally important topics for the future of our capital markets. We'll begin with rationalizing the implementation of SOX section 404; move on to consideration of the role that IFRS will play in America's future; and finally, we'll consider two proposals to address the question of how the fed proxy rules can be better aligned with the state law rights of shareholders.

These topics are very much related to one another. As the world's capital markets converge and competition among both markets and financial products becomes broadly international, investors will demand more and different things from securities regulation that is, after all, intended to serve their interests.

They will want to know that the costs of regulation are aligned with the benefits it produces, which is why we're considering a completely rewritten audit standard to implement SOX 404. They'll demand better comparability among financial statements from issuers in America and around the world, which is why we're considering a concept release on the relationship between IFRS and US GAAP.

And shareholders of U.S. companies will insist that their property rights as owners and investors — which include above all else the right to choose the board of directors — be respected by the federal proxy rules. As was pointed out recently by the Committee on Capital Markets Regulation, shareholders of U.S. companies have fewer rights in a number of important areas than do their foreign competitors, giving foreign firms a competitive advantage. For that reason, the Committee on Capital Markets Regulation urged the SEC "to address and resolve appropriate access by shareholders to the director nomination process." We will consider two very different approaches to that issue today.

So let us turn to the first item on the agenda, which is rationalizing the implementation of Section 404 of the Sarbanes-Oxley Act of 2002. The first item consists of two parts: first, approval of the PCAOB's Auditing Standard No. 5, "An Audit of Internal Control Over Financial Reporting that is Integrated with An Audit of Financial Statements," a related independence rule, and conforming amendments. And second, the adoption of a definition of the term "significant deficiency."

Next Monday, July 30, will mark the five-year anniversary of the Sarbanes-Oxley Act. Section 404 has posed the single biggest challenge to companies under the entire Act. Without question, it has imposed the greatest costs; but it has also contributed significantly to more reliable financial reporting as companies improved their internal controls to meet Section 404's requirements.

For the past two years, the Commission, the PCAOB and our respective staffs have been hard at work to improve the implementation of Section 404 while maintaining Section 404's benefits and protections to investors. Over this two-year period, we have held two roundtables, in 2005 and 2006, to listen to issuers' first- and second-year experiences with the PCAOB's Auditing Standard No. 2. We also issued a concept release concerning management's report on internal control over financial reporting; proposed and adopted additional extensions of time for non-accelerated filers, certain foreign private issuers, and newly public companies; provided staff guidance; convened the Advisory Committee on Smaller Public Companies to study, among other things, the impact of Section 404 on smaller companies; and proposed and adopted guidance for management to follow in conducting their evaluations of internal control over financial reporting. With respect to the PCAOB and the internal control auditing standard, last fall and winter we worked closely with the PCAOB and its staff as they developed their proposed new internal control auditing standard; and we convened an open meeting of the Commission on April 4 to discuss with our staff their approach to the PCAOB's proposed new standard and the alignment of that standard with our management guidance.

Along the way, we carefully considered all of the public comments that we and the PCAOB received on Section 404 implementation. Many companies and their auditors are now entering their fourth year of reporting on internal control over financial reporting. Throughout this period, management, auditors, investors, and other interested parties have provided ongoing extensive and enormously helpful feedback to both the Commission and the PCAOB about what has worked well, and what could be improved.

On May 24, the PCAOB voted to replace the auditing standard under SOX 404 that led to excessive costs and serious implementation problems with a top-down, risk-based approach focused on internal controls that are material to a company's financial statements and scalable for companies of varying size and complexity. This new standard — Auditing Standard No. 5 — can take effect only if it is approved as final by the SEC. On June 12, the Commission published the new standard for public comment, and the comments have been overwhelmingly favorable.

This morning, we consider whether to grant final approval to Auditing Standard No. 5. As we approach the five-year anniversary of Sarbanes-Oxley, we can be proud that confidence in our markets is restored, that compliance costs are coming down, and that today the final approval of the PCAOB's Auditing Standard No. 5 will make a giant step forward in facilitating a more effective and efficient approach to the implementation of Section 404 — by refocusing resources on what truly matters to the integrity of financial statements. This is an exceptionally positive step for investors and for America's capital markets.

Although the new auditing standard and the Commission's guidance to management should enable cost-effective compliance with Section 404 for companies of all sizes, smaller public companies — as defined by the report of the Advisory Committee on Smaller Public Companies, which is referred to in AS 5 — should particularly benefit from the scalability built into the PCAOB's new auditing standard and the SEC's interpretive guidance. In addition, because we deferred Section 404's external audit requirement for the category of smaller companies that are non-accelerated filers until the filing of their 2008 annual reports, management of these smaller companies will have additional time to develop an evaluation approach specific to their facts and circumstances and to coordinate their approach with a cost-effective external audit.

We are confident that Auditing Standard No. 5 will improve effectiveness and efficiency and will reduce 404 compliance costs, and we are committed to ensuring that its implementation is consistent with our expectations. To that end, we will analyze real-world information to determine that the costs and benefits of implementing section 404 are in line with our expectations. In addition, through our oversight of the PCAOB's inspection program, we will monitor whether audit firms are implementing Auditing Standard No. 5 in a manner designed to achieve the intended results of audit efficiency and cost reduction and whether the PCAOB is inspecting audit firms in a manner consistent with our expectations. With a significantly improved audit standard that enables auditors to deliver the most cost-effective audit services, the SEC and the PCAOB expect a change in the behavior of the individuals who are responsible for conducting internal control audits.

I want to once again thank our staffs of the Office of the Chief Accountant, Division of Corporation Finance, and General Counsel's Office for all of their work. Your tireless efforts over the past year will benefit investors in our capital markets for many years to come. Specifically, from the Office of the Chief Accountant, I'd like to recognize Zoe-Vonna Palmrose, Brian Croteau, Josh Jones, Amy Hargrett, Esmeralda Rodriguez, Jeff Ellis, and Kevin Stout. From the Division of Corporation Finance, I'd like to recognize Betsy Murphy and Sean Harrison. And, from the Office of General Counsel, David Fredrickson. I'd also like to recognize the work of the PCAOB Board and their staff for their efforts.

Finally, I'd like to take this opportunity to express again the Commission's appreciation to the Advisory Committee on Smaller Public Companies, and the hundreds of investors, companies, auditors, professional organizations and others who responded to the Commission's and the PCAOB's various requests for comments regarding audits of internal control over financial reporting. The Commission's efforts in improving Section 404 implementation were considerably aided by their helpful insights and suggestions.

I will now recognize John White, Conrad Hewitt and Zoe-Vonna Palmrose for a presentation of the staff's recommendation.

Item 2: Concept Release on Allowing U.S. Issuers to Report under IFRS

The next item on today's agenda is a recommendation from the Office of the Chief Accountant and the Division of Corporation Finance that the Commission issue a Concept Release to obtain information about the public's interest in allowing U.S. issuers, including investment companies, to prepare their financial statements in accordance with International Financial Reporting Standards as published in English by the International Accounting Standards Board. U.S. issuers currently prepare their financial statements under U.S. generally accepted accounting principles.

The Commission has long advocated for globally accepted accounting standards that are high-quality, comprehensive and rigorously applied. As issuers and investors increasingly look beyond borders for opportunities to invest and raise capital, it is critical that the financial information they use to make their decisions be accurate and timely. One of the obstacles that must be overcome in making investment decisions is the different ways in which financial information can be reported. Often, the differences are due simply to the country in which an issuer is located. That's why virtually everyone — issuers, investors, and stakeholders alike — agrees that the world's capital markets would benefit from the widespread acceptance and use of high-quality global accounting standards.

Global accounting standards benefit investors by allowing better comparisons among investment options and increased access to foreign investment opportunities. They reduce costs for issuers, who no longer have to incur the expense of preparing financial statements using differing sets of accounting standards. And lower costs facilitate cross-border capital formation as well as benefit shareholders, who ultimately bear the burden of the entire cost of the financial reporting system.

Five years ago, with the Commission's express support, the Financial

Accounting Standards Board and the International Accounting Standards Board formalized their commitment to the convergence of U.S. and international accounting standards. More than two years ago, we endorsed a roadmap that would commit us to eliminating the U.S. GAAP reconciliation requirement for foreign private issuers, with the result that eligible firms listing on U.S. exchanges could choose whether to report under IFRS or U.S. GAAP. Once the U.S. GAAP reconciliation requirement is eliminated, if an issuer chose IFRS, it would not be required to reconcile the differences with U.S. GAAP, just as today, issuers reporting under U.S. GAAP are not required to reconcile the differences with IFRS.

In supporting convergence between IFRS and U.S. GAAP, the Commission has recognized that progress could result in IFRS and U.S. GAAP co-existing and even freely competing in U.S. capital markets. This commitment to convergence has meant that issuers, markets, and investors will someday have a choice — because they, not the government, will decide between IFRS and U.S. GAAP. It has also meant that the SEC was seriously contemplating a system in which both foreign and domestic issuers would someday have that choice.

In March, the Commission held a roundtable on IFRS to assess the impact of the co-existence of two sets of accounting standards on the U.S. markets, on the decisions investors make, and on the Commission's program of investor protection. We heard from key participants in the capital-raising process — issuers, accountants, investors, credit rating agencies, investment bankers and lawyers — on whether the benefits of eliminating the U.S. GAAP reconciliation requirement for foreign private issuers are, in fact, achievable in practice, and their responses were resoundingly positive.

Today, nearly 100 countries require or allow the use of International Financial Reporting Standards. Since 2005, when the European Union mandated the use of IFRS for public companies in all of its Member States, the Commission has received a significant volume of financial statement filings using IFRS from foreign private issuers. Likewise, U.S. investors, analysts, and others who rely on these issuers' financial statements are becoming increasingly familiar with IFRS. In light of these developments and our roundtable, the Commission last month proposed to eliminate the requirement that foreign private issuers who submit financial statements prepared using IFRS also submit a reconciliation of those financial statements to U.S. GAAP. This proposal, if adopted, would result in the co-existence of two different sets of accounting standards in the U.S. capital markets.

This morning, we are considering publishing a staff Concept Release that solicits public comment on the future role of IFRS in U.S. markets and asks whether U.S. issuers should be permitted to use IFRS for purposes of complying with our rules and regulations. In some respects, this is the mirror image of allowing foreign private issuers to file IFRS financial statements without reconciling their financial statements to U.S. GAAP, in that it would give U.S. issuers the same choice that foreign private issuers would have. Such a concept would also touch potentially every aspect of the

U.S. capital markets — from how U.S. accountants are educated and trained, to how U.S. issuers prepare their financial statements, to how U.S. investors understand financial statements, and to how accounting standards are developed and interpreted to apply to U.S. companies.

The purpose of this Concept Release is to solicit views from a broad range of investors, issuers and other market participants on the benefits and costs — and the advantages and disadvantages — of allowing U.S. issuers to report using IFRS. This public feedback will be enormously valuable to the Commission. In addition, many countries have already made the change from their home country GAAP to IFRS, and we would be particularly interested in hearing from issuers and regulators and other affected parties in these jurisdictions to understand and learn from their experience.

Before I recognize Conrad Hewitt and John White to lead the discussion of the staff's recommendation for soliciting that feedback through the proposed Concept Release, I want to thank the staffs of the Office of the Chief Accountant and of the Division of Corporation Finance for their excellent work — in particular, Julie Erhardt, Jim Kroeker, Katrina Kimpel, Joe Ucuzoglu, Jeff Ellis, Stephen Brown, Mark Barton, Craig Olinger, Paul Dudek, Michael Coco, and Sondra Stokes. I also want to thank Ethiopis Tafara and Sarah Otte from the Office of International Affairs, Richard Sennett from the Division of Investment Management, and David Fredrickson and Zachary May from the Office of the General Counsel.

Item 3: Shareholder Proposals

The final item is a recommendation from the Division of Corporation Finance concerning amendments to the federal proxy rules governing shareholder proposals and shareholder communications. The most significant of the proposed amendments concern the question of a shareholder's ability to propose procedures in a company's bylaws for the nomination of directors.

Current Exchange Act Rule 14a-8(i)(8) provides that a company may exclude from its proxy materials a proposal that relates to an election for membership on the company's board of directors. The purpose of this provision is to prevent the circumvention of other proxy rules designed to ensure that shareholders receive adequate disclosure and an opportunity to make informed voting decisions in election contests. Accordingly, in applying this provision, the Commission's staff has determined that companies may exclude from their proxy statements proposals to establish a process for conducting contested elections outside of the Commission's detailed disclosure and regulatory regime governing contested elections.

Last September, the U.S. Court of Appeals for the Second Circuit invalidated the SEC staff's long standing interpretation of Rule 14a-8(i)(8). That interpretation had been applied since 1990, but the court found it inconsistent with a prior interpretation. The court said that it would "take no side in the policy debate regarding shareholder access to the corporate ballot," noting that "such issues are appropriately the province of the SEC."

Since the effect of the decision is to create uncertainty about the application of Rule 14a-8 in the Second Circuit, on the one hand, and in the other 11 judicial circuits in America, on the other hand, the Commission is required to act. Moreover, the effect of applying the court's decision as a rule of general application would be to permit director election contests without the disclosures required by the election contest rules.

In light of this opinion and the paramount importance of meaningful disclosure to investors in election contests, we have undertaken a careful and extensive review of the proxy process, including the provisions of Rule 14a-8. This review included three Roundtables this past May that focused on the relationship between the federal proxy rules and state corporation law, proxy voting mechanics, and shareholder proposals.

Today we are formally considering two different proposed resolutions to this question — so that, as we continue to evaluate the legal, economic, and policy aspects of all that is involved here, we will continue to have choices. I have stated previously, and will repeat again today, that it is my intention as Chairman to have a clear, unambiguous rule in place in time for the next proxy season.

The Government in the Sunshine Act requires that whenever more than two Commissioners are gathered to discuss policy making on a matter such as this, it must be at a public meeting. So unfortunately, the obvious way to work out tough technical and policy issues is off limits to us — that is, Commissioners can't get together to roll up our sleeves, sit around the table and brainstorm about potential ideas. Still, that's what this issue calls for, and so we'll be doing some of that work right here during this open meeting — just as the Government in the Sunshine Act would have us do it. As you'll hear, we don't all agree. And when the dust settles today, we won't be finished. We won't be making any fateful decisions just yet, but instead we'll open up these topics for formal comment from the entire country.

By advancing two very different proposals, we will have the benefit of the full breadth of commentary about different ways of attacking this issue. By considering serious alternatives, we will have the benefit of thorough analysis of a variety of ways to accomplish our stated objectives. This approach will also give us a richer context in which to evaluate public comment concerning the potential costs and benefits of any new rule. And exposing both of these proposals to public comment will enable us to better understand the impact that any new rule would have on competition — an analysis that we're required to undertake pursuant to Section 23(a)(2) of the Exchange Act. For all of these reasons, it is my intention to support both Releases at the proposing stage.

Having said that, the Commission's analysis of shareholder participation in the nomination and election of directors hardly begins with our proposals today. This issue and its several offshoots have a long and storied history, and many previous Chairmen and Commissioners have attempted to tackle them. As Chairman John Shad put it during the Reagan Administration, "the

Commission has always encouraged shareholder participation in the corporate electoral process." And, he added, the SEC's "responsibilities for regulating proxy solicitation have been premised on the need to assure 'fair corporate suffrage' for every securityholder." He advanced an idea to use the Commission's "jurisdiction over the self-regulatory organizations with a view to standardizing listing standards as regards shareholder voting." We have a different approach before us today, but the objective remains the same.

Fair corporate suffrage is just as important now as it was in the 1980s, and several commentators, from all across the spectrum, have recently been making the case. The distinguished group of securities experts, market professionals, and academics that comprised the Committee on Capital Markets, under the direction of Prof. Hal Scott of the Harvard Law School and the co-chairmanship of Glenn Hubbard, President Bush's former Chairman of the Council of Economic Advisers, and John Thornton, the former President of Goldman Sachs, devoted an entire section of their recent report to shareholder rights.

They did so because of the same reasons that the SEC today just approved our reforms of Sarbanes-Oxley and our Concept Release on IFRS: because, in the Committee's words, "the strength of shareholder rights in publicly traded firms directly affects the health and efficient functioning of U.S. capital markets."

The Committee on Capital Markets observed that "[o]verall, shareholders of U.S. companies have fewer rights in a number of important areas than do their foreign competitors." And they added that "[t]his difference creates an important potential competitive problem for U.S. companies." As one way of addressing that need, the Committee recommended that the SEC take the opportunity of the court's decision in the *AIG* case to ensure "appropriate access by shareholders to the director nomination process."

But we enter upon this discussion today with the full benefit of recent experience that ended badly. Four years ago, under Chairman Donaldson, the Commission proposed a rule that would have established a mandated procedure under which companies would be required to include shareholder nominees in their proxy materials. That rule generated enormous controversy and was ultimately unsuccessful.

There are several lessons to infer from that experience. First, the federal proxy process must be respectful of the preeminent role of state law in determining shareholder rights. Second, as we heard repeatedly at our three May roundtables on the proxy process, changes to the existing system — even changes that everyone agrees are improvements — should be measured and incremental, to insure that first we do no harm. Third, the federal proxy rules should not embellish shareholders' state law rights or create new ones, but rather vindicate their existing rights under state law, the company's charter, and its bylaws. And finally, the federal interest is preeminent when it comes to disclosure. Ensuring that shareholders get full and fair disclosure in connection with proxy contests is a fundamental concern of the Exchange Act and of this agency.

So neither of the proposals that we are considering today takes the approach of aborted Rule 14a-11, which for all intents and purposes would have imposed a national bylaw on every public corporation in America. Instead, today we're considering whether, if shareholders and companies wish to propose their own bylaws, should those proposals be allowed in the company's proxy materials — and if so under what circumstances? And just as the many Roundtable participants advised us to do, we will conduct this analysis on a foundation of respect for state law and the fundamental principles of shareholder choice and private ordering, which are the genius of our free enterprise system.

At bottom, a share of stock is private property, and the law's enforcement of private property rights is what gives it its value. America's investors currently entrust over $20 trillion of their assets in exchange for these property rights as holders of equity securities. And yet a common stockholder has precious few specific rights that undergird this fantastic investment, and so it's of the utmost importance that what the stockholder does have is jealously guarded by our legal system.

The stockholder is said to own the company, but he or she cannot direct management or the board to do anything. Indeed, even 100% of the shareholders acting in concert could not do so — instead they must rely on the directors. Only after every unsecured creditor is taken care of does the common shareholder receive a penny of assets on liquidation. A common stockholder can receive dividends, but only if the company decides to declare them. But the shareholders do have the ironclad legal right to do one thing for themselves — and that's to choose the company's directors.

And yet some say the company's proxy materials, which are produced at the shareholders' expense, should under all circumstances be inaccessible to the shareholder, when it comes to nominating directors. That would seem to stand the principle of "fair corporate suffrage" on its head. And that harsh conclusion would seem especially warranted if what is being considered is not the shareholder's opportunity to use the company's proxy to nominate a director, but rather only to propose a bylaw that would set up a procedure by which that could happen — and that would itself have to first be approved by a majority of the company's shareholders.

Beyond all of this, as so many participants at our Roundtables described, it is an irony that the federal proxy rules force many other things onto the corporate proxy that are at the periphery of shareholder's rights — if they are within the scope of their state-law rights at all. If a proposal has nothing to do with the ordinary business of the company, if it is non-binding and even superfluous, then the proxy rules might well require its inclusion on the company's proxy. But if the proposal concerns the most fundamental of shareholder rights — the most unqualified, unbridled right that the shareholder has — then in the current system the answer is no, and indeed no under all circumstances.

As Chairman Shad observed in 1984, "Under our corporate form of enterprise, more, not less, equity capital is essential to growth and development. The disenfranchisement of shareholders poses a present and real issue that must be debated and addressed."

And I would add: protecting the private property rights of America's shareholders is the only way to insure that boards of directors remain accountable to the interests of investors. It is the check and balance on boards and management that is built into the corporate form under state law, and its proper functioning is essential to our free enterprise system.

Still, some would say that any incremental improvement in the way the proxy system vindicates the shareholder's state law right to choose the directors will threaten capitalism. To that I would reply, by all means we should be cautious and measured when we adjust the workings of our proxy system. And this process of soliciting public comment that we are embarking upon today will ensure that. But we should also keep first principles firmly in mind.

We cannot have capitalism without capital. There can be nothing more central to our mission of promoting healthy capital formation than defending the rights of capital and the property interests of shareholders. Ensuring that the proxy system respects the state law rights of shareholders is essential to maintaining the balance of federalism. And upholding the rights of ownership is fundamental to the maintenance of investor confidence and the workings of our entire free enterprise system.

At this point let me thank and congratulate my fellow Commissioners for their diligent, professional, and responsible investigation into these issues for the better part of a year. While the proposals we're considering today only begin a process of public comment that will consume several more months, they also mark the culmination of 10 months of sustained work. Commissioners faithfully attended each of the Roundtables on these subjects, and devoted countless hours to study, to meetings, to research, and to collaborative learning with our professional staff and many other participants in our capital markets. And during the last month since the Division's initial draft of its recommended Release was circulated to all Commissioners, they have contributed many useful comments and shepherded through many changes. I have no doubt that process will continue during the weeks and months ahead.

It has been a hallmark of our work in recent years on many, many difficult subjects that we have sought whenever possible to reach a unanimous result, because we knew that by first considering one another's viewpoints, we would inevitably improve our own understanding and the final result, even if in the end we did not agree. Today, despite the difficulty that the Commission has had in wrestling with this issue over several decades, all of us — Commissioner Atkins, Commissioner Campos, Commissioner Nazareth, Commissioner Casey, and I — agree unanimously that the objective of this rulemaking is to protect investors' interests and to promote capital formation for the benefit of the entire nation. I hope and expect that all of us will continue to work to get it right.

Before I turn it over to John White for a detailed explanation of the two alternatives, let me offer a very brief summary. The first proposal would amend Rule 14a-8(i)(8) to codify the interpretation of the election exclusion since 1990. That approach would insure that in all proxy contests, shareholders would receive the disclosures currently required under the other proxy rules. And it would permit the exclusion from the company's proxy materials of all shareholder-proposed bylaws concerning director nominations.

The second approach would expressly permit the inclusion of such shareholder-proposed bylaws in the company's proxy materials. This approach would also insure that shareholders receive the disclosures currently required under the other proxy rules. And it would require important new disclosures about the shareholder or shareholders who are proposing the bylaw. The disclosures would be made under the Schedule 13D/G regime, which requires that shareholders who own more than five percent of the company's shares provide certain information about themselves. The shareholder proponent would have complete freedom to structure the bylaw, so long as the procedure for director nominations that it sets out complies with applicable state law and the company's charter and bylaws. This reflects a decision not to impose a federal, one-size-fits-all approach, but rather to promote shareholder choice and private ordering. For this reason, the current proposal differs sharply from what the Commission proposed in 2003.

In addition, the second approach includes important new features to facilitate greater online interaction among shareholders and between shareholders and management. It would amend the proxy rules to remove obstacles to electronic shareholder communications. It would clarify that a company or shareholder who maintains an electronic shareholder forum is not liable for statements by any other participant in the forum. It would also eliminate any ambiguity concerning whether participation in an electronic shareholder forum could constitute a proxy solicitation.

I want to thank the staff of the Division of Corporation Finance for their excellent work on these proposals. In particular, I want to thank John White, Marty Dunn, Lily Brown, Tamara Brightwell, Steve Hearne and Ted Yu. I also want to thank Brian Cartwright and the Office of General Counsel, as well as the Office of Economic Analysis, for your excellent work. And now I will turn it over to John White to explain the two proposals in more detail.

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