U.S. Securities and Exchange Commission

Speech by SEC Staff: Addressing International Concerns under the Sarbanes-Oxley Act

by

Ethiopis Tafara

Acting Director, Office of International Affairs
U.S. Securities and Exchange Commission

Remarks before the American Chamber of Commerce in Luxembourg
June 10, 2003

Good afternoon. It is my pleasure to be here today to discuss the SEC's implementation of the Sarbanes-Oxley Act of 2002. I would like to thank the American Chamber of Commerce in Luxembourg for their kind invitation.

Before beginning my remarks, I must state that the views expressed are my own and do not necessarily reflect those of the Commission or its staff.[1]

The Sarbanes-Oxley Act is arguably the most sweeping and important US federal securities legislation affecting public companies and other market participants since the SEC was created in 1934. The reforms in the Act are broad ranging, and include provisions affecting disclosure by public companies, corporate governance and auditor oversight. But what is especially striking is the amount of interest, concern and debate that the Act has generated among the foreign community. Nearly 70 years ago, when the SEC was created, no one could have imagined that revisions to the US federal securities laws could have such an impact abroad. It is clear that, more than ever, capital markets around the world are increasingly interdependent, and changes to national laws can have repercussions outside of borders.

Moreover, while much attention has focused on the failures of some US corporations, such as Enron and WorldCom, the underlying issues transcend national boundaries and affect us all. The United States is not alone in its efforts to restore investor confidence. As the saying goes, every rain cloud has a silver lining, and today lawmakers and regulators around the world are actively working, both on a unilateral and multilateral basis, to improve corporate governance, auditor oversight and other aspects of the financial system. The events of the past few years have led to a fast-developing international consensus on the critical areas necessary for investor confidence in securities markets, as illustrated in IOSCO's (the International Organization of Securities Commissions) recently released statements on issuer transparency and disclosure, auditor independence, and auditor oversight. Global investors are entitled to consistent, comparable financial information on which to base their investment decisions. Although we may approach solutions differently, I believe that regulators and policy makers on both sides of the Atlantic share this goal.

While we share many of the same objectives, the SEC recognized from the beginning that aspects of the Sarbanes-Oxley Act posed special concerns for foreign market participants accessing the US capital markets. Congress was clear that the Act generally should make no distinction between domestic and foreign firms. After all, US investors transacting on US markets are entitled to the same protections regardless of whether the issuer is foreign or domestic. The SEC also realized, however, that the application of our rules to foreign companies must be done in a reasonable, measured way, as has been our historical practice. One of the greatest challenges that the SEC has faced in implementing the Act is to fulfill our congressional mandate, while also respecting foreign laws and regulatory schemes. Although some may disagree, I believe that, as evident by SEC rulemaking to date, the SEC has worked hard to strike this balance and has afforded accommodations to foreign firms where consistent with the letter and spirit of the Act.

Our ability to address foreign concerns, while operating under a very short Congressionally imposed timeframe, is a testament to the importance that the SEC places on open dialogue and the strong relationships it has with its foreign counterparts, particularly with many EU member states. Through comment letters, public roundtable discussions, and bilateral and multilateral meetings, the Commission and its staff have endeavored to learn from foreign regulators and market participants. We sought information about how the requirements of the Act conflict with local law or local stock exchange requirements, and how foreign laws and regulations address in alternative ways the same issues as the Act. The input we received from the foreign community has been extremely important.

I would like to spend the majority of my time discussing selected SEC and other rulemakings under the Act to give you a feel for how accommodations for foreign companies were crafted. I think you will see that the SEC has engaged in a very thoughtful process, taking into careful consideration foreign comments. To my mind, rulemakings under the Act can be grouped into four key categories: corporate governance; accountability; disclosure; and auditor oversight.

I. Auditor Oversight

I would like to begin with auditor oversight, which has certainly generated a great deal of discussion with our EU counterparts. I think it's important, at the onset, to note that, while the appropriate scope of oversight over foreign accounting firms by the US Public Accounting Oversight Board (which I will refer to as "the PCAOB" or "the Board") is being debated, there is widespread international support for efforts to enhance auditor oversight. In fact, many jurisdictions, including some EU member states, have undertaken, or are undertaking, efforts to reform their auditor oversight systems. In fact, in May, the EU announced Priorities for Improving the Quality of Statutory Audits throughout the EU. Let me start though with a bit of background about the PCAOB, which I think is important to understanding its mandate.

Title II of Sarbanes-Oxley establishes a private sector Public Company Accounting Oversight Board to oversee public accounting firms that perform audits of companies that file reports with the SEC. The Board is a non-governmental, nonprofit corporation consisting of five full-time, independent members, only two of which can be certified public accountants. The Board is responsible for:

- Registering accounting firms that prepare audit reports on US listed issuers;
- Writing and administering rules governing: (1) auditing standards; (2) quality control; (3) ethics; and (4) independence;
- Conducting inspections of registered accounting firms; and
- Conducting investigations, bringing disciplinary proceedings and imposing sanctions for violations related to the preparation of audit reports on the financial statements of US public companies.

On April 23, 2003, the Board adopted, and submitted to the SEC for approval, final rules requiring the registration of all public accounting firms, foreign or domestic, that issue or prepare audit reports on the financial statements of US public companies, or that play a substantial role in the preparation of such audit reports. The rules reflect careful consideration of comment letters from foreign authorities and market participants, as well as views obtained at an international roundtable meeting held on March 31.

Although the Board determined not to exempt foreign accounting firms from registration, it recognized the need to work with its foreign counterparts to avoid unnecessary burdens or legal conflicts, while at the same time fulfilling its mandate. To this end, the Board has made certain preliminary accommodations for foreign firms, consistent with the spirit and intent of the Sarbanes-Oxley Act. These include:

- Not requiring foreign audit firms to provide registration information to the PCAOB, where provision of such information would violate home country laws (subject to certain considerations such as the provision of a legal opinion).
- Granting foreign audit firms an additional six months to register, in recognition of the fact that foreign audit firms will have to assess whether the registration requirements do pose conflict with local law.

- Limiting registration only to proprietors, partners and principals of foreign audit firms that provide over 10 hours of services on a particular audit.

Going forward, the PCAOB has indicated a desire to work with non-US accounting regulatory bodies to develop cooperative registration, inspection and disciplinary procedures. Although the PCAOB's final rules call for registration of non-US firms by April 2004, the PCAOB hopes, before that time, to be able to make substantial progress with its foreign colleagues in developing harmonized registration and oversight models.

As required by the Act, the SEC recently published for public comment the PCAOB's proposed rules, and I encourage everyone with an interest in this matter to provide the Commission with your comments.

II. Corporate Governance

The Act recognizes that effective oversight of the financial reporting process is fundamental to preserving the integrity of our markets. The board of directors, elected by and accountable to shareholders, is the focal point of the corporate governance system. The audit committee should play a critical role in serving as a check on a company's financial reporting system by providing independent review and oversight of a company's financial reporting processes, internal controls and independent auditors.

Audit Committees: On April 9, 2003, the SEC adopted a new rule directing the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements mandated by the Act. All members of the audit committees of public companies must be independent directors and audit committees must be directly responsible for the appointment, compensation and oversight of the issuer's audit firm. Also, the committee must establish procedures for handling complaints regarding accounting and internal control matters of the issuer, including confidential methods for addressing concerns raised by employees.

Some members of the foreign financial community expressed concern that the audit committee provisions would require foreign private issuers to adopt new corporate governance standards without giving consideration to conflicting home country requirements on auditor oversight. For example, some countries, such as Germany, require that employees serve on the supervisory board, which has audit oversight responsibility. Based on a consideration of these and other conflicting foreign legal requirements, the SEC's rule includes certain accommodations for foreign private issuers that take into account foreign corporate governance schemes, while preserving the intention of the Act to ensure that those responsible for overseeing a company's outside auditors are independent of management. These accommodations include:

- Allow non-management employees to serve as audit committee members, consistent with "co-determination" and similar requirements in some countries;
- Allow shareholders to select or ratify the selection of auditors, also consistent with requirements in many foreign countries;
- Allow alternative structures such as statutory auditors or boards of auditors to perform auditor oversight functions where they are authorized by home country requirements, they are not elected by management of the issuer, and no executive officer of the issuer is a member; and
- Allow for foreign government and controlling shareholder representation on audit committees.

III. Accountabilty

The Act addresses issues of accountability by clearly assigning responsibility to certain persons charged with corporate oversight to help ensure that companies are run properly. The Act directs the SEC to clarify and increase the accountability of: (a) principal executive officers, (b) attorneys who work for public issuers, (c) accounting firms, (d) research analysts and (e) credit ratings agencies. While much as been done in this area, I would like to highlight two rulemakings that have been of particular interest to the foreign community: auditor independence and attorney conduct rules.

Auditor Independence: On January 22, 2003, the Commission adopted rules designed to strengthen auditor independence and to require additional disclosures to investors about the services provided to issuers by the independent accountant. The Commission approved measures that will, among other things:

- Revise the rules related to the non-audit services that, if provided to an audit client, would impair an accounting firm's independence;
- Require that certain partners on the audit engagement team rotate after no more than five or seven consecutive years, depending on the partner's involvement in the audit, and would include a cooling-off period; and
- Establish rules that an accounting firm would not be independent if certain members of management of that issuer had been members of the accounting firm's audit engagement team within the one-year period preceding the commencement of audit procedures.

Foreign commentators expressed concern that the broad application of the audit rotation requirement would adversely affect audit quality, especially in emerging markets. These markets frequently have only a limited pool of accountants with expertise in US GAAP and US GAAS. It was also noted that the prohibition of certain services, such as legal services, could conflict with some home country requirements.

The SEC's final rules reflect concerns raised by both foreign and domestic commentators:

- For example, the partner rotation requirement will apply to partners that serve the client at the issuer or parent level. Partners serving an issuer's subsidiary will be subject to rotation only if they are lead partners and the subsidiary's revenues or assets constitute 20% or more of the consolidated revenues or assets in the consolidated financial statements.

- Restrictions on employment will apply only with respect to positions at the issuer, as distinguished from entities affiliated with the issuer.

- Moreover, the cooling-off period only will apply to the lead partner, the concurring partner or any other member of the audit engagement team, unless exempted, who provides more than 10 hours of audit, review or attest services.

- The rule also clarifies that foreign accounting firms can provide tax services (which are permitted under the Act), despite their local definition as legal services, which are among the enumerated list of services prohibited by the Act.

In other areas where conflicts between US and foreign requirements may result, the SEC will continue to address such circumstances on an *ad hoc* basis, including, for example, the prohibition on contribution-in-kind reports, which auditors in some EU countries are legally required to provide.

Standards of Professional Conduct for Attorneys: On January 23, 2003, the SEC adopted rules implementing provisions of the Act that prescribe "minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers." The standards must include a rule requiring an attorney to report "evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by the company or any agent thereof" to the chief legal counsel and the chief executive officer of the company (or the equivalent); and, if they do not respond appropriately to the evidence, requiring the attorney to report the evidence to the audit committee, another committee of independent directors, or the full board of directors.

The foreign community expressed concern that it would be inequitable to apply the attorney conduct rules to foreign attorneys, who may have conflicting home country ethics requirements or who lack the expertise to assess violations of US law. Also, foreign, as well as domestic commentators, reacted adversely to the "noisy withdrawal" provision of the proposed rules, which would require attorneys, under certain circumstances, to notify the Commission that they have withdrawn from representing an issuer for professional reasons. Commentators argued that such a provision could constitute a breach of attorney-client privilege.

The rule as adopted excludes most foreign attorneys not licensed to practice law in the United States from its coverage. As a general matter, only foreign attorneys who provide advice regarding US securities law may still be subject to the rule.

In addition, based on the large number of adverse comments received, the final rule does not include a mandatory "noisy withdrawal" provision. Instead, the Commission requested further comment on that issue and proposed an alternative, whereby the issuer would be required to disclose its counsel's withdrawal to the Commission as a material event. The Commission sought specific comments from foreign private issuers on this proposal, which may address the potential conflict between SEC rules and foreign attorney-client privilege requirements. Commission staff is in the process of analyzing comments received.

IV. Disclosure

The Act also instituted a statutory mandate to improve disclosure in areas such as pro forma financial information, off-balance sheet financial information, and disclosure of the financial expertise of audit committee members.

Enhanced Disclosures Regarding Financial Experts and Code of Ethics: On January 15, 2003, the SEC approved final rules requiring a company to disclose: (i) the number and names of the "audit committee experts" serving on the company's audit committee, and whether they are independent of management; and (ii) whether the company has adopted a code of ethics that covers the company's principal executive officer and senior financial officers, or if it has not, the reasons therefore. The rules apply to foreign private issuers filing reports with the Commission.

Due to concerns raised by both domestic and foreign commenters about whether the term "financial expert" was too restrictive, the SEC changed the terminology to "audit committee expert" and broadened the means by which expertise could be gained to include an understanding of an issuer's home country GAAP rather than US GAAP.

* * *

In closing, I would like to leave you with some observations. The financial failures of the past few years, and the regulatory responses that have ensued, have brought to light not only the areas where we share common ground, but also those circumstances where tensions among foreign laws may arise. The importance of cooperation and dialogue in bridging those differences is unquestionable. In the case of Sarbanes-Oxley, we believe that input from the foreign community has helped us to craft rules that are well-reasoned and fair to all market participants and, most importantly, to investors.

We realize that some, particularly in the EU, do not think that the SEC has gone far enough in accommodating foreign market participants. They have called, instead, for full exemptions for their firms based on principles of mutual recognition. However, while we certainly respect those views, we believe that the SEC, as well as any other national regulator, has the right to determine the terms and conditions under which financial service providers access investors in its jurisdiction. The challenge for all of us is to do so in a reasonable manner that is applied on an equitable basis.

I think this is precisely what the SEC has done in implementing the Sarbanes-Oxley Act. We have worked hard to take the necessary steps, mandated by our Congress, to restore investor confidence. What's more, we have done so in a measured way, taking into careful consideration foreign conflicts of law and alternative regulatory schemes. The result, I believe, is meaningful accommodations intended to avoid unnecessary burdens and conflicts of law. I hope that many of you will join me in viewing Sarbanes-Oxley as a positive exercise in open dialogue and cooperation among regulators.

Thank you.

Endnote

[1] The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. This speech expresses the author's views and does not necessarily reflect those of the Commission, the Commissioners, or other members of the staff.

http://www.sec.gov/news/speech/spch061003et.htm