Speech by SEC Commissioner: Remarks Before the American Chamber of Commerce

by

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Thank you, João [César Lima], for that kind introduction. It is truly an honor to be here with you this afternoon in Rio de Janeiro. I thank the American Chamber of Commerce for hosting this event and for the work that you do in facilitating a strong relationship between Brazil and the United States. Before I begin, I must make a statement that is required because I am only one of the now three SEC commissioners — that is the views I express here are my own and do not necessarily reflect those of the Securities and Exchange Commission or my fellow Commissioners.

Brazil and the United States share many common historical experiences. Among other commonalities, both of our countries were colonized from across the Atlantic, eventually earned our independence and built democracies, have prospered because of rich natural resources and fertile agricultural areas, experienced a gold rush, and fought on the same side in World War II. Our countries also share national heroes who were willing to lay down their lives in the struggle for freedom. A week from today, Brazil will celebrate a holiday in honor of one such hero, Tiradentes. Tiradentes was executed on April 21, 1792, for his role in the fight for independence from Portugal. He was influenced by the American Revolution, which came to a successful end in 1789, the year in which Tiradentes' independence struggle took place.

The United States and Brazilian movements for independence were both motivated in part by protests over taxes levied by European kings. In the case of Brazil, it was a tax on gold, and in the case of the United States, it was a tax on imported tea. In the subsequent centuries, our transatlantic relationships have improved. As important as ties between America and Europe are, inter-American ties are also extremely important. Even as North and South Americans were sharing dreams of independence in the 1700s, today we share a common vision for economic prosperity. The prosperity in one country, of course, need not take away from the prosperity of another. Indeed, economic prosperity spills across borders if governments are open to it. Frédéric Bastiat, a famous 19th Century French economist, said that if goods do not cross borders, armies will. The more international ties between economies there are, the more likely it is that the

prosperity of one country will benefit other countries.

Both Brazil and the United States are important players in the international economy. The U.S. capital markets have been a popular destination over the years for products and capital. Brazil, as the largest economy in South America and the world's tenth largest market, is also of great importance in the world economy. As of earlier this year, Brazil moved past China to claim first place in a well-known emerging markets index. Neither Brazil nor the United States can afford to ignore the other country. Fortunately, we have not done so. We buy from and sell to one another. According to one estimate, nearly eighteen percent of Brazilian exports go to the United States, and U.S. imports account for about sixteen percent of Brazilian imports.[1]

The Brazilian and U.S. capital markets are also integrated. U.S. investors are increasingly looking to Brazil and other thriving, emerging markets to diversify their investment portfolios. Many Brazilian companies look to the United States to raise capital. There are, for example, approximately thirty-five Brazilian companies registered with the Securities and Exchange Commission. This number makes Brazil one of the best-represented countries in the U.S. marketplace.

An important contributor to the integration of Brazilian and U.S. capital markets is the cooperative regulatory relationship that we enjoy. The SEC and the CVM, for example, work together through organizations such as the International Organization of Securities Commissions and the Council of Securities Regulators of the Americas. We also have a strong bilateral relationship, which is memorialized in a twenty year-old memorandum of understanding and through which we cooperate extensively on enforcement matters.

Both the United States and Brazil must remain vigilant to identify and address any continuing barriers between our economies. Over the past couple years, academics, politicians, the Treasury Department, and industry groups have undertaken formal studies to look at the competitiveness of the capital markets in the United States. These studies have asked what we need to do to keep our markets attractive for foreign companies and investors at a time in which other countries' markets are demonstrating many of the features that used to be unique to the U.S. The U.S. Chamber of Commerce has issued two reports in the last two years. The common goal of these reports is to maintain and enhance the attractiveness of the U.S. markets to foreign companies seeking to raise capital and foreign investors. Doing this is vital for our economic health — it builds jobs, opportunity, and productive relations among countries.

In the latest of these reports, which came out last month, the Chamber of Commerce noted that the attractiveness of the U.S. markets faces many challenges. The report noted: "We need to reverse the unintended consequences and costs of our current legal and regulatory systems and make them supportive of a fair, balanced, and efficient financial marketplace today and in the future. Both end users and suppliers of capital will benefit greatly if we act constructively."[2]

The Chamber's work and that of the other groups that produced capital markets studies clearly demonstrate that regulatory overreaching has played a role in diminishing the attractiveness of the U.S. relative to other capital markets. Of

course, a strong regulatory structure that is designed to ensure fairness, predictability, and efficiency is a crucial prerequisite for any healthy capital market. Investors need and demand effective recourse to the rule of law and enforceability of contract. They rely on a system of integrity. The SEC's mission to maintain the integrity of our markets is based on a rather simple premise: if investors have confidence that they will be treated fairly, they will invest their money and demand a lesser premium because of a lesser risk. This should yield a lower cost of capital.

If, however, we get the balance wrong, regulation can become part of the problem rather than part of the solution. Central to the issue of attractiveness of our markets is regulatory effectiveness and efficiency. Investors ultimately pay for regulation. If regulations impose costs without commensurate benefits, investors suffer the costs of lack of effectiveness and efficiency, not only through higher prices but also through constrained investment opportunities. That ultimately hurts them in their investment performance, because it means less opportunity for diversification.

Provoked in part by the capital markets studies, the SEC has taken steps to address concerns that it has gotten the balance wrong in certain regulatory areas. An area of considerable concern has been Section 404 of Sarbanes-Oxley Act. The Sarbanes-Oxley Act, passed six years ago by the U.S. Congress, was a reaction to financial frauds such as Enron and WorldCom.

Section 404, which relates to companies' internal control over financial reporting, contains two requirements. First, management must conduct an assessment of internal controls for effectiveness. Second, outside auditors must review management's assessment. The objective of ensuring that companies have strong internal controls is a good one. However, the implementation of Section 404 of the Sarbanes-Oxley Act got off to an embarrassingly bad start. As a consequence, potential gains to investors were diminished by the spiraling compliance and audit costs.

When we embarked on implementing Section 404, the SEC envisioned a top-down, enterprise-focused approach, in which a company would concentrate on entity-level controls that could materially affect the consolidated financial statements. With that in mind, the SEC adopted a rule that contained a principles-based approach for management's assessment of internal controls.

However, implementation of the audit standards for the second requirement of Section 404 — the review by independent auditors) was led by the Public Company Accounting Oversight Board (PCAOB). The PCAOB was created by the Sarbanes-Oxley Act to oversee the auditing profession. It is a non-governmental entity with a government-type mandate and government-like powers, subject, though, to SEC oversight. The PCAOB adopted Audit Standard 2 to implement the auditor provision of Section 404. Audit Standard 2 was extremely long, overly prescriptive, and encouraged auditors to focus on items that were not material. It deterred auditors from using the work of others and from talking to their client companies. Audit Standard 2 effectively discouraged auditors from exercising their judgment. As a result, great effort was expended at great cost to look at and produce documentation for controls, some of which were of little significance to companies' financial statements.

Criticism of the rule was loud, particularly when people began to realize that the prospect of incurring Section 404 costs was causing companies to reconsider raising capital and investing in the United States. The SEC and the PCAOB responded with changes that took effect last year. In June, the SEC issued guidance that is intended to provide management with a risk-based, top-down approach to complying with their obligations under Section 404. The goal was to provide management with guidance addressed to corporate management. Previously, companies had looked to Audit Standard 2 for guidance, since no other guidance existed. This put the emphasis on the audit function when, in fact, the 404 review is meant to be a management assessment. In English, we call that putting the cart before the horse.

In July, the SEC approved the Public Company Accounting Oversight Board's new Audit Standard 5, which replaced the prior Audit Standard 2. Under the new standard, auditors should direct their efforts toward identifying any material weaknesses in internal control. The standard is intended to discourage a bottom-up approach in which auditors get diverted by looking for immaterial internal control issues. I understand that the changes have had a positive effect. If you have heard or experienced otherwise, please let me know. The SEC is undertaking a study to assess the costs of Section 404, which should help us to gauge the effectiveness of the changes that we made last summer.

A second step that the SEC took to address concerns about the capital markets was the elimination, last December and effective immediately, of the reconciliation requirement for foreign companies that file using International Financial Reporting Standards (IFRS), as promulgated by the International Accounting Standards Board. Previously, companies had to restate their financial statements according to U.S. generally accepted accounting principles (U.S. GAAP). This action comes in response to a move by much of the rest of the world to shift to IFRS. Brazilian companies, which are scheduled to adopt IFRS by 2010, will be able to benefit from this change. This change also should benefit U.S. investors who seek to invest in non-U.S. companies. The rationale is that U.S. investors are already investing directly abroad in IFRS-reporting companies and have become accustomed to relying on it. At any rate, reconciliations to U.S. GAAP are published only months after the companies' financial statements are released. Thus, performing reconciliations is costly for companies, and reconciliations appear to be of limited use to those who look at financial statements.

Meanwhile, the SEC is considering whether to permit U.S. companies to file using IFRS. If IFRS is good enough for non-U.S. companies, then why not for American companies as well? Making this change would leave the choice between U.S. GAAP and IFRS to the markets. If investors prefer one set of accounting standards over another, they may well reward with premium pricing those issuers who use the preferred set. You can easily see the utility of IFRS for multi-national U.S. companies that access international capital markets and have non-U.S.-based competitors.

IFRS, of course, is still a work in progress, and there are areas in which IFRS has no applicable standards. The U.S. Financial Accounting Standards Board (FASB) and the IASB have much still to do in converging U.S. GAAP and IFRS, but both are committed to this work. Other issues that remain concern the funding and governance of the IASB, supporting the further development and consistent

implementation of IFRS, encouraging education of accountants in IFRS, and working towards continued convergence.

A third step that the SEC took to enhance the attractiveness of its capital markets was an overhaul of the rules that govern when a foreign private issuer can deregister, or leave the U.S. markets. We made an important decision — we would make it easier for companies to leave in order to make it more likely that they would come to the U.S. in the first place. The SEC's former deregistration rules required a nearly impossible count of U.S. investors to determine if the company had fewer than 300 U.S. investors. The new approach, a much more flexible, realistic, and forward-looking one, measures trading volume instead of the number of U.S. investors. Essentially, if an SEC-registered foreign company has less than five percent of its worldwide trading volume in the U.S., it can leave. Measuring U.S. trading volume to determine if registration is required simply makes sense because it focuses on domestic U.S. investor interest in an issuer.

The new deregistration approach embodies the philosophy that the SEC ought not apply our laws to purely foreign transactions. This is consistent with the SEC's long-held "territorial approach" to regulation. Over the last 20 years, the SEC has generally refrained in rules, like 144A for private placements and Rule 15a-6 for foreign brokers dealing with U.S. customers, from applying our regulations to transactions occurring outside the United States.

Having used trading volume as an appropriate condition to deregister, it logically follows that we should consider using trading volume to govern whether there is sufficient contact with the United States to take the extraordinary step of requiring a foreign corporation to register in the United States. Since 1934, Congress has required any company to register if it has more than 300 U.S. stockholders and $10 million in assets. The SEC has been struggling with this requirement ever since. This requirement may arise even if the corporation has not taken any steps on its own to create that contact. In February, the SEC proposed amendments that would add an exemption from registration based on relative trading volume. The proposal is that companies with more than twenty percent of their worldwide trading volume in the U.S. should register. The issuers, after all, can influence where their shares are traded. This is a changing world, though, and twenty years from now, after more technological change, it may be impossible to say where shares are traded.

Concurrently with that proposal, we also proposed rule changes related to disclosures by foreign private issuers who already file with us. Among other things, the amendments would eliminate all requirements for paper filings. Investors would instead have access to documents in English on the Internet, and companies would also save time and money through electronic filing. The amendments would also shorten the reporting deadlines for the filing of annual reports on Form 20-F. The deadline would be shortened from six months to ninety days after the issuer's fiscal year-end in the case of large accelerated filers and accelerated filers, and to 120 days after the issuer's fiscal year-end for all other issuers. There would be a two-year transition period. I hope that non-U.S. companies send us their comments on this proposal. They can tell us, for example, whether the proposed ninety-day deadline for companies with a public float of $75 million or more would be earlier than the deadlines for comparable reports in their home jurisdictions. If we were to impose another unduly

burdensome requirement on foreign companies, it could well undermine the efforts that we have taken in the last year to remove unnecessary regulatory burdens to our capital markets.

I have found in my nearly six years as a commissioner that foreign companies affected by our proposed rule changes often do not understand our process. Our laws require the SEC, before it adopts a rule, to announce the proposal publicly, solicit comments, and then take those comments into account before it adopts the rule. In many cases over the past six years, especially regarding Sarbanes-Oxley, we listened carefully to foreign comments and adjusted our proposed rules accordingly. So, your voice does matter. Please be involved.

Recent economic events have led some to suggest that concerns about attractiveness of the U.S. markets should be abandoned and all attention should be focused on the short-term problems that we are now experiencing. We certainly do need to focus on addressing the current problems and identifying ways to avoid them in the future. Preoccupied as all of us are with addressing the challenges of the day, however, we cannot forget the resilience of the market economy. The markets have within themselves the wherewithal not only to solve the problems that we are experiencing, but to continue the economic growth that we have enjoyed during recent years. The increasingly international nature of the markets makes our attention to the underlying attractiveness of our markets even more important to draw foreign capital and foreign companies looking for capital. It is true that our interconnected markets feel each other's shocks, just as you in Brazil have felt the effects of the recent troubles in the U.S. Nevertheless, the fact that liquidity can come from across national borders and indeed from across the world makes it easier for an economy in a liquidity crisis to recover.

In the U.S., we are experiencing in some markets a "liquidity drought" — by which I mean a lack of ready buyers in contrast to former conditions. The deteriorating liquidity in the U.S. asset-backed securities markets has led to significant volatility in the broader capital markets. The run-on-the-bank of Bear Stearns appears to have been an outgrowth of this situation. Of course, no financial institution can survive an event of such magnitude.

The reasons for the liquidity drought are readily apparent. Market participants began to question the value of a variety of financial products, especially those with complex structures and the assumptions underlying their valuation models. Consequently, liquidity in these products fell sharply. The lack of liquidity complicates the task of valuing complex instruments. In many cases, mark-to-market accounting rules resulted in the taking of additional reserves or recognition of lower book values by financial institutions in respect of these instruments. While demand for complex structured products may be diminished, the flight to quality has still meant strong demand for investment-grade products. As the interest rate environment, itself a product of investor expectations, settles down and as investors gauge the performance of existing structured products, demand will ultimately return to these sorts of products.

There is no doubt that investors will apply what they have learned to the new environment. In our dynamic marketplace, we can be sure that where there is a potential reward, sooner or later there is someone at some price who is willing to blaze the trail and take the risk. We as regulators must not stand in the way of

investors' and market participants' sorting this situation out. It would be most unfortunate for the economy — investors, workers, consumers — if regulators were to contribute to market uncertainty through interfering with contracts, judging the merit of products or business strategies (especially with the benefit of 20/20 hindsight), or setting arbitrary rules based not on economics but on conjecture. Uncertainty breeds aversion to risk, and aversion to risk has the potential to slow down our economy.

Currently, the SEC — along with many of its international counterparts — is examining the role played by credit rating agencies in the current global market. Credit rating agencies have been criticized about the accuracy of their ratings, for failing to adjust timely those ratings, and for not maintaining appropriate independence from the issuers and underwriters. Our examinations will review whether the rating agencies diverged from their stated methodologies and procedures for determining credit ratings. They will also focus on whether the rating agencies followed their procedures for managing conflicts of interest inherent in the business of determining credit ratings. We must carefully review the results of these examinations. We must keep in mind that ultimately a rating is an expression of opinion. More importantly, we must remember that a triple-A opinion issued by a credit rating agency — no matter how much expertise the rating agency may have — is no substitute for an investor's making an informed decision and undertaking careful due diligence.

Past regulatory failures have already prompted an examination of the regulatory structure in the United States. Exactly two weeks ago, the Department of Treasury released its long-awaited Blueprint for a Modernized Regulatory Structure. Given the multiplicity of potentially affected parties, the debate about the proposals will no doubt be an interesting one. The Blueprint recommends short-, medium-, and long-term steps to address regulatory issues in the financial markets, including a long-term reordering of the regulatory structure in the United States. This would involve a shift to an objectives-based regulatory approach, in which regulatory authority would be allocated according to regulatory objective rather than industry segment. The Blueprint identifies three broad categories of regulation: market stability regulation, prudential financial regulation, and business conduct regulation. Treasury envisions an optimal regulatory structure in which the Federal Reserve would be the market stability regulator. A newly created Prudential Financial Regulatory Agency would oversee capital adequacy, impose investment and activity limits, and supervise risk management at institutions that enjoy government guarantees. Finally, business conduct regulation, including most current SEC and Commodity Futures Trading Commission functions, would be carried out by a new Conduct of Business Regulatory Agency.

In suggesting these structural reforms, Treasury did not anticipate that they would occur overnight. These are long-term proposals. Based on past experience with similar Treasury proposals, the debate will be measured in years and maybe even decades. Any changes that we make to our regulatory structure, long-term or short-term, must be made with a consideration of their international effects. We must make regulatory changes with an eye towards making our capital markets more open and welcoming to goods, services, and capital from abroad.

Thank you for your attention. I very much look forward to hearing your views of the current market conditions. I also would like to hear any suggestions that you

might have about steps that the United States can take to strengthen our shared American capital markets.

Endnotes

[1] CIA World Factbook (available at: https://www.cia.gov/library/publications/the-world-factbook/geos/br.html#Econ).

[2] U.S. Chamber of Commerce, *Strengthening U.S. Capital Markets: A Challenge for All Americans*, at 10, 14 (Mar. 2008) (available at: http://www.uschamber.org/NR/rdonlyres/epxmiyyxp5ikebwrkwogtexrssv7mntmw4sgpnnc4kgihn7uadc6rk6oqgplxreow72bthace2uwd2xzqczzlcsxfuh/0803capmarkets.pdf).

http://www.sec.gov/news/speech/2008/spch041408psa.htm