Speech by SEC Commissioner: The SEC's Role in Globalization of the Capital Markets

by

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Thank you, Charles [Lake, President of the ACCJ], for that kind introduction. I appreciate the efforts of the Financial Services Committee and the Capital Markets Subcommittee for organizing this event. I am very pleased to have the opportunity to deliver a few remarks before the American Chamber of Commerce in Japan (ACCJ) about the SEC's role in globalization of the capital markets. I should add that the views I express today are my own and do not necessarily reflect those of the SEC or my fellow Commissioners.

Since 1948, the ACCJ has sought to further the development of commerce between the United States and Japan, to promote the interests of U.S. companies and members, and to improve the international business environment in Japan. Your efforts — to strengthen the important relationship between our two countries — are greatly appreciated by those of us back in Washington.

It is now the month of October and the beginning of fall. In Japan, this period carries special meaning as the autumn season beckons the changing of the foliage into gorgeous shades of red, yellow and brown. Traditionally, it will be a time of spiritual and cultural significance as the rice planted earlier in the spring will be harvested. But perhaps, more importantly, it will mark the end of the high temperatures and high humidity of summer.

In America, we have similar views of autumn, particularly in my native North Carolina. Besides the beautiful leaves in the mountains, nothing quite compares to driving along a curving mountain road and smelling the overwhelming scent of Macintosh apples even before you get to the orchard or the apple stand. October is well-known for something else: baseball and the Major League playoffs. Four teams are competing to advance to the World Series. For many baseball fans here in Tokyo (as well of course in New

York), it is a sad time since Hideki Matsui and the New York Yankees were eliminated in the first round of the playoffs by the Cleveland Indians. But the Japanese will still have some players to root for. Kazuo Matsui is still playing for the Colorado Rockies and Daisuke Matsuzaka and Hideki Okajima will see if they can deliver for the Boston Red Sox.

The first Japanese to play Major League Baseball was Masanori Murakami. He played as a relief pitcher for the San Francisco Giants for two seasons starting in 1964, but no Japanese player would be part of Major League Baseball until Hideo Nomo joined the Los Angeles Dodgers 30 years later. However, today, as you can see from the rosters of the playoff teams, it is common for Japanese players to be in the Major Leagues.

There are a number of reasons behind the 30-year interval between Murakami and Nomo, but the important fact is that eventually the obstacles that prevented Japanese players from coming over to the United States faded away. In a similar manner, the barriers that once separated the global capital markets have fallen away as the markets have become interconnected. As a result, regulation by any single national regulator can have a profound effect on the global marketplace, especially to the extent that there are different philosophical approaches and regulatory regimes. Thus, it is critical for agencies like the U.S. Securities and Exchange Commission to consider the global consequences of its actions — or inactions — in its rulemaking and enforcement efforts. In today's world, there are wider consequences — intended and unintended — of our actions than ever before.

The capital markets of today look very different from those faced by the SEC when it was created nearly seventy-five years ago. Indeed, the SEC's world is dramatically different than it was just ten years ago, or even five years ago when President Bush appointed me as commissioner. The U.S. markets are huge and continue to grow, but the international markets are also significant and growing fast.

Rapid changes in technology have spawned a whole new array of financial products, services, and modes of delivery. Financial products that were once illiquid are being standardized so that they can trade more easily. Private capital markets are flourishing and new venues are being developed to trade non-public securities. Many other countries are enjoying a surge in entrepreneurial behavior as they restructure their legal frameworks to reward entrepreneurs.

Although the United States continues to offer access to a tremendous amount of capital and liquidity, it is easy for companies to access capital in other places, too. Europe now considers itself one market, not just a loose union of national markets. And, here in Asia, countries are continuing towards a vision of a region-wide free trade area as announced last month at the 15th Asia-Pacific Economic Cooperation (APEC) Leaders' Meeting. The twenty-one members of APEC account for nearly 60% of the world's GDP and nearly half of all global trade.

Exchanges are merging or entering into strategic relationships with one another without much regard for the national borders that have separated them in the past. More importantly, combinations such as the recent NYSE and Euronext merger will offer exchanges the opportunity to capitalize on potential efficiencies and give much larger economies of scale for the technology required for such platforms.

These changes are happening at a time of concern about the global competitiveness of the U.S. capital markets. This concern has been manifested, in part, in three major reports on U.S. competitiveness. A constant theme in the reports is that excessive, overlapping, and unnecessary regulation in the United States is a major reason for our loss of market share in the global capital markets. As a consequence, we have been talking a great deal about whether we are losing pace with capital markets outside the United States.

Among the reforms suggested by these reports are better cooperation among U.S. financial services regulators, restructuring the SEC, and reformulating the SEC's regulatory approach into a more prudential model. I believe that the Commission is duty-bound to analyze, understand, and — if warranted — respond to the recommendations that pertain to us. Unfortunately, some nay-sayers reject not only the recommendations of these reports, but also the very need to examine our regulatory scheme. I disagree and welcome this debate, because investors and companies are rational — they expect benefits of the public capital markets to exceed the costs, particularly since investors ultimately pay these costs. If the benefits do not exceed the costs, companies will go abroad or remain private.

The SEC must pay attention to these discussions and consider appropriate reforms. We also need to listen to and learn from regulators, participants, and investors in the capital markets outside the United States. Undoubtedly, the SEC can learn some lessons from them. In the end, our job as regulators is to examine the costs that we impose on market participants through our regulations and to make sure that those costs do not exceed the benefits.

International Financial Reporting Standards

The increasing globalization of the capital markets represents a challenge for the SEC — the agency can no longer focus solely on domestic issues. One area in which I believe that the SEC has been making significant headway, thanks to the leadership of Chairman Chris Cox, is with respect to international accounting standards.

In July, the SEC proposed to allow foreign private issuers to file using International Financial Reporting Standards (IFRS), as promulgated by the International Accounting Standards Board, without reconciling to U.S. generally accepted accounting principles (GAAP) as they are now required to do. This action comes in response to a move by much of the rest of the world to shift to IFRS. A failure to respond in a rational and timely manner to this shift could affect U.S. investors, who seek to invest in non-U.S. companies, and U.S. companies, who seek to compete with their foreign counterparts for capital. I would note here that the International Accounting Standards Board and the Accounting Standards Board of Japan announced in September that they have targeted 2011 to achieve convergence between Japanese GAAP and IFRS. That is a very propitious development.

Strong arguments can be made for the rapid elimination of the reconciliation requirement. Reconciliation is an additional cost for foreign private issuers registered in the United States. That cost is hard to justify. In the discussions at the SEC's IFRS roundtable earlier this year, we learned that the reconciliations are of limited use to those who look at financial statements.

The Keidenren wrote to us last month regarding the proposed rule. Its comment letter underscored the cost and effort needed to reconcile financial statements to U.S. GAAP as Japanese companies must "engage in double the amount of disclosure and audit preparatory work — first in connection with their Japanese annual reports that are required to be prepared and filed with the Japanese regulatory authorities within three months of their fiscal year end in accordance with Japan's Financial Instruments and Exchange Law, and second in connection with their [U.S.] annual reports."

The SEC is working with our fellow international securities regulators and accounting standard setting bodies to achieve the consistent application and interpretation of IFRS. The SEC staff, which receives IFRS filings from all over the world, is in an excellent position to spot potential issues, but it does not intend to become the arbiter of IFRS. I hope that if the rule is adopted and properly implemented, investors will benefit from the elimination of the costly reconciliation requirement, and businesses will be able to refocus their resources on more productive measures.

As further evidence of the global nature of the capital markets, the SEC likely will consider whether to take the additional step of permitting U.S. companies to select between using U.S. GAAP and IFRS. You can easily see the utility of IFRS for multi-national American companies that access international capital markets and have foreign-based competitors. Last month, the SEC voted to issue a concept release on permitting U.S. issuers to file their financial statements using IFRS rather than U.S. GAAP. That 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.

Section 404 of the Sarbanes-Oxley Act

It is critically important for regulators to remember that it is the shareholders — not companies — that ultimately bear the costs imposed by regulation. Five years ago, the U.S. Congress passed the landmark Sarbanes-Oxley Act. A number of the law's provisions have benefited shareholders.

However, the implementation of Section 404 of the Sarbanes-Oxley Act got off to an embarrassingly bad start. Section 404 relates to companies' internal control over financial reporting. Section 404 contains two provisions: first, management must conduct an assessment of internal controls for effectiveness and, second, outside auditors must evaluate management's assessment.

Now, the objective of ensuring greater focus on effective internal controls was not the problem with Section 404. Instead, it was the manner in which Section 404 was implemented. I believe that the poor initial implementation of Section 404 reduced its effectiveness as any gains to investors obtained by strong internal controls were erased by the spiraling compliance and audit costs.

I hope the lessons learned by American experience will be helpful to other countries like Japan, which is proceeding with its own version of Section 404 under its new financial instruments and exchange law. When we embarked on implementing Section 404, the SEC envisioned a top-down, enterprise-focused approach, where a company would focus on entity-level controls that could materially impact the consolidated financial statements. The SEC adopted a rule that contained a principles-based approach aimed at management that addressed the first part of Section 404.

However, implementation of the audit standards for the second part of Section 404 was led by the Public Company Accounting Oversight Board (PCAOB), a non-governmental entity with a government-type mandate that is subject to SEC oversight. Early on, the PCAOB adopted Audit Standard 2 to implement Section 404. Audit Standard 2 was overly prescriptive, and it encouraged auditors to focus on items that were not material, and discouraged auditors from using the work of others. Audit Standard 2 drove auditors to act — not necessarily based on attention to risk or by the application of reason — but instead in a check-the-box approach that precluded the exercise of professional judgment.

Earlier this summer, the SEC made significant adjustments to the implementation of Section 404. In June, the Commission issued guidance that is intended to provide management with a risk-based, top-down, tailored approach to complying with their obligations under Section 404. In July, the Commission approved the Public Company Accounting Oversight Board's new Audit Standard 5, which replaced the prior Audit Standard 2.

Audit Standard 5 is intended to refocus the manner in which auditors carry out their responsibilities under Section 404. Under the new standard, auditors should direct their efforts to identifying any material weaknesses in internal control without getting diverted by looking for immaterial internal control issues. As both the Commission and the PCAOB have acknowledged, we will not be able to judge the effectiveness of the new audit standard and management guidance until we see how they are implemented.

If auditing fees do not come down as a result of these changes, then something is terribly wrong with the interpretation of Audit Standard 5 and perhaps with the competitive landscape of the auditing profession itself.

Auditors need to change their approach in response to the new standard. The PCAOB needs to inspect with an eye towards ensuring that auditors are applying the new standard properly. The SEC, in turn, should keep a close eye on PCAOB and whether the Section 404 reforms are working. It is my hope that these improvements will be properly utilized by issuers, auditors, and regulators alike and will go far in improving the regulatory environment for publicly traded companies.

Mutual Recognition

The concept of mutual recognition of foreign securities firms and exchanges is currently being debated at the SEC. This approach to regulation has been attempted in the past by the SEC, with limited success. For instance, in the early 1990s, the SEC and Canada entered into a multi-jurisdictional disclosure system so that prospectuses of one country could be used in the other. While not exactly mutual recognition, this system has successfully lowered costs for issuers to some extent and recognizes the closeness of our two markets. With the global marketplace becoming ever more closely related, it is high time that we look to expand such efforts. For example, France's AMF two weeks ago announced that US filings of foreign firms not doing a public offering in France would be accepted as equivalent in France for the purpose of cross-listing.

In June, the SEC hosted a roundtable on the subject of selective mutual recognition. The roundtable focused primarily on the issue of substantially comparable regulation. This is an interesting topic for academics and policy wonks, but I am afraid that we are in danger of dissipating our opportunities to make real progress on more practical issues that could produce immediate results.

In sum, the roundtable focused on the possibility of the SEC's allowing foreign exchanges or broker-dealers to participate more freely in U.S. markets, provided that they are subject to a foreign regulatory regime that is substantially comparable to U.S. regulation. I have long been a proponent of more flexible treatment of foreign firms in the U.S. markets. And, increased access by foreign and U.S. securities exchanges in each others' markets should also produce great benefits. Investors will be the ultimate beneficiaries through lower costs and more choice if restrictions are eased.

When we talk about "mutual recognition," we should be careful about our terminology and how we set out to achieve our goals. It can be all too easy to say that we should achieve actual harmonization of regulations between various jurisdictions — as in a rule-by-rule comparison of how each regime puts its principles into effect. If the rules are not in harmony, then must the jurisdictions work to bring them into harmony? That may be a great goal, but to me, this is a bottom-up approach and would result in a completely unworkable and potentially never-ending process.

An alternative framework would be a top-down approach, similar to one employed by other U.S. regulators such as the Commodity Futures Trading

Commission (CFTC) and the Federal Reserve. The CFTC, for example, first identifies the important elements that a compatible regulatory jurisdiction should embody. In the SEC's case, this would include investor protection standards, such as protection against misappropriation of customer assets, fraudulent sales practices, financial responsibility of registered entities, and effective examination, licensing and qualification of brokers. Instead of examining each rule of the foreign jurisdiction, we would generally assess the adequacy of that jurisdiction's oversight. If the foreign jurisdiction's regulatory regime is deemed adequate, a firm could be eligible for exemption.

My main concern with the discussion on mutual recognition is that attention will be diverted from achievable, near-term goals. For example, we sorely need to modernize Rule 15a-6, which governs the activities of foreign broker-dealers in the United States. This rule started out in the 1980s as a reform that for the first time allowed foreign broker-dealers to conduct business in the U.S. without subjecting themselves to the full regime of U.S. broker-dealer regulation. Rule 15a-6 was a breakthrough twenty years ago, but as the global markets continued to evolve it has caused consternation and increased costs for brokers and, ultimately, investors. A rule that recognizes the reality of the modern markets, including the different needs of institutional investors, is long overdue.

Shareholder Activism

The active participation of investors is a key element of the price-setting mechanism in the marketplace. In a fully-functional marketplace, investors are assumed to be acting in their best interest to maximize value and to bear different tolerances for risk. To the extent an investor disagrees with the direction of a business or judges a business to present a greater risk, then the investor can either sell — or refuse to purchase — a security of that business or demand a higher return. These actions can depress the price of a security.

Another important side of the market is the role of those who engage in short-sales. Perhaps short-sellers are derided for their pessimistic outlook, but so long as they engage in lawful tactics, they serve as a critical — and in fact necessary — component of price discovery, especially if prices are not supported by underlying fundamental values. Japan knows only too well the consequences of a "bubble" economy — due to an unsupported rise in the value of assets or the securities markets.

To the extent that management of a business is unresponsive to shareholders or has performed poorly and its shares are significantly undervalued, it can become the target for a hostile takeover. The threat of a hostile takeover serves as an incentive for corporate management to do their best to maximize shareholder returns. Hostile takeovers can improve shareholder value as it is not uncommon for the share price of a target company to increase upon speculation of a hostile bidder.

The decision of Japan's Supreme Court regarding poison pills last August creates an interesting investment environment in Japan. Although the court upheld the use of a poison pill, it did suggest that the use of poison pills as takeover defenses would be closely scrutinized. In the United States, where it is not the federal government or the SEC, but the corporation laws of the various states, that substantively govern corporate takeovers, state law has frequently recognized that companies may adopt limited defenses to prevent a hostile acquirer from walking away with a company for an artificially low price. However, state laws also require the boards of directors of corporations to act as fiduciaries to the shareholders and, so directors must consider the best interests of the shareholders when faced with a hostile bid. Usually a higher price is deemed best for shareholders. I look forward to watching the future developments in this area in the Japanese market.

Shareholder activists can express themselves in other ways, such as through shareholder proposals. I note that only yesterday, the ACCJ held another event to discuss shareholder proposals under Japanese law. I wish that I could have been there. As with takeover laws, the corporation laws of the various states generally govern this area. At the SEC, we have been considering similar issues about how much access should (or can) be granted via the federal proxy rules to place shareholder proposals on the company's proxy statement. The SEC is generally precluded from creating any substantive law in this area — we are limited by previous court decisions to procedural aspects of solicitation of proxies. There are largely two issues: first, to what extent can a shareholder propose a bylaw amendment requiring a company to include shareholder-nominees for director; and second, to what extent should shareholders be permitted to present non-binding advisory proposals.

The comment period on the shareholder proposal rules closed earlier this month. The SEC staff is busy compiling the thousands of comment letters that the Commission received. In fact, the SEC received more comments on the shareholder access proposals than any previous proposal except for last year's proposal on executive compensation. I look forward to reviewing the comments and moving forward to achieve closure.

Corporate Penalties

It is my understanding that the Japanese Securities and Exchange Law was revised in 2005 to introduce a civil money penalty system against companies and individuals who violate the securities law. The SEC has held similar authority to impose penalties since the passage of what we call the "Remedies Act" in 1990. Before that time, the SEC only had limited remedies against companies. The primary remedy was to get an injunction against the company — essentially telling them to go forth and sin no more. The legislative history of the Remedies Act clearly reflects that both the SEC and Congress had one major concern when contemplating SEC authority to penalize corporations. That concern was the possibility that shareholders might be penalized twice — once by the fraud and again by the civil penalty. The SEC noted this concern in its request for legislation, and the Senate echoed the concern in its Report accompanying the Remedies Act.

All too often people in government and outside overlook the fact that corporations are ultimately owned by shareholders. Shareholders are the ones who, at the end of the day, bear most of the costs imposed on the corporation. I am happy to say that shortly after Chris Cox became SEC chairman, the SEC expressly addressed the potential problems that corporate penalties pose. In January 2006, the Commission returned to first principles, and issued a statement on corporate penalties. The statement at least acknowledged the problem of fining corporations, which is tantamount to fining shareholders. The penalty statement has successfully heightened the awareness by the Commission and the SEC staff of potential shareholder harm in cases in which a penalty is sought. At the same time, however, I am not sure that the statement has become the guiding light for defendants and their counsel — and our staff, for that matter — that we had anticipated. With that in mind, I hope and expect that the Commission will continue to monitor the implementation of the penalty statement and will make improvements, or provide further guidance, where needed.

In the name of deterrence, we have seen heavier and heavier fines against corporations in the securities law context. Prosecutors have one eye on the public relations effect of their actions (that, after all, is the deterrent effect). Meanwhile, management at some defendant companies are all too willing to offer up the shareholders' money — after all, it is other people's money — in order to try to deflect personal liability for particular managers. Managers may be hoping that a large sacrifice and public flogging of the corporate entity might just assuage the government prosecutors. But, individuals commit fraud; corporations do not. And sometimes corporate boards approve a settlement and pay a hefty penalty, even if they dispute the factual record or legal theories, because it actually **is** in the best interests of shareholders to avoid the negative effects of a prolonged litigation with the SEC. It is easy to see who the big loser is in all of these scenarios — the shareholders.

Sometimes, of course, it is too hard — or just not appropriate — to pin blame on individuals, particularly when they did not have the full picture, had no intent to do something underhanded, got wrong legal or other advice, and so on. We also have to guard against criminalizing business decisions by looking at them through the regulator's lens of 20/20 hindsight. So, in those cases, other steps against a corporate defendant may be in order, including remedial organizational or managerial steps. Fundamentally, we also have to remember that the corporation may already have been punished through reputational and stock-price damage.

Unless the corporation is inherently a criminal enterprise, or the shareholders themselves have somehow benefited from the fraud to the detriment of other corporations or the marketplace as a whole, fines against shareholders do not seem to be appropriate. And even in those circumstances a penalty may not be the right remedy. The SEC has the authority to seek "disgorgement" of ill-gotten gains, which is a remedy that, if available, is supposed to be exhausted before the SEC seeks a penalty. So, it would seem that only in the rarest of circumstances would the SEC be able to seek a penalty that accomplishes the goal of stripping away an ill-gotten benefit. Unfortunately, that has not been the case in many SEC penalty actions. Many of those actions have blurred the distinction between "benefit" and "restitution"; the SEC has no statutory authority to seek the latter. And we must also be mindful that, in the majority of SEC corporate penalty cases, the corporation has also been sued for the same transgressions in civil class action suits seeking restitution for allegedly harmed shareholders.

In some situations the company — and the shareholders — may have benefited at the expense of others. Some easy examples are in the non-securities context, including anti-competitive actions, willful failure to comply with environmental regulations, and money-laundering transgressions. In these situations, the company — and thus the shareholders — have had a material benefit (increased revenues from decreased competition, expenses that were avoided, and increased revenues). But, corporations fined for financial fraud or disclosure-based transgressions use shareholder money to pay for behavior of which the shareholders were the victims. We have to ask ourselves: Who are the victims? Who really is paying the fines? By imposing such fines, are we not punishing the very people who were already punished through the marketplace when the stock price was clobbered?

In some of our recent cases, we have been fining corporations large sums for accounting and other financial reporting fraud. Some are egregious frauds that reflect wide-spread cultural and ethical problems. In some cases, the companies and their boards found and took corrective action, including firing senior executives, particularly CEOs and CFOs — without any prompting from the government.

In this context, the SEC is working under new authority from Congress that we got under the Sarbanes-Oxley Act to direct fines to special funds that can be set up to provide a sort of restitution to shareholders harmed by the fraud. Some believe that this new authority, because it allows the SEC to return penalty money to investors instead of the U.S. Treasury, eliminates any concern that injured shareholders will be further harmed by a penalty. Unfortunately, the new authority only heightens the conundrum that we face. Basically, we fine the corporation in order to put the fine money into a fund to reimburse the shareholders who were just themselves fined.

Of course, in the context of multinational mega-corporations with millions of shareholders, a fine of even hundreds of millions of dollars results in a relatively trivial payout to each individual shareholder. Another aspect of these settlements is that the SEC often places its penalty into the same pot as the settlements from private securities law suits, although none of the SEC penalty money is paid to the private attorneys. So, I fear that, if we are not careful, we may become an extension of the plaintiffs' bar, with similar philosophy and tactics. I would love to get your feedback and suggestions on this issue, especially as Japanese regulators gain experience with their new penalty authority.

Conclusion

Going forward, I believe that the SEC will be a good partner as the capital markets continue their globalizing trend. The SEC understands that it is one player in a tremendously large, rapidly changing, interconnected, and interdependent marketplace. The SEC knows that if it is to be successful, it must work with and learn from the investors whom it protects, the entities that it regulates, and the regulators with whom it shares responsibility.

I look forward to hearing your thoughts now and in the future when you find the time to stop by and visit my office in Washington. Thank you all for your attention. I would be happy to answer any of your questions.

Endnotes

[1] Comments of the Nippon Keidenren (Japanese Business Federation) (Sept. 18, 2007) (available at: http://www.sec.gov/comments/s7-13-07/s71307-21.pdf).

http://www.sec.gov/news/speech/2007/spch101607psa.htm

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