U.S. Securities and Exchange Commission

Speech by SEC Commissioner: Recent Experience With Corporate Governance in the USA

by

Commissioner Paul S. Atkins

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I'd like to thank Dr. Gerhard Cromme for his gracious invitation to speak this morning. It is a great honor and privilege to be here with you today. As an initial matter, I must note that the views expressed here today are my own and do not necessarily reflect those of the SEC as an institution or of the other Commissioners.

I would like to start my talk today with a simple truth. In recent months we have heard much talk about differences between the United States and various counties in Europe. Some of the issues of contention have been related to security, of course, some to trade and finance. But I believe that all of them share a common quality. They are transient. They come. They go. What endures is the simple truth that Germany and each of the Member States of the European Union are crucial allies of the United States. Our friendship and mutual respect are of the utmost importance as we look to the future in these uncertain political and economic times. While there have been some encouraging signs regarding the global markets recently - such as, apparently sustainable increases in certain markets - these signs, of course, come at the heels of spectacular corporate failures. These failures over the last few years, which were largely caused by questionable accounting practices, bad management and week internal controls, impact all of us. Consequently, restoring investor confidence by strengthening corporate governance is of great importance to the world's financial markets; it is not an issue unique to the U.S. or the E.U.

Financial crises - similar to those we have dealt with over the last few years - have yielded a legislative reaction many times in the past, often resulting in politicians to "do something." Last year, in fact, the market decline and large corporate failures led to just such a general sense that politicians should "do something." Because these corporate failures stemmed from lax accounting and corporate governance practices, "Corporate Responsibility" became an important issue in the United States, for the first time in perhaps 70 years. In

late July of 2002, Congress passed the Sarbanes-Oxley Act, with only 3 members voting "no." Corporate responsibility is still a critically important mainstream *political* issue in America. Indeed, in his last State of the Union address, the President, referring to Sarbanes-Oxley, said that "tough reforms" were passed to "insist on integrity in American business."

In light of this political issue, some people have charged that Sarbanes-Oxley is just a cynical political reaction to a market crisis at the end of bubble. I think that the better way to look at Sarbanes-Oxley, in the whole and in context, is that it is more than just a political response. Although it certainly represents what formerly would have been an unimaginable incursion of the U.S. federal government into the corporate governance area, it also contains many advances for corporate governance and attempts to provide best practices to prevent the misdeeds that have led to the investor losses. Many of these ideas are not new, but have been floating around in one form or another for quite a number of years. Many are not outright prescriptive requirements, but rather are items of disclosure, with the burden then on issuers and the market to decide what importance to place on that disclosure.

Sarbanes-Oxley required the SEC to make many rules within specific time limits. In the United States, the SEC is bound by law to give people subject to our rules fair notice of what rules the SEC plans to adopt and to have an opportunity to send to us comments on and objections to those rules. We are required by law to take those comments into account and say why we accept or reject those objections. With respect to Sarbanes-Oxley, because the time given us by Congress was so short, we typically left the wording of the rules rather general and, in most cases, stayed very close to the statute's wording, even though Congress gave us some discretion to be more flexible in some cases. We hoped that the comments and objections would help us tailor our rules to make them workable in the U.S. and abroad. Ultimately, we received a great deal of comment, much of it from non-U.S. commenters. I believe, and hope that you agree, that the final rules that we adopted demonstrate our responsiveness to those comments.

The final result of Sarbanes-Oxley and our rules, after all of the back and forth of recent months, is a positive step for general corporate governance. Through the comment process, we have been able to craft something more than just a political reaction to a crisis.

Fundamentally, the Act acknowledges the importance of stockholder value. Without equity investors and their confidence, our economic growth and continued technological innovations would be slowed. Sarbanes-Oxley strengthens the role of directors as representatives of stockholders and reinforces the role of management as stewards of the stockholders' interest.

A lesson from the recent corporate failures in America is the importance of corporate culture and what we call the "tone from the top." A CEO's tolerance or lack of tolerance of ethical misdeeds and a CEO's philosophy of business conveys a great deal throughout the organization. The role of directors is to monitor and oversee that situation on behalf of stockholders. Directors are

not and can never become full time employees. There will always be a natural tension between directors as business advisors - a vital role - and their role as monitors of management on behalf of the stockholders' ownership interests.

It is my hope that Sarbanes-Oxley may indirectly help directors in this regard. The law's effect will be to make board members be more inquisitive. Therefore, questions that might have seemed to be "hostile" to management two years ago will now be seen to be in furtherance of a director's function. Since some of the recent problems concerned corporate managers using the corporation as a personal "piggy bank" or other theft by management of corporate assets, the Act's emphasis on a board's oversight function is certainly a step in the right direction.

Of course, Sarbanes-Oxley generally makes no distinction between U.S. and non-U.S. issuers. The Act does *not* provide any specific authority to exempt non-U.S. issuers from its reach. The Act leaves it to the SEC to determine where and how to apply the Act's provisions to foreign companies. The SEC is well aware that new U.S. requirements may come into conflict with home-country requirements on non-U.S. issuers. We have tried and we will continue to try to balance our responsibility to comply with the Act's mandate with the need to make reasonable accommodations to our non-U.S. issuers.

Europeans and Americans have fundamentally the same goals with respect to strengthening corporate governance. Despite the general thrust of Sarbanes-Oxley, the basic philosophy in the United States is for the States and the stock exchanges to determine their corporate governance requirements. Similarly, a group set up by the European Commission did *not* propose harmonization of corporate governance standards among the Member States. Instead, the group recommended that the Member States should each set forth minimum standards of conduct. The proffered rationale for this approach is that the corporate governance standards of the Member States are necessarily different and flexibility is critically important.

The European approach generally stresses the importance of the non-executive Chairman of the Board. While it certainly may be beneficial, depending on the company, to separate the board chairman from the company's chief executive for oversight purposes, the separation of these two positions will not necessarily cure all corporate governance issues. For example, I would note that both Enron and WorldCom had a non-executive chairman and, of course, this separation did not prevent corporate failures.

As for accounting practices, the European approach has been to stress "principles-based" accounting standards. In concept, the E.U. and the U.S. are not far apart on this issue. As you know, GAAP means "generally accepted accounting principles." But, over the years, and particularly because of our liability standards in the U.S., accountants have relentlessly sought greater certainty as the accounting issues and demands of the marketplace became more complex. Accordingly, by necessity, our rules have become more complex and legalistic. Whether or not this evolutionary process is good

for the accounting profession or investors is a debate for another time.

The SEC is interested in finding the "common ground" between the approach of the U.S. and the E.U. to these issues. Since the passage of Sarbanes-Oxley, the SEC has hosted several roundtables on the application of the Act to non-U.S. issuers. We have met with foreign delegations and European securities regulators. I think I can state with confidence that the process is working and that your active participation in our rule-making process helps the SEC to understand the particular needs of non-U.S. issuers. Just because our approaches are different does not mean that they cannot work together effectively.

If a foreign company considered a U.S. listing before Sarbanes-Oxley, neither the Sarbanes-Oxley Act nor our rules implementing the Act should dissuade the company from doing so. A primary goal of the SEC is to make it inviting for global businesses to offer and list their securities in our markets. Sarbanes-Oxley does *not* have an effect on this goal.

Let me briefly discuss some of the specific issues raised by Sarbanes-Oxley and the rules thereunder, as well as certain implications to non-U.S. issuers:

Audit Committees

Sarbanes-Oxley significantly expanded the role and responsibilities of audit committees. Sarbanes-Oxley requires the audit committee to be responsible for the outside auditor relationship, including the responsibility for the appointment, compensation, and oversight of a company's outside auditor. And, the Act requires that members of the audit committee be "independent" from company management. At the beginning of April, the SEC implemented those Sarbanes-Oxley mandates by adopting new rules.

Exchanges may not list any security of an issuer that does not have a fully independent audit committee. The rules establish two criteria for audit committee member independence: (1) an audit committee member must not be an affiliated person of the issuer apart from his capacity as a member of the board; and (2) audit committee members must be barred from accepting any compensatory fee from the issuer, other than in the member's capacity as a member of the board. The rule specifies that, unless a stock market's listing standards provide otherwise, "compensatory fees" do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the listed issuer (provided that such compensation is not contingent in any way on continued service).

I should note that the rules apply to both foreign and domestic listed issuers. Still, based upon significant input and dialogue with foreign regulators and issuers, several provisions have been added to address special circumstances of particular foreign jurisdictions. These provisions include:

- Allowing shareholders to select or ratify the selection of auditors;

- Allowing alternative structures such as boards of auditors to perform auditor oversight functions where such structures are provided for under local law;

- Addressing the issue of foreign government shareholder representation on audit committees; and

- Allowing non-management employees to serve as audit committee members.

This last accommodation relates to Mitbestimming, the German requirement of non-management employees' serving as members of a company's audit or supervisory board. These employees would often not meet our definition of independence. The SEC has no interest in creating conflicts with local law, especially when these employees actually represent non-management interests. Through our comment process, we were able to consider this matter and provide, in the final rule, that these individuals would be exempt from the independence requirements. This also applies to leitinde Angestellter. We appreciate the critically important information regarding corporate governance that non-U.S. issuers and foreign regulators provided during the rulemaking process.

I think it is worth mentioning at this point that seeking "independence" of board members is not a new concept in the U.S. As early as 1972, the SEC recommended audit committees of "outside directors." Many non-U.S. issuers already have independent audit committees as part of their corporate governance structure and the global trend appears to be toward setting up such audit committees. I have often stated that a one-size-fits-all rule almost never works, and this is especially true in the non-U.S. issuer context. However, there is almost universal support for some form of independent check on company management by a disinterested board. Indeed, the German corporate governance code makes recommendations regarding obtaining more independence of the supervisory board members from company management. For this, I salute Dr. Cromme and the Government Commission on the German Corporate Governance Code. Further, in the U. K., the value of independent directors is emphasized in the recommendations of Derek Higgs regarding corporate governance, building on the earlier work of the Cadbury Commission.

The SEC is a disclosure-based agency, not a merit regulator. Information powers the marketplace, which, I believe, is the only acceptable merit regulator. In keeping with our disclosure tradition, the rules provide that, if a non-U.S. issuer utilizes an exemption to audit committee independence, this information must be disclosed to U.S. investors. The most effective regulator, the marketplace, will determine whether a country's differing independence standards are relevant to U.S. investors.

Internal Controls

At the end of last month, we adopted the final rules regarding the internal

control provisions required by Section 404 of Sarbanes-Oxley. The new rules require management to complete an annual internal control report and require the company's auditor to attest to, and report on, management's assessment. Section 404 of Sarbanes-Oxley makes no distinction between domestic and foreign issuers, and, by its terms, it applies to non-U.S. issuers. The rules, therefore, will apply to non-U.S. issuers. However, since these rules might require significant internal changes, the SEC provided non-U.S. issuers with an extended compliance date.

These latest rules, of course, are driven by statutory mandate. Our release adopting the rules explains that the certifications and attestations required by the new rules are separate requirements from the CEO and CFO certifications related to financial statements that the SEC adopted earlier this year.

Further, we specifically state in our adopting release that management must base its evaluation of the effectiveness of the company's internal controls on a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. The final rules do not mandate use of a U.S. framework or any other framework for that matter. For example, we noted that the *Turnbull* Report published by the Institute of Chartered Accountants in England and Wales is an example of a suitable framework.

The rules are important for establishing accountability of management for the integrity of financial information. My hope is that investors will be able to gauge the level of risk of a company's reporting system by knowing what sort of oversight framework for financial reporting a company has. I also hope the rules will help to lay the groundwork so that one day we will get to the point that the market will clearly favor companies that develop stringent internal controls and aggressive oversight programs. Cheaper cost of capital and better reception from investors is the marketplace feedback that will encourage good internal controls.

Additionally, I hope that these internal control provisions do not create major new burdens or result in accounting firms attempting to simply generate business through the implementation of substantial new documentation programs. I believe that a well-run corporation that stands behind its published financial statements should have sufficient documentation to meet this requirement. Regarding the actual implementation of these rules, we will need to be vigilant and periodically ask two important questions: (1) are investors better protected as a result of our actions or are we just fattening the pockets of accounting firms and law firms; and (2) assuming that investors are receiving *some* enhanced protection, is this benefit greater than the costs imposed on registrants, and is it possible to be done more efficiently? We will continue to monitor how these rules will impact issuers in practice. Please tell us your stories - good or bad, happy endings or horror stories.

Financial Experts

Sarbanes-Oxley also directs the SEC to adopt rules requiring the disclosure of whether a company has a "financial expert" on its audit committee and to define a "financial expert." In January, we released rules in response to this directive. I think it is beyond debate that it is beneficial to have financially literate directors. Indeed, studies show that companies that have board members with significant financial knowledge need to restate the financial statements less than companies with less-experienced board members.

In the final rules, every issuer, including a non-U.S. issuer, must disclose whether it has a financial expert on its board and whether the financial expert is independent from management. An issuer that does not have an audit committee financial expert must disclose this fact and explain why it has no expert. The good news about our final rule is that we worked hard to make it so that it is not, as I first feared at the proposal stage, what would have amounted to a full-employment act for retired accountants. It is more flexible and inclusive. This flexibility is critical to the 17,000 issuers registered with us. Ultimately, however, this is a disclosure provision. Whether or not financial expertise should be ensconced on the board is something that the market and corporations are best placed to decide, depending on the circumstances.

Oversight Board

And now, because I see that there are members of the Press here in the audience, I should say a couple of sentences about the Public Company Accounting Oversight Board. As you might know, Sarbanes-Oxley directed us to create the new Public Company Accounting Oversight Board to oversee the accounting profession and public company audits. It was created because of deep failings in the U.S. accounting profession's ability to regulate itself. The Oversight Board is a non-governmental, nonprofit corporation and has begun to organize itself. The Oversight Board expects to conduct limited reviews of the Big Four U.S. accounting firms in 2003, and annual inspections of those firms and others will commence in 2004.

Of understandable concern to you is the fact that Sarbanes-Oxley requires foreign public accounting firms that audit SEC-registered issuers, including non-U.S. issuers, to register with the Oversight Board and be subject to its oversight. Recently, the Oversight Board adopted its rules regarding registration for public accounting firms; the rules, however, do not take effect unless the SEC approves them.

As adopted by the Oversight Board, the rules make certain accommodations to address difficulties that may be posed by conflicts in non-U.S. law and by differences in approaches and custom. In its release, the Oversight Board noted that these accommodations were to address some of the numerous comments in letters from public accounting firms, foreign governments and foreign professional accounting associations and also to address comments obtained at the public roundtable meeting the Oversight Board held to discuss issues related to non-U.S. accounting firms.

I have not come to any conclusion about these new rules. According to procedures set by statute, the SEC has requested comment on these rules. Our past practice certainly indicates that we listen and react. In this case, we are required to ensure that the goals of Sarbanes-Oxley are achieved, without imposing unnecessary burdens on foreign accounting firms. The normal standard under the World Trade Organization is "national treatment." The Oversight Board seems to have granted that and even made accommodations on top of that. They did not recognize any foreign supervisory regime, which is somewhat troubling. I look forward to considering the comments that we receive on this issue and others.

So, those are a few of the major corporate governance matters that have recently come before the SEC pursuant to Sarbanes-Oxley. I appreciate your time and interest in these matters. Also, I appreciate the input that so many of you have given us, particularly with respect to how these matters impact non-U.S. issuers. As I've noted, we've tried to get these regulations right - implementing the spirit of Sarbanes-Oxley, while attempting to ensure that our markets remain attractive to non-U.S. issuers. I hope that going forward, we will continue to receive your assistance to make certain that we keep that correct balance.

As I said at the start, the enduring truth of E.U.-U.S. relations is alliance - economic alliance as well as political and security alliance. With financial markets effectively global, financial regulators are today custodians of that alliance, in many respects as much - or at least nearly as much -- as other parts of government. At the SEC we are working to strengthen the infrastructure of alliance, that is the smooth workings of international investing. That's been our goal with Sarbanes-Oxley. That's why we've paid such careful attention to comments from overseas. That's why listening to you and to so many other European voices will continue to be how we conduct our business, now and for years to come.

Thank you very much.

http://www.sec.gov/news/speech/spch062603psa.htm