

1 THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION

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UNOFFICIAL TRANSCRIPT

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OPEN MEETING

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MEETING THE COMPETITIVE CHALLENGES OF THE GLOBAL MARKETPLACE

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Wednesday, July 25, 2007

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(Amended 9/19/07)

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P R O C E E D I N G S

CHAIRMAN COX: Good morning. This is a meeting of the Securities & Exchange Commission under the Government in the Sunshine Act on July 25, 2007.

We have a great deal of work today. Today's meeting is going to cover three vitally important topics for the future of our capital markets.

We'll begin with rationalizing the implementation of Section 404 of the Sarbanes-Oxley Act. We'll move on to consideration of the role that International Financial Reporting Standards will play in America's future.

And finally, we'll consider two proposals to address the question of how the federal proxy rules can be better aligned with the state law rights of shareholders. These topics are very much related to one another.

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

They'll want to know that the costs of regulation are aligned with the benefits it produces, which is why we're considering a completely rewritten audit standard to implement SOX 404.

They'll demand better comparability among financial

1 statements from issuers in America and around the world,
2 which is why we're considering a Concept Release on the
3 relationship between International Financial Reporting
4 Standards and U.S. Generally Accepted Accounting Principles.

5 And shareholders of U.S. companies will insist that
6 their property rights as owners and investors, which include
7 above all else the right to choose the board of directors, be
8 respected by the federal proxy rules.

9 As was pointed out recently by the Committee on
10 Capital Markets Regulation, shareholders of U.S. companies
11 have fewer rights in a number of important areas than do
12 their foreign competitors, giving foreign firms a competitive
13 advantage.

14 For that reason, the Committee on Capital Markets
15 Regulation urged the SEC to address and resolve appropriate
16 access by shareholders to the director nomination process.
17 We'll consider two very different approaches to that issue
18 today.

19 So let's turn to the first item on the agenda,
20 which is rationalizing the implementation of Section 404 of
21 the Sarbanes-Oxley Act of 2002.

22 The first item consists of two parts; first,
23 approval of the PCAOB's Auditing Standard No. 5, "An Audit of
24 Internal Control Over Financial Reporting that is Integrated
25 with An Audit of Financial Statements," a related

1 independence rule and conforming amendments. And second, the
2 adoption of a definition of the term "significant
3 deficiency."

4 Next Monday, July 30th, will mark the five-year
5 anniversary of the Sarbanes-Oxley Act. Section 404 has posed
6 the single biggest challenge to companies under the entire
7 act, without question has imposed the greatest costs, but it
8 has also contributed significantly to more reliable financial
9 information and more reliable financial reporting as
10 companies improve their internal controls to meet Section
11 404's requirements.

12 For the past two years, the Commission, the PCAOB
13 and our respective staffs have been hard at work to improve
14 the implementation of Section 404 while maintaining Section
15 404's benefits and protections to investors.

16 Over this two-year period we've held two
17 roundtables in 2005 and 2006 to listen to issuers' first- and
18 second-year experiences with the PCAOB Auditing Standard No.
19 2.

20 We also issued a Concept Release Concerning
21 Management's Report on Internal Control Over Financial
22 Reporting. We proposed and adopted additional extensions of
23 time for non-accelerated filers, certain foreign private
24 issuers and newly public companies.

25 We provided the Staff Guidance. We convened the

1 Advisory Committee on Smaller Public Companies to study,
2 among other things, the impact of Section 404 on smaller
3 companies, and we proposed and adopted guidance for
4 management to follow in conducting their evaluations of
5 internal control over financial reporting.

6 With respect to the PCAOB and the internal control
7 auditing standard, last fall and winter we worked closely
8 with the PCAOB and its staff as they developed their proposed
9 new internal control auditing standard, and we convened an
10 open meeting of the Commission on April 4th to discuss with
11 our staff their approach to the PCAOB's proposed new standard
12 and the alignment of that standard with our own management
13 guidance.

14 Along the way we carefully considered all of the
15 public comments that we and the PCAOB received on Section 404
16 implementation. Many companies and their auditors are now
17 entering their fourth year of reporting on internal control
18 over financial reporting.

19 Throughout this period, management, auditors,
20 investors and other interested parties have provided ongoing,
21 extensive and enormously helpful feedback to both the
22 Commission and the PCAOB about what has worked well and what
23 could be improved.

24 On May 24th, the PCAOB voted to replace the
25 auditing standard under SOX 404 that had led to excessive

1 costs and serious implementation problems. They voted to
2 replace it with a top-down, risk-based approach focused on
3 internal controls that are material to a company's financial
4 statements and scalable for companies of varying size and
5 complexity.

6 This new standard, Auditing Standard No. 5, can
7 take effect only if it is approved as final by the SEC. On
8 June 12th, the Commission published the new standard for
9 public comment, and the comments have been overwhelmingly
10 favorable.

11 This morning, we consider whether to grant final
12 approval to Auditing Standard No. 5. As we approach the
13 five-year anniversary of Sarbanes-Oxley, we can be proud that
14 confidence in our markets is restored, that compliance costs
15 are coming down and that today the final approval of the
16 PCAOB's Auditing Standard No. 5 will make a giant step
17 forward in facilitating a more effective and efficient
18 approach to the implementation of Section 404 by refocusing
19 resources on what truly matters to the integrity of financial
20 statements.

21 This is an exceptionally positive step for investors and for
22 America's capital markets.

23 Although the new auditing standard and the
24 Commission's guidance to management should enable
25 cost-effective compliance with Section 404 for companies of

1 all sizes, smaller public companies -- as defined by the
2 report of the Advisory Committee on Smaller Public Companies,
3 which is specifically referred to in AS 5 -- should
4 particularly benefit from the scalability built into the
5 PCAOB's new auditing standard and the SEC's interpretive
6 guidance.

7 In addition, because we deferred Section 404's
8 external audit requirement for the category of smaller
9 companies that are non-accelerated filers until the filing of
10 their 2008 annual reports, management of these smaller
11 companies will have additional time to develop an evaluation
12 approach specific to their facts and circumstances and to
13 coordinate their approach with a cost-effective external
14 audit.

15 We're confident that Auditing Standard No. 5 will
16 improve effectiveness and efficiency and will reduce
17 inventory compliance costs, and we're committed to ensuring
18 that its implementation is consistent with our expectations.

19 To that end, we'll analyze real-world information
20 to determine that the costs and benefits of implementing
21 Section 404 are in line with our expectations.

22 In addition, through our oversight of the PCAOB's
23 inspection program we'll monitor whether audit firms are
24 implementing Audit Standard No. 5 in a manner designed to
25 achieve the intended results of audit efficiency and cost

1 reduction and whether the PCAOB is inspecting audit firms in
2 a manner consistent with our expectations.

3 With a significantly improved audit standard that
4 enables auditors to deliver the most cost-effective audit
5 services, the SEC and the PCAOB expect a change in the
6 behavior of the individuals who are responsible for
7 conducting internal control audits.

8 I want to once again thank our staffs, in
9 particular the Office of the Chief Accountant, the Division
10 of Corporation Finance and the General Counsel's Office for
11 all of their work. Your tireless efforts over the past year
12 will benefit investors in our capital markets for many years
13 to come.

14 Specifically from the Office of the Chief
15 Accountant, I'd like to recognize Zoe-Vonna Palmrose, Brian
16 Croteau, Josh Jones, Amy Hargrett, Esmerelda Rodriguez, Jeff
17 Ellis and Kevin Stout.

18 From the Division of Corporation Finance I'd like
19 to recognize Betsy Murphy and Sean Harrison. And, from the
20 Office of General Counsel, David Frederickson. I'd also like
21 to recognize the work of the PCAOB board and their staff for
22 their efforts.

23 Finally, I'd like to take this opportunity to
24 express once again the Commission's appreciation to our own
25 Advisory Committee on Smaller Public Companies and the

1 hundreds of investors, companies, auditors, professional
2 organizations and others who responded to the Commission's
3 and the PCAOB's various requests for comments regarding
4 audits of internal control over financial reporting.

5 The Commission's efforts in improving Section 404
6 implementation were considerably aided by their helpful
7 insights and suggestions.

8 So I'll now recognize John White, Conrad Hewitt and
9 Zoe-Vonna Palmrose for a presentation of the staff's
10 recommendation.

11 MR. WHITE: Thank you, and good morning. Chairman
12 Cox and members of the Commission, as Chairman Cox has
13 explained, we are here today to recommend that you approve
14 the PCAOB's Auditing Standard No. 5, a related PCAOB
15 independence rule, and conforming amendments to the PCAOB
16 standards. Additionally, we're recommending that the
17 Commission adopt a definition of the term "significant
18 deficiency."

19 The PCAOB's Auditing Standard No. 5, if approved by
20 the Commission today, will replace the current Auditing
21 Standard No. 2. The Independence Rule 3525 will require
22 auditors to obtain audit committee pre-approval of non-audit
23 services related to internal control over financial
24 reporting. As you may recall, Auditing Standard No. 2
25 contains a pre-approval requirement, but the PCAOB has

1 determined that it was more appropriate to include this
2 requirement in its ethics and independence rules rather than
3 to continue to include it within its internal control
4 auditing standard.

5 In addition, we are recommending that you approve
6 for the first time a definition of the term "significant
7 deficiency." We believe it is appropriate to include the
8 definition of "significant deficiency" within the
9 Commission's rules given the communications requirements in
10 the rules implementing Section 404 of Sarbanes-Oxley as well
11 as the certification requirements of Section 302 of
12 Sarbanes-Oxley.

13 Including a definition of "significant deficiency"
14 in Commission rules in combination with the definition of
15 "material weakness," which was adopted by the Commission this
16 past May, will enable management, appropriately and
17 conveniently, to refer to Commission rules and guidance for
18 the meanings of these terms rather than referring to auditing
19 standards, which it does today.

20 Conrad and Zoe-Vonna will describe the proposed
21 rule amendment to adopt the definition of "significant
22 deficiency" and the comment letters received by the
23 Commission on Auditing Standard No. 5 in more detail in a
24 moment.

25 Before we move to that, I wanted to take a moment

1 to reflect on the journey that we have taken to arrive at
2 today's recommendations to the Commission, a journey that
3 started soon after I arrived on the staff just a little over
4 a year ago.

5 Addressing the implementation of SOX 404 has been a
6 significant priority of the Commission over past several
7 years. As you know, the Commission and the PCAOB have been
8 working closely together during this period to improve the
9 implementation of Section 404.

10 Going back to May 10, 2006, many of us were here in
11 this very auditorium as the Commission and the PCAOB hosted a
12 roundtable on second-year experiences with Section 404.

13 The roundtable was followed one week later with
14 press releases in which the Commission and the PCAOB each
15 announced a series of steps they planned to take to improve
16 the implementation of Section 404.

17 In the Commission's press release, it outlined four
18 actions that it was undertaking to improve the implementation
19 of Section 404.

20 These actions were: One, issuing for the first
21 time guidance for management in performing its assessment.
22 Two, working with the PCAOB in revising Audit Standard No. 2.
23 Third, providing extensions of the compliance deadline for
24 non-accelerated filers; and 4, providing SEC oversight of the
25 PCAOB inspection process which was designed last year to

1 focus on the efficiency of Section 404 implementation.

2 So I'm happy to say that with its actions today the
3 Commission will have affirmatively acted on three of these
4 four steps by providing extensions to non-accelerated filers
5 at the end of last year, through its approval of interpretive
6 guidance for management this past May, and now today with its
7 consideration of Auditing Standard No. 5 to replace Auditing
8 Standard No. 2.

9 And that's not to say we haven't been working very
10 diligently on the fourth item, our oversight of the PCAOB
11 inspection process, but I'm going to leave that item to
12 Conrad Hewitt to expand on in a moment.

13 So since the May 2006 announcements, the PCAOB, in
14 coordination with the SEC staff has been working to provide a
15 new auditing standard, one that makes clear that the
16 auditor's primary focus during an integrated audit is on
17 areas that pose the highest risk of material misstatement to
18 the financial statements and that does not require procedures
19 unnecessary to an effective audit of internal controls.

20 The PCAOB released its proposed new auditing
21 standard in December of last year. Over 175 Comment Letters
22 were received. In addition, as part of the Commission's
23 process of issuing its interpretive guidance for management,
24 we received over 200 Comment Letters many of which focused on
25 the interplay between our interpretive guidance and the

1 PCAOB's auditing standard.

2 As a result of the comments received on both
3 proposals, the Commission held an open meeting on April 4,
4 which you alluded to, to discuss its views on the comments
5 received with respect to the auditing standard.

6 The Commission directed the staff to focus on four
7 areas when working with the PCAOB staff. The PCAOB and its
8 staff considered the comments received and the Commission's
9 guidance carefully and, as a result, made significant changes
10 from its proposal in December.

11 So the end result of their hard work is an auditing
12 standard that is shorter, less prescriptive, focused on the
13 areas of highest risk and clearly scalable to fit any
14 company's size and complexity.

15 Zoe-Vonna will speak in more detail about those
16 changes, but I am very happy to report to you today that the
17 staff of the Commission believes that you have a very much
18 improved auditing standard for your consideration due to the
19 PCAOB's and the Commission's coordinated efforts, and we in
20 the staff are very pleased and very proud to make our
21 recommendation to you here today.

22 Before I turn it over to Conrad I'd like to
23 acknowledge the cooperative efforts within the SEC staff as
24 well as with the staff of the PCAOB.

25 Investors in our capital markets deserve and they

1 are relying on our hard work and our teamwork to improve the
2 implementation of Section 404, and I believe the public has
3 been well served by an abundance of each.

4 Chairman Cox, you've already thanked the many staff
5 members who have worked on these releases as well as the
6 PCAOB staff and the PCAOB who have worked with us. I just
7 want to echo those thanks, and I say that with great
8 sincerity.

9 I'm very, very appreciative to everybody who has
10 worked on this project, now for all the time that I've been
11 on the Commission staff. With that I'll turn it over to you,
12 Conrad.

13 MR. HEWITT: Thank you, John, Chairman Cox and
14 members of the Commission. The increased focus on companies'
15 internal controls over financial reporting under Section 404
16 of the Sarbanes-Oxley Act and the Commission rules has led to
17 an improved investors' confidence in our financial markets.

18 This improved confidence is a result of improved
19 public disclosures related to ICFR. Also, the increased
20 focus on internal controls has helped many companies to
21 establish and maintain more effective internal controls.

22 However, as you know, these benefits have come with
23 costs that were significantly greater than expected. Of
24 particular concern has been indications of audit and
25 compliance costs for smaller companies.

1 Concerns for Section 404, of course, are not new.
2 Efforts by the Commission and the PCAOB have been underway
3 for some time to meet the challenge of providing new guidance
4 and revising the prior requirements to better balance the
5 implementation costs with the benefits.

6 The proposed auditing standard that you are
7 considering today to replace AS 2 is intended to address the
8 specific concerns of smaller public companies by enabling and
9 encouraging auditors to effectively tailor and scale their
10 audits according to the relevant facts and circumstances of
11 each company.

12 If adopted, the new standard will become effective
13 for audits fiscal years ended on or after November 15, 2007.
14 That's this year. However, it is important to note that
15 early adoption of the new standard would be permitted.

16 In fact, the staff would encourage early adoption
17 by auditors so that issuers and then investors can begin to
18 benefit from the improvements that have been made relative to
19 the effectiveness and efficiency in the conduct of internal
20 control audits.

21 Although Zoe-Vonna Palmrose will discuss the
22 comment letters in more detail I want to highlight one
23 additional matter.

24 Some commenters expressed concern that there was
25 not sufficient incentive for auditors to modify their methods

1 of performing the audit of internal controls. Therefore,
2 they were concerned that the benefits afforded by AS 5 would
3 not be fully implemented and realized.

4 These commenters noted that it was important for
5 the PCAOB to adjust its inspection program to align it with
6 the many changes in the new audit standard and to respect the
7 auditor's use of professional judgment in conducting the
8 audit. Now, this has been an area that both the Commission
9 and the PCAOB recognize and continue to focus on.

10 For example, the inspection process was an area
11 specifically identified in the Commission's and the PCAOB
12 2006 Announcement of Actions following the Commission's
13 second roundtable on Section 404 implementation.

14 The PCAOB has incorporated procedures to evaluate
15 the efficiency and effectiveness of ICFR audits in their
16 inspection process.

17 Further, as directed by the Commission, the staff
18 is examining whether the PCAOB inspection program has been
19 designed to be effective encouraging changes in the conduct
20 of integrated audits to again to improve both efficiency and
21 effectiveness of attestations on ICFR.

22 The staff recognizes that even with the adoption of
23 a new standard the hard work is not over. Appropriate
24 implementation will be just as important as having an
25 improved auditing standard in place.

1 If approved, we will work closely with the PCAOB,
2 management, auditors and others to monitor the implementation
3 of this new standard. I believe that it is also important
4 for audit committees to be involved with the implementation
5 to enable the success of Auditing Standard No. 5.

6 The successful implementation of Auditing Standard
7 No. 5 will depend on several participants in the financial
8 reporting process.

9 For example, the PCAOB has indicated that it will
10 retrain its inspection team and adjust its inspection
11 program. External auditing firms will need to retrain their
12 staffs and change their audit programs for a more integrated
13 audit.

14 The management of each company can challenge its
15 own evaluations of internal controls based upon our
16 interpretive guidance. And just as important, audit
17 committees should play a more active and direct role with
18 particular attention to their Management Guidance
19 implementation and the scope of the external auditor's
20 year-end audits on an integrated basis in accordance with
21 Auditing Standard No. 5.

22 Now, if above are implemented properly, costs
23 should become more in line with the benefits for investors
24 and particularly for smaller, including micro cap, companies.

25 Lastly, the staff believes it is appropriate for

1 the Commission to include a definition of a term "significant
2 deficiency" in the Commission rules.

3 The staff recommends that you adopt the definition
4 which the Commission published for additional public comment
5 in June. As you know, the definition of "significant
6 deficiency" is used in the context of evaluating the minimum
7 required communications under both Section 302 and 404 of
8 SOX.

9 That is, "A significant deficiency is a deficiency
10 or a combination of deficiencies in internal control over
11 financial reporting that is less severe than a material
12 weakness, yet important enough to merit attention by those
13 responsible for the oversight of a registrant's financial
14 reporting."

15 We received 22 comment letters on this proposed
16 definition, and the majority of the commenters expressed
17 their support for it. In addition, the commenters noted that
18 a consistent definition of "significant deficiency" in our
19 Commission rules and the PCAOB standards was important.

20 The staff believes that the definition
21 appropriately emphasizes the communication requirements
22 between management, the audit committee and the independent
23 auditors on those matters that are important enough to merit
24 attention.

25 And the definition will allow management to use its

1 judgment to determine deficiencies that should be reported to
2 the audit committee and the independent auditor.

3 At this point, I would like to reiterate the
4 chairman's thanks to all the staff who worked tirelessly on
5 our efforts to improve the implementation of Section 404.
6 During this process, we worked closely with the PCAOB.

7 And I would like to add my thanks to the board and
8 staff of the PCAOB. We'd also like to thank the
9 Commissioners and their staffs for all the hours they have
10 worked together with us on this topic, a very important
11 topic, over the past several months providing their input and
12 guidance.

13 At this time, I'd like to turn it over to my
14 deputy, Zoe-Vonna Palmrose, who will discuss the Comment
15 Letters of AS 5 in more detail. Zoe-Vonna.

16 MS. PALMROSE: Thank you, Conrad. Let me begin by
17 looking back a few months and reviewing. First, as John
18 mentioned, the PCAOB received 175 letters when it exposed a
19 draft of Auditing Standard No. 5 for public comment in
20 December.

21 Then, as has been noted, at this year's April 4th
22 open Commission meeting, the Commission and staff discussed
23 the comments received by the PCAOB along with those received
24 by the Commission in connection with its proposed
25 interpretive guidance for management.

1 At the 404 meeting, the Commission directed us to
2 focus on four areas when working with the PCAOB staff. Those
3 areas were, first, aligning the proposed auditing standard
4 with the Commission's proposed interpretive guidance for
5 management, particularly with regard to prescriptive
6 requirements, definitions and terms.

7 Two, scaling the audit to account for the
8 particular facts and circumstances of companies, particularly
9 in smaller companies. Three, encouraging auditors to use
10 professional judgment, particularly in using risk assessment.
11 And four, following a principles based approach to
12 determining when and to what extent the auditor can use the
13 work of others.

14 We're very pleased to be able to report to you
15 today that the PCAOB has addressed each of these areas in
16 addition to the other matters raised by commenters in the
17 version of AS 5 they adopted in May and that you're now
18 considering.

19 While I won't detail all of the improvements,
20 suffice it to say this standard is much less prescriptive,
21 appropriately allows for auditor judgment, eliminates
22 unnecessary procedures from the audit and directs the auditor
23 to focus on what matters most.

24 These improvements are significant, and they are
25 responsive to the comments received by the PCAOB, including

1 those discussed at our April 4th open meeting.

2 Now let me turn to the comments in response to the
3 Commission's June 7th request for comment on the standard you
4 have before you.

5 The Commission received 27 comment letters. These
6 comment letters came from issuers, registered public
7 accounting firms, professional associations, investors and
8 others. Overall, many commenters expressed support for the
9 proposed standard and recommended that the Commission approve
10 the standard and the related conforming amendments.

11 Some of these commenters requested that this
12 approval be done on an expedited basis to enable auditors to
13 implement the provisions of AS 5 prior to the required
14 effective date.

15 A number of commenters noted that AS 5 includes
16 appropriate investor safeguards, that it will facilitate a
17 more effective and efficient approach to the ICFR audit and
18 that the PCAOB appropriately responded to concerns raised by
19 issuers, auditors, investors and others.

20 Specifically, some commenters noted that the
21 standard's focus on principles rather than prescriptive
22 requirements expands the opportunities for auditors to apply
23 well-reasoned professional judgment.

24 Still, a few commenters expressed their continuing
25 concern that in reducing the number of ICFR related audit

1 opinions from two to one, the Commission and the PCAOB retain
2 the wrong opinion.

3 These few commenters indicated their belief that
4 auditors should opine on the assessment made by management in
5 order to comply with Section 404(b) of the Sarbanes-Oxley
6 Act, which some go on to equate to opining on management's
7 evaluation process.

8 These commenters expressed their belief that
9 auditors opining directly on ICFR, as opposed to management's
10 assessment, entails unnecessary and duplicative work. The
11 staff has carefully considered this comment and continues to
12 believe that consistent with Sections 103 and 404 of the
13 Sarbanes-Oxley Act and the Commission's recent rule
14 amendments AS 5 requires the appropriate opinion to be
15 expressed by the auditor.

16 Further, the staff believes that an auditing
17 process that's restricted to evaluating what management has
18 done would not necessarily provide the auditor with a
19 sufficient level of assurance to render an independent
20 opinion as to whether management's assessment about the
21 effectiveness of ICFR is correct.

22 Finally, the staff believes that the expression of
23 a single opinion directly on the effectiveness of ICFR is not
24 only important from an investor protection standpoint but
25 provides clear communication to investors that the auditor is

1 not responsible for issuing an opinion on management's
2 process for evaluating ICFR.

3 In the staff's view, an opinion on the latter may
4 not only have the unintended consequence of hindering
5 management's ability to apply appropriate judgment in
6 designing their evaluation approach but also may have the
7 effect of increasing audit costs without commensurative
8 benefits to issuers and investors.

9 As you know, the Commission sought comments on
10 seven specific questions in a supplemental June release as
11 part of its request for public comment. I'll touch on the
12 responses we received to each of these seven questions, and
13 then we'd be pleased to discuss in issues in greater detail
14 and answer any questions that you might have.

15 On the first question with respect to whether
16 materiality is appropriately defined throughout AS 5 to
17 provide sufficient guidance for auditors, the majority of
18 commenters who expressed a view on this question said yes.

19 Some commenters elaborated that while application
20 of materiality concepts in the context of planning and
21 performing an audit requires the use of judgment. AS 5
22 appropriately specifies the basis on which those judgments
23 should be made.

24 The staff agrees that AS 5 adequately addresses
25 materiality throughout the standard. Even so, a few

1 commenters expressed a view that some auditors may need
2 further and clearer guidance than is provided about
3 materiality generally for integrated audits of both ICFR and
4 the financial statements.

5 However, the staff does not believe that AS 5 is
6 the appropriate forum to address broader questions about
7 materiality as the concept of materiality is fundamental to
8 the federal securities laws. Nonetheless, this is an area
9 the staff continues to focus on in the broader context.

10 With respect to the second question as to whether
11 the communication requirement regarding significant
12 deficiencies will divert auditors attention away from
13 material weaknesses, commenters who expressed a view on this
14 matter overwhelmingly said no.

15 They said, for example, that AS 5 clearly directs
16 the auditor to scope the audit to identify material
17 weaknesses to be disclosed to investors, and the staff
18 agrees.

19 With respect to the third question whether AS 5 is
20 sufficiently clear that multiple control deficiencies should
21 only be looked at in combination if they are related to one
22 another, most of those commenting on this question said yes,
23 that AS 5 is sufficiently clear in this regard although a
24 couple of commenters disagreed, stating that the auditor is
25 expressing an opinion on the effectiveness of internal

1 control as a whole.

2 Again here the staff agrees that AS 5 is
3 sufficiently clear and notes that it's aligned with the
4 Commission's interpretive guidance for management in this
5 regard.

6 With respect to the fourth question whether the
7 definition of "material weakness" appropriately describes the
8 deficiencies that should prevent the auditor from finding
9 that ICFR is effective, the majority of those commenting on
10 this topic responded affirmatively. And the staff agrees.

11 On the fifth question related to the auditor's use
12 of the work of others, the majority of those who commented
13 expressed their view that AS 5 is clear about the extent to
14 which auditors can use the work of others to gain
15 efficiencies in the audit with some noting that AS 5 provides
16 substantial flexibility in the application of auditor
17 judgment when determining whether and to what extent to use
18 the work of others.

19 The staff agrees that AS 5 is sufficiently clear
20 about the extent to which the auditor can use the work of
21 others. However, two commenters recommended that if the work
22 of others is found to be competent and reliable, then the
23 standard should require the auditor to utilize it.

24 But while we anticipate auditors would use the work
25 of others under appropriate circumstances, including when the

1 approach results in greater efficiency, we do not believe
2 that it's necessary or appropriate to preclude the auditor
3 from utilizing his or her judgment in determining whether or
4 not to use the work of others based on the particular facts
5 and circumstances of the engagement.

6 As to the sixth question on whether AS 5 will
7 reduce costs and result in cost-effective integrated audits,
8 a number of commenters stated their view that AS 5 as
9 approved by the PCAOB together with the Commission's guidance
10 for management will result in a reduction of the total
11 Section 404 compliance effort.

12 Some commenters agreed that a cost reduction would
13 occur but also noted that the amount of reduced effort and
14 cost associated with the ICFR audit will vary by company
15 depending on factors such as the size, complexity, the degree
16 of change from year to year, the quality of their internal
17 control systems and documentation and the extent to which
18 management appropriately applies the Commission's
19 interpretive guidance for management.

20 None of the commenters suggested that costs would
21 increase. Even so, so commenters noted that while AS 5 may
22 curtail excess of testing of controls and reduce some of the
23 unnecessary documentation currently required for Section 404
24 audits they still have concerns about the extent to which it
25 will reduce costs for smaller companies.

1 A number of commenters urged the Commission and the
2 PCAOB to closely monitor the extent to which the standard is
3 implemented and achieves a reduction in costs and to take
4 action if there's not an appropriate reduction.

5 In a minute, I'll say more about this issue, but
6 first and relatedly let me cover the seventh question as to
7 whether AS 5 inappropriately discourages or restricts
8 auditors from scaling audits, particularly for smaller
9 companies.

10 Most commenters who responded to this question said
11 no. They noted that the standard appropriately discusses the
12 concept of scalability based on size and complexity without
13 including inappropriate restrictions on the auditor's ability
14 to scale the audit.

15 The staff agrees that AS 5 appropriately recognizes
16 scaling and tailoring of all audits to fit the relevant facts
17 and circumstances so that ICFR audits will fit the size and
18 complexity of the company being audited rather than the
19 company's control system being made to fit the auditing
20 standard.

21 The staff also agrees with the statement made by
22 the board in its release to AS 5 that scaling will be most
23 effective if it's a natural extension of the risk-based
24 approach and applicable to all companies.

25 Before leaving question seven I'd also like to

1 respond to the observation by some commenters that where
2 feasible AS 5 should provide additional guidance on how to
3 effectively plan an integrated audit for smaller companies
4 along with some discussion of related best practices to
5 enhance broader understanding of risk-based auditing.

6 First, let me mention that the COSO guidance issued
7 a year ago and directed to smaller companies should be
8 helpful to both those companies whose COSO as their framework
9 for evaluating their controls and their auditors in
10 effectively and efficiently implementing 404.

11 In addition, COSO currently is conducted a project
12 to develop guidance intended to help organizations better
13 understand the monitoring component of the framework and
14 comply with Section 404 in a cost-effective manner.

15 Further and importantly, for responding to the
16 concerns of some commenters, the PCAOB has underway a
17 separate project to develop guidance and education for
18 auditors of smaller companies.

19 We're monitoring this project. The staff
20 recognizes its importance as part of getting a good
21 implementation of AS 5 for non-accelerated filers on their
22 first ICFR audits with their filings in 2009.

23 Moreover, in addition to this project, the staff is
24 working in a number of other ways as we go forward to monitor
25 the implementation of the Commission's new guidance for

1 management and the PCAOB's new guidance for auditors.

2 As selected examples, the staff will continue its
3 ongoing participation in public forums and events to discuss
4 the significant improvements made by the Commission and the
5 PCAOB.

6 As just one illustration, the staff participates in
7 the PCAOB's forums on auditing in the small business
8 environment. These forums are held throughout the country
9 and designed to help share important information concerning
10 the PCAOB with respect to registered public accounting firms
11 and public companies operating in the small business
12 community.

13 Presentation materials from past events are
14 available on the PCAOB's web site. These forums along with
15 our speaking engagements provide for excellent two-way
16 communication so that questions that arise can be dealt with
17 on a real-time basis.

18 Further, as Conrad noted, we expect a change in the
19 behavior of the individuals who are responsible for following
20 these new procedures. To that end, the PCAOB's inspection
21 program will monitor whether audit firms are complementing
22 the new auditing standard in a way that is designed to
23 achieve the intended results.

24 And it's noteworthy that the PCAOB's Office of the
25 Chief Auditor, which drafted the standard, helps train PCAOB

1 inspectors on AS 5. Moreover, in our oversight capacity, the
2 staff, at the Commission's direction, will monitor the
3 effectiveness of the PCAOB's inspection process.

4 So these are among the activities that illustrate
5 going forward both the SEC and PCAOB will be focused on
6 whether audit firms are achieving an effective and efficient
7 implementation of the new 404 guidance.

8 In closing, I'd like to reinforce the appreciation
9 expressed by others to the Commission, including for your
10 guidance to the staff throughout the year and especially at
11 the April 4th open Commission meeting, to the PCAOB board and
12 staff and to the Office and Division staff that have worked
13 so hard on this project, including my staff, in particular,
14 Brian Croteau, Josh Jones, Amy Hargrett, Esmerelda Rodriguez,
15 Jeff Ellis and Kevin Stout.

16 Brian Croteau and Josh Jones, who have played key
17 roles in our efforts to rationalize the implementation of 404
18 are at the table to help answer your questions. That
19 concludes our opening remarks.

20 Chairman Cox, staffs of the OCA and Division of
21 Corp Fin would be happy to discuss any questions that you and
22 the Commissioners might have. Thank you.

23 CHAIRMAN COX: Thank you for that very complete
24 presentation. This is a lot of work. We've covered a lot of
25 ground, and I think everyone has a lot to be proud of.

1 At our April 4th open meeting, we discussed the
2 need for AS 5 to make clear that the audit is scalable to
3 account for the fact that companies come in different shapes
4 and sizes and different complexities, and we were
5 particularly focused on smaller companies.

6 So I want to begin by asking how does AS 5 do this
7 specifically?

8 MS. PALMROSE: Well, let me start out by saying,
9 first of all, its principles based. It offers the
10 opportunity for the auditor to make judgments based on the
11 facts and circumstances, and it's a risk-based approach, and
12 so scaling is a natural extension of this approach.

13 Second of all, AS 5 includes specific discussion on
14 scaling the audit based on size and complexity of the
15 company, and the staff agrees with this discussion and that
16 scaling is the most effective way to get -- that reflects
17 this natural, as I said, extension of the risk-based
18 approach.

19 Third, the Board made an important change from
20 their December proposal. Not only did they have a special
21 section that talked about scaling, but what they did is they
22 imbedded scaling concepts that can apply in particular to
23 small companies throughout the standard to help illustrate
24 and provide a little bit more context and guidance in that
25 setting.

1 And fourth, I should note that consistent with the
2 discussion and plans there is the build-out of this guidance
3 that is expected to come from the additional guidance that
4 the board and staff are working on for smaller companies.

5 And that project is progressing nicely, will be
6 available for public comment in the not to distant future and
7 will be able to be applied by auditors of small firms well
8 before the implementation for the filings in 2009.

9 CHAIRMAN COX: Thank you for that. We, of course,
10 have published guidance for managements in meeting their
11 obligations under Section 404(a). I seem to recall that the
12 PCAOB is planning its own guidance for audits of smaller
13 companies. How is that going?

14 MS. PALMROSE: That's going well. Actually, that
15 was part of just, sort of, what I briefly ended on. As you
16 know, the staff is an observer on that project. We've been
17 working with them.

18 This project also has the advantage of having a
19 task force that's made up of representatives from the public
20 accounting firms, in particular the public accounting firms
21 that are auditing smaller companies so not just the largest
22 firms and their audits of smaller companies but the smaller
23 firms, too.

24 So that task force has been working with the PCAOB.
25 We've been working as observers, and that guidance will, as I

1 said, be available for exposure in the not too distant
2 future. But we are reviewing drafts of that as it goes along
3 as are the task force. So it's going well.

4 MR. WHITE: I might also mention that we're working
5 on a brochure for smaller companies that will be, basically,
6 a plain English explanation of how to use management guidance
7 and to, kind of, lead companies through this that we think
8 will be helpful to them.

9 CHAIRMAN COX: And that's something, of course,
10 that smaller companies have asked for, so that will be very
11 responsive.

12 MR. WHITE: Yes. It is something that they have
13 asked for, and it was discussed in your congressional
14 testimony a few weeks ago.

15 CHAIRMAN COX: Excellent. John, you mentioned a
16 number of ways in which the staff are going to monitor the
17 implementation of AS 5 as well as Management Guidance.

18 I note that we received a number of recommendations
19 that we perform a cost study of AS 5. Could you describe
20 what plans you have to study -- what plans the Agency has to
21 study the costs of AS 5 and Management Guidance and when you
22 might be in a position to report to us on these costs?

23 MR. WHITE: We'd be glad to, but I think I'm going
24 to let Zoe-Vonna do that because she has done most of the
25 planning for this.

1 MS. PALMROSE: Well, I think that's overstated, but
2 I certainly would be glad to provide some comments here. And
3 the answer is yes, at the direction of the Commission.

4 Actually, our Office of Economic Analysis will be
5 conducting an analysis to address whether the costs and
6 benefits of implementing Section 404 are in line with our
7 expectations.

8 The Office of Economic Analysis is working with the
9 staffs of the other offices and divisions, and we have
10 started the process of planning such a report. So we would
11 be hopeful that those plans would be well in line within the
12 not too distant future.

13 As part of this, I should reaffirm that -- and in
14 light of this direction, we're also revisiting the other
15 research that has been done in what I call the growing
16 literature and research related to the implementation of SOX.

17 So it's not just our own efforts that we're
18 considering, but we're considering the efforts of others, and
19 that's informing not only how we think about the issues but
20 also how we're developing our own study as we go forward.

21 So the answer is yes. We're working in a number of
22 ways to move this project along, and we recognize its
23 importance. And it's really part of our over-arching
24 activities in a number of ways to work on the implementation
25 of 404.

1 MR. HEWITT: I might just add on that point, if I
2 may, KPMG, there are other organizations also that do studies
3 on these costs and benefits. And KPMG just came out with
4 their third annual benchmark study of 404, and it will be
5 interesting to see next year's.

6 Because these costs won't be known until the end of
7 this year or early next year as to what these actual costs
8 are because of AS 5. There will be a lot of other
9 information available that we'll be able to look at.

10 CHAIRMAN COX: Thank you for that. One of the
11 concerns that we've heard repeatedly over the past years
12 relates to management feeling that it's constrained by the
13 auditor in the development and execution of their own
14 evaluation of internal control over financial reporting under
15 404(a).

16 What is different about AS 5, as it's finally
17 before us, that provides us comfort that that problem has
18 been fixed?

19 MS. PALMROSE: Let me start off, and others can
20 jump in here. First of all, there's a big change. AS 2 had
21 what was known as the 40s paragraphs, which, essentially,
22 required that the auditor evaluate management's process.
23 Those are no longer in the standard. So there is no
24 requirement in the standard for the auditor to explicitly
25 evaluate management's process.

1 Second of all, there was no interpretive guidance
2 for management. In other words, management actually looked
3 to the auditing standard for guidance on doing their
4 evaluation, and that's, of course, now changed with the
5 guidance that we have provided for management.

6 Again, it's important to recognize we've worked to
7 align that so it will work together with the auditing
8 standard. So management can look to our rules for guidance,
9 and the auditors can look to the auditing standard.
10 Management does not have to look to the auditing standard.

11 Third of all, the auditor's report that I talked
12 about briefly in my opening remarks we're down to one
13 opinion, which makes sense, and that opinion is on the
14 effectiveness of ICFR.

15 So there's no notion because of the auditor's
16 second opinion that that would equate to evaluating
17 management's process.

18 So all three of those are very helpful in
19 responding in just big ways to this concern that management
20 was constrained through their evaluation.

21 MR. WHITE: I kind of like to say it the short way,
22 that no longer does management have to follow the audit
23 standard, but instead the auditors have to adjust their
24 procedures to follow what management does.

25 MS. PALMROSE: But let me just reinforce they are

1 aligned so that they can work effectively and efficiently
2 together.

3 CHAIRMAN COX: Well, that's good news. I just have
4 one final question. I'm sorry. Do you have further comment,
5 John, on that?

6 MR. WHITE: No.

7 CHAIRMAN COX: Okay. Just one final question about
8 the range of comments that we received on AS 5. If you want
9 to characterize the types of comments we received and in
10 particular the comments that were received on significant
11 deficiency and how we addressed those comments.

12 MS. PALMROSE: I can start out, and others can
13 chime in. I think it's important to recognize, first of all,
14 we very much appreciate, we understand how time-consuming it
15 is to write us, and we've asked for comment in a number of
16 ways a number of times.

17 But notice that the number of comments is much
18 lower to AS 5 that was exposed for comment in June than it
19 has been before. So it's less than a fourth of the people in
20 terms of number.

21 More importantly -- which provides some inferences
22 that the larger marketplace is very happy with where it ended
23 up, and also that's reinforced by the comment letters
24 themselves.

25 The comment letters are very supportive of this

1 standard and where it ended up, and that's also in terms of
2 the "significant deficiency" definition, too.

3 So there is contentment would maybe be the word I
4 would choose with those standards and the proposed definition
5 that will be in our rule as well as in AS 5. Overwhelming
6 support I would characterize what we're hearing.

7 MR. WHITE: The other thing, and I pointed it out
8 earlier, we think it is a very good thing if nothing more
9 than just good housekeeping that we now have the definition
10 of "significant deficiency" and "material weakness" in our
11 rules.

12 We do, after all, ask CEOs and CFOs to certify with
13 respect to those matters every quarter, and I think it's very
14 nice to -- it's a good idea to have our own definitions there
15 instead of having to look over at the auditing literature.

16 CHAIRMAN COX: Well, thank you. I haven't any
17 further questions. I just want to add since I thank the
18 Office of the General Counsel, Office of the Chief Accountant
19 and the Division of Corporation Finance but I didn't thank
20 the people who run them, I want to thank particularly John
21 White, Conrad Hewitt and Brian Cartwright for all of your
22 work on this over a very long period of time.

23 Since I haven't any further questions, it is up to
24 Commissioner Atkins to carry the ball forward.

25 COMMISSIONER ATKINS: Okay. Thank you very much,

1 Mr. Chairman. I, too, would like to commend the hard work of
2 the Public Company Accounting Oversight Board and the staff
3 here at the SEC and the Office of the Chief Accountant,
4 Division of Corporation Finance and Office of Economic
5 Analysis and the General Counsel's Office for all of your
6 hard work.

7 The audit standard that we're considering today is
8 intended to enable auditors to conduct top-down audits that
9 are focused on matters that they believe give rise to the
10 greatest risk of material misstatements.

11 Despite all of the public attention that's paid to
12 other items on our agenda today, this matter is the most
13 important that we consider today. I hope that today marks
14 the start of a new phase of the life of Section 404 of the
15 Sarbanes-Oxley Act.

16 The infant years of Section 404 have been, to say
17 the least, unpleasant. I had better caveat that. At least
18 audit firms have been trumpeting record earnings. A couple
19 months ago I ran across a full page advertisement by one of
20 the Big 4 that boasted about, "five straight years of double
21 digit growth."

22 Now, this year, of course, just happens to be the
23 fifth anniversary of the Sarbanes-Oxley Act. Implementation
24 costs and efforts soared far above anyone's expectations.
25 Accounting firms driven by pecuniary interest, a poorly

1 written rule and risk mitigation had every incentive to
2 engage in make-work efforts. Managers and auditors engaged
3 in check the box compliance exercises at direct cost to
4 shareholders.

5 Money and time spent on these exercises were
6 diverted from other important areas. The magnitude of the
7 troubles that arose under Audit Standard 2 made it clear to
8 virtually everyone that mere modifications to the existing
9 standard would not have been enough. A completely new
10 approach was needed.

11 As the old Chinese proverb says, rotten wood cannot
12 be carved. I'm happy today to be able to vote for the
13 replacement of Audit Standard 2 with Audit Standard 5. The
14 old standard is not being laid to rest a day too soon.

15 That said, we need to be cautious with respect to
16 Audit Standard 5. Even under this less prescriptive leaner
17 standard, success is not guaranteed. If this standard is
18 implemented incorrectly, then we will not experience the
19 clean break with the past that AS 5 is intended to bring to
20 pass.

21 Many commenters warned us that we and the PCAOB
22 cannot simply sit back and relax now that AS 5 is in place.
23 It's incumbent upon auditors to take the new guidance to
24 heart.

25 As part of this they will need to abandon the

1 notion that AS 5 governs management and instead allow
2 management to follow the top-down risk-based approach that we
3 set forth in the management guidance that we adopted last
4 month.

5 As the PCAOB itself has acknowledged, it must
6 monitor the manner in which auditors implement the new
7 standard. Likewise, the SEC, in fulfillment of its statutory
8 responsibilities, must monitor how the PCAOB is overseeing
9 the audit profession's implementation of AS 5.

10 We need to be prepared to make changes if AS 5
11 fails to deliver on its promises of reshaping internal
12 control audits.

13 Until we know whether AS 5 works, a further
14 extension for non-accelerated filers I think is necessary.
15 Let us give these small public companies an additional year
16 to observe how their larger counterparts implement AS 5.

17 I advocate not requiring them to file Section 404
18 audit reports until they file financial statements for their
19 fiscal year ending on or after December 15, 2009. Congress,
20 of course, is considering delaying all internal control
21 reviews.

22 In the interim, I'm also looking forward to seeing
23 the guidance that the PCAOB develops for audits of smaller
24 companies, as we discussed earlier. I hope that this will go
25 a long way towards addressing some of the concerns that small

1 companies raised about the standard.

2 We're also considering, of course, the "significant
3 deficiency" definition that's before us today, and I'm happy
4 to support it as well. It's important both that we have a
5 definition in our rules and that the definition matches the
6 definition in Audit Standard 5.

7 Significant deficiencies have been a continuing
8 source of concern for me, but I hope that the new definition
9 will help to alleviate those concerns. As the new definition
10 appropriately acknowledges, a significant deficiency is less
11 severe than a material weakness.

12 Management and auditors are to concentrate their
13 efforts on identifying material weaknesses. Accordingly,
14 they should not scope or test for significant deficiencies.
15 If attention is diverted to hunting for significant
16 deficiencies, then internal control reviews will be derailed
17 from their intended focus.

18 It is in no one's interest, least of all the
19 shareholders, who pay for internal control work, if
20 management and auditors get tripped up in trying to identify
21 issues that are not material.

22 I approve also of the definition's pragmatic
23 consideration of whether deficiencies are "important" enough
24 to merit attention by those responsible for oversight of a
25 registrant's financial reporting.

1 We should be clear this standard is consistent with
2 the definition of "reportable condition," which is very well
3 understood in the accounting literature.

4 As I mentioned, in connection with Audit Standard
5 5, implementation will be of the utmost importance. Even a
6 well-constructed definition would be meaningless if the
7 implementation is not carried out properly.

8 I just have a few questions for you. I know the
9 hour is getting later. Paragraph 30 of AS 5 directs an
10 auditor to ask himself "what could go wrong" within a given
11 significant account or disclosure.

12 What boundaries are there to this question to
13 ensure that an auditor does not invite mountains out of
14 molehills through a series of extrapolations of what could go
15 wrong? After all, it was just this type of thought process
16 that led to so many problems under AS 2.

17 MS. PALMROSE: Let me answer that question. First
18 of all, it's important to note where paragraph 30 appears.
19 It's in the context of identifying significant accounts and
20 relevant assertions.

21 In other words, what it is directing is for the
22 auditor to think about the likely sources of potential
23 misstatements that would cause the financial statement to be
24 materially misstated. So materiality, what matters, what's
25 important, bounds that discussion.

1 And it asks the auditor to think about what might
2 be the likely sources of potential misstatement, and that's
3 the "what could go wrong." It's not intended for them to
4 consider every possible risk regardless of how insignificant.

5 Instead, it's really intended to help focus on what
6 matters most and the risks that could result in a material
7 misstatement, and, under a risk-based approach, obviously,
8 this is the important question, so it is the essential
9 question.

10 I also should add there's also a subtlety here that
11 this question is actually one of alignment between management
12 guidance and AS 5.

13 Management guidance does not require that -- our
14 guidance for management does not require management identify
15 significant accounts and relevant assertions. It's actually
16 imbedded in the COSO framework, but our guidance doesn't say
17 you must walk through that gate per se.

18 We say focus on the risk of material misstatement
19 to the financial statements, and one of the subtle linkages
20 here between what the auditor and management is doing is we
21 included "what could go wrong" as the question that
22 management would want to think about, too, in identifying
23 those financial reporting risks, the risks of material
24 misstatement.

25 So both the auditor and management, even if they

1 don't use quite the same process or approach, are asking the
2 same fundamental question, and both are taking a risk-based
3 approach. And that's what is demonstrated by that question.

4 COMMISSIONER ATKINS: Okay. As we're talking about
5 materiality, then, if you look just up from paragraph 30 up
6 to the earlier one, paragraph 29, there it refers to the
7 evaluation of qualitative and quantitative risk factors in
8 identifying significant accounts and disclosures in their
9 relevant assertions.

10 To get back to the point of materiality, then, what
11 sort of qualitative factors are we talking about here?

12 MS. PALMROSE: That paragraph does provide some
13 enumeration of what would be qualitative risk considerations
14 Let me ask Brian to, sort of, jump in here.

15 MR. CROTEAU: As Zoe-Vonna said, actually, I think
16 they're really listed there as examples of things you would
17 want to think about.

18 Some of those are quantitative, and others are
19 qualitative but making the point that clearly it's not just a
20 quantitative analysis when considering significant accounts
21 and that the auditors qualitative assessments can impact and,
22 in fact, remove a significant account, if you will, or add a
23 significant account.

24 So we think that's important so that it's not just
25 a quantitative analysis that's done in considering scoping.

1 MR. HEWITT: A good example of that would where the
2 estimates, the broad estimates in the accounting records and
3 transactions and they end up in the financial statements
4 whether it be warranty reserves, or those types of things.
5 And those are all qualitative and not quantitative in nature,
6 and that's where the risk is.

7 COMMISSIONER ATKINS: Right. But this is still
8 bounded ultimately by materiality at the consolidated level
9 as we talked about at the proposing?

10 MS. PALMROSE: Yes.

11 COMMISSIONER ATKINS: Okay. So of course, this,
12 basically, comes to the crucial problem of materiality and
13 how one is supposed to divine what that might be especially
14 in a prospective sense.

15 And that has been particularly thorny, of course,
16 in the internal control context and throughout financial
17 reporting that we struggle with enforcement cases, and
18 everything else.

19 So what steps are we taking to try to provide more
20 clarity with respect to materiality in general?

21 MS. PALMROSE: Let me just start off by saying that
22 you're absolutely right. The issues around materiality are
23 really over-arching with respect to the financial statement
24 audit that bleed into the ICFR audit.

25 So they're much broader issues here. So the staff

1 is cognizant of that, and we do have in process work to
2 examine the issues surrounding materiality both interim
3 materiality and materiality in general.

4 So the staff is working that issue and would hope
5 to have some recommendations going forward at some point.

6 COMMISSIONER ATKINS: Great. I would encourage
7 that, because the last time the Commission -- actually, it
8 was the staff, I guess, that addressed that was now eight
9 years ago. I think it's high time that the Commission itself
10 consider that.

11 So I would encourage the chairman and the staff to
12 push this forward as fast as possible, because that is the
13 thing that's eating away at a lot of these things that people
14 have to deal with.

15 I guess sort of a related point is what material
16 weaknesses are about and how they are defined. In paragraphs
17 69 and 70 of AS 5, they set forth indicators of material
18 weakness.

19 Now, are these indicators which include, for
20 example, restatements, are they definitive evidence of
21 material weakness?

22 MS. PALMROSE: No. Again, notice one change
23 between AS 2 and AS 5 is the term "strong" has been deleted.
24 So they are indicators. And, in fact, the discussion around
25 those both in the standard itself and in guidance, the

1 released text as well as in management guidance are that
2 these are judgmentally determined.

3 So they're based on the facts and circumstances,
4 and these are just considerations. They are not
5 determinative of a material weakness.

6 I might just add that the empirical evidence seems
7 to support that. In other words, if we look at the material
8 weaknesses, we find that the percentage of those that are
9 reflected or are in conjunction with a restatement have
10 dropped off significantly.

11 So it does appear that auditors and management and
12 audit committees, issuers are sorting through this and
13 understand that it is based on the facts and circumstances
14 and a judgment determination.

15 MR. CROTEAU: And I might just add to Zoe-Vonna's
16 comment to note that there's discussion of this in the
17 PCAOB's release and our release that makes these points clear
18 or at least interpretive guidance.

19 COMMISSIONER ATKINS: Okay. Good. Now, the
20 definition of "material weakness" refers to interim financial
21 statements. So I was wondering how do we square that with
22 our emphasis on consolidated annual type outlook.

23 MS. PALMROSE: We actually did receive two
24 comments. As you say, it does include in the definition of
25 "material weakness" interim financials. We only had two

1 comments on this issue.

2 So it doesn't appear that it's cause for much
3 concern. Again, part of the angst around -- I should mention
4 that one of commenters said, please, for heaven's sakes,
5 don't hold anything up over this issue, too.

6 But let me just retrace my steps and say that our
7 discussion around the issues with respect to materiality also
8 relate to interim materiality, too. And the staff, again, is
9 cognizant of that in the context of the broader project. So
10 we understand that.

11 Anyway, from the standpoint of the ICFR audit, it's
12 clear that scoping is based on annual materiality
13 considerations. It's clear from the audit standard. It's
14 clear from the release text. It's clear from our management
15 guidance. There appears to be no confusion around that.

16 Now, "interim" is still in the definition, because
17 we think that interim financial reporting is important to
18 investors. And even though you don't scope around interim
19 materiality, controls over interim financial reporting are,
20 essentially, one aspect that has to be considered.

21 So those controls are something that needs to be
22 considered. And also, and maybe most importantly, even
23 though you don't scope to find, if you identify a material
24 weakness, those -- excuse me.

25 If you identify a control deficiency, those

1 controls deficiencies need to be evaluated as to whether
2 they'll have a material impact on the interim financial
3 statements, and that's all that this is asking to do here.

4 The staff believes that investors have a right to
5 know whether the control deficiencies identified would have
6 an impact on the interim financials, and it's a disclosure of
7 that that's being asked for here.

8 COMMISSIONER ATKINS: I just wanted to bring that
9 nuance out, because I think that's an important one from the
10 scoping perspective. But of course, Qs are important also,
11 as we know, for investors as far as the information that's
12 disclosed.

13 The Biotechnology Industry Association objected to
14 the removal of the definition of "small company" from AS 5 in
15 our management guidance. Why was no objective definition
16 included?

17 MS. PALMROSE: Well, actually, in both management
18 guidance and in AS 5 there's still a footnote that recognizes
19 the work of the Small Business Advisory Committee. That work
20 is important. We very much appreciate it, informs the
21 process, and there is that acknowledgment.

22 There's not a quantitative bright line that's
23 specified that if you're on one side of it you're large and
24 the other side that you're small.

25 That's actually an impediment to scaling. In other

1 words, it wouldn't make sense for a company that had two
2 companies, one just slightly over a bright line and one
3 slightly under a bright line, but something different would
4 happen to them.

5 That's not the way the standard is written. This
6 is written so it's scaled based on facts and circumstances
7 for companies based on their size and complexity, and those
8 have to be determined within the context of each company.

9 Also, it would make no sense to have companies on
10 the lower end of a bright line that had very different facts
11 and circumstances and expect the auditor to treat them the
12 same. So, essentially, the scaling is important here, and
13 bright lines would be an impediment to that.

14 That's not to say that it isn't important to
15 recognize that smaller -- the notion of a smaller company in
16 conjunction with the complexity, and that's what is
17 acknowledged with the footnote.

18 COMMISSIONER ATKINS: I agree generally with that.
19 I just worry that auditors who might be free to exercise
20 their judgment about whether scaling is appropriate might
21 simply hide behind complexity and then refuse to scale audits
22 of small companies.

23 MS. PALMROSE: I mean, it's unlikely that that
24 would be the case, again, because that goes back to a
25 risk-based approach. You'd have to identify what's higher

1 risk.

2 So it's within that context. And again, that's
3 what makes the scaling work for everyone.

4 COMMISSIONER ATKINS: I think, in general, I'm
5 happy to support the adoption of AS 5. We might not be
6 completely happy with it.

7 I'm at least happy to put AS 2 out of its misery
8 or, more importantly, out of the shareholders' misery of
9 paying for it. The secret will be in the implementation and
10 how we monitor that. So thank you very much.

11 CHAIRMAN COX: Thank you. Commissioner Campos

12 COMMISSIONER CAMPOS: Thank you, Chairman Cox.
13 Well, it has taken a long time to get here, but we've finally
14 arrived. As promised, today marks the culmination of a
15 tremendous amount of hard work and determination on the part
16 of many people here at the SEC and at the PCAOB.

17 I won't go again and list the names, but I think
18 all of you know who you are, and the chairman and your
19 division directors have mentioned all of you.

20 Generally, first, I want to congratulate the PCAOB
21 and their staff for responding to public comments and for
22 crafting this excellent standard.

23 Second, I also want to thank the staff of our
24 Office of Chief Accountant for all the efforts in the
25 process. I know that the General Counsel, the Office of

1 Economic Analysis and other offices also participated.

2 I know that AS 5 is the product of intensive hard
3 work and tremendous cooperation on the part of the staff of
4 the SEC and the PCAOB. The adoption of AS 5 is evidence that
5 we and the PCAOB have developed a framework to work on
6 complex accounting issues and to resolve them in a
7 professional manner.

8 I think it is an important milestone, and I think
9 that we have overcome certain growing pains and that we have,
10 hopefully, established a framework to deal with tough issues,
11 good faith differences of opinion and still come out with a
12 joint position on guidance and rule-making.

13 At this point, the SEC and the PCAOB, it seems to
14 me, have done everything that we promised. After granting
15 numerous extensions over the years to companies, particularly
16 non-accelerated filers, we and the PCAOB have finally adopted
17 standards and guidance for both auditors and management that
18 should promote more effective and more efficient audits of
19 internal control over financial reporting.

20 I'm confident that AS 5 and the management guidance
21 will greatly help companies of all sizes but particularly
22 smaller companies comply with Section 404 in a cost-effective
23 manner that seeks to minimize the possibility of a material
24 misstatement in the financial statements.

25 AS 5, as has been noted, is rational, right-sized

1 and principles based, an approach that should enable auditors
2 to properly scale the audit for smaller or less complex
3 companies.

4 I'm confident that once auditors and companies
5 begin to comply with and implement the new standard costs
6 will be rational and appropriate for smaller public
7 companies. From this point forward, issuers should have
8 nothing to fear from Section 404 of the Sarbanes-Oxley Act.

9 Certainly, investors both domestic and foreign have
10 always appreciated the protections offered by SOX 404. Now
11 they will still have the protections offered by SOX 404, but
12 they will also benefit by getting these protections in a more
13 efficient and cost-effective manner.

14 As I repeatedly emphasized, the rigorous disclosure
15 regime in the United States which protects the recent
16 protections offered by Sarbanes-Oxley is a great protector of
17 capital and, in my view, attracts capital from all over the
18 globe.

19 Let me focus on a few discreet aspects of AS 5 that
20 I think deserve mentioning. First, much has been made by
21 making the standard more principles based and top-down
22 focused.

23 This is entirely appropriate and necessary, but we
24 can't lose sight of the fact that the passage of the
25 Sarbanes-Oxley Act was due, in large part, to the massive

1 financial frauds of a few years ago; that is, intentional
2 fraud by senior management who managed to override internal
3 controls.

4 In this respect, I think and hope that AS 5 has
5 done an even better job of trying to focus auditors on the
6 risk of fraud. Specifically, I know that addressing the risk
7 of fraud has been moved into the "Planning the Audit" section
8 of the standard.

9 The focus on fraud risk during the planning stage
10 of the audit should put fraud risk in the minds of auditors
11 from the very beginning of the process.

12 I also think it's appropriate that AS 5 provides
13 examples of controls that might address fraud risks. This,
14 too, should focus auditors on the biggest risk of a massive
15 financial misstatement.

16 I'm also pleased with respect to the definitions of
17 "material weakness" and "significant deficiency." I know
18 that we specifically asked the question about material
19 weaknesses when we voted to put AS 5 out for public comment.

20 I note that a majority of commenters believe that
21 the definition appropriately describes the deficiencies that
22 should prevent the auditor from concluding that internal
23 controls over financial reporting are effective.

24 Further, it is entirely appropriate for the
25 definition to reference interim financial statements. It

1 makes perfect sense to me that if auditors uncover a
2 deficiency that poses a reasonable possibility of a material
3 misstatement in a company's Form 10-Q that deficiency should
4 be disclosed to investors.

5 I also think AS 5 has done a much better job with
6 respect to scaling the audit. In particular, I appreciate
7 the fact that the standard emphasizes that scaling should be
8 based on both size and complexity of the company.

9 As AS 5 notes, "Even a larger, less complex company
10 might achieve its control objectives differently than a more
11 complex company." Notably, however, the notion of scaling
12 the audit should not result in a less rigorous audit, nor
13 does it exempt smaller or less complex companies from any of
14 the principles set forth in AS 5.

15 In general, what makes AS 5 an appropriate and
16 consistent standard is that all of the parts seem to fit
17 together in a way that, hopefully, will produce a more
18 effective yet more efficient audit.

19 It allows companies to scale the audit to eliminate
20 unnecessary procedures and to use more principles based
21 approaches. In this way, auditors should focus on what
22 matters most. Instead of checking the box auditors should
23 focus on the big picture.

24 With that said, let me just ask a few questions.
25 I've focused on fraud controls and the fact that auditors

1 must consider the risk of fraud when planning the audit.
2 Zoe-Vonna, do you think that AS 5 has done enough to focus on
3 the risk of fraud?

4 MS. PALMROSE: Yes. Actually, this is one of the
5 areas that is a change between the exposure draft and the
6 final standard, and the board and staff have taken it very
7 seriously and, as you said, have moved up the fraud
8 discussion to the Planning section.

9 So the optics around it are important, too. That's
10 part of emphasizing its importance. And as you said, there
11 are now some examples of anti-fraud controls. And then the
12 third thing is that the standard does discuss the expectation
13 that fraud would be an area of high risk, and thus the
14 auditor's efforts would respond to that higher risk.

15 And so all of those are important elements in
16 bringing this focus on fraud to the forefront, and we're very
17 supportive of that, yes.

18 COMMISSIONER CAMPOS: Given the significance of the
19 improvements from AS 2, both auditors and management
20 hopefully are very anxious for the new standard to be
21 implemented. How soon can auditors begin using AS 5?

22 MS. PALMROSE: Well, actually, AS 5 is effective
23 for years ending on or after November 15, 2007, but it's
24 important to note that early adoption is encouraged by the
25 PCAOB, and we very much support that.

1 We really encourage auditors to take advantage of
2 this ability, and we've heard that a number of audit firms
3 have already started updating and integrating AS 5 into their
4 audit programs, their materials and their training. So it
5 looks like that is happening.

6 Maybe I could use this as an opportunity to just
7 cover something that's a little bit more technical here, too,
8 and that's that the Commission's amendment to Regulation SX
9 related to the required auditors attestation report -- that's
10 the auditor's opinion on the effectiveness on internal
11 control -- we adopted that in May. And it will become
12 effective on August 27, 2007.

13 So companies can begin filing the new single ICFR
14 opinions proscribed in accordance with AS 5 in timely filings
15 received starting on August 27th. So this means that
16 auditors can begin using AS 5 today and can actually report
17 on it as long as the reports will be filed by their client on
18 or after August 27th.

19 COMMISSIONER CAMPOS: Do you expect that to happen?

20 MS. PALMROSE: Yes.

21 COMMISSIONER CAMPOS: There has been much talk in
22 various circles about the potential need of the small
23 business community to get yet another extension.

24 Now, we all know that we have a year for the
25 management guidance and the management assessment to be done

1 before the second year and the second stage of full
2 implementation for the smaller accelerated filers.

3 In your technical view, is that enough time?

4 MR. WHITE: Why don't I start on that.

5 COMMISSIONER CAMPOS: Sure.

6 MR. WHITE: I won't give the technical accounting
7 view. I'm a lawyer, as you know.

8 COMMISSIONER CAMPOS: I won't hold that against
9 you.

10 MR. WHITE: You probably should, actually, but
11 never mind. Just to, kind of, break up the two pieces of it,
12 the management assessment, of course, is due next spring, in
13 March for the end of this year.

14 I think that at least listening to the advice of
15 the accountants around me we are pretty confident that
16 companies will be able to follow the new management guidance
17 and comply with the requirement in that time frame.

18 Zoe-Vonna went through a fair amount of detail of
19 how we had designed this and scaled it for smaller companies.
20 We talked a lot about this back in May, actually.

21 And we were, obviously, thinking about at the time
22 that this was in time and would work for smaller companies in
23 terms of the management assessment that's due next March, the
24 reports that are due next March.

25 In terms of the extension -- so the answer is we do

1 not believe there are any extensions needed with respect to
2 404(a), because I think we were, basically, giving that
3 advice back in May.

4 With respect to 404(b), in effect, that's more than
5 a year and a half from now before those reports are due. We
6 are, obviously, going to be monitoring how things are going
7 with AS 5. As Zoe-Vonna just described, we anticipate that
8 companies that are already subject to AS 5 will be complying
9 with it I will just say this season.

10 So we will have kind of a season in which companies
11 can -- we will see how it's working with larger companies.
12 This is not something that you necessarily have to address at
13 this stage. This can wait, basically. It is not a current
14 topic, I would say.

15 MR. HEWITT: I would like to add some information
16 on this point, because we're talking about micro cap
17 companies, those with a floating market cap of under 75
18 million.

19 These companies operate in a completely different
20 environment. Their internal control system environment is
21 completely different than anything else. The auditors have
22 to approach the audit in a different approach because of the
23 size and characteristics of these micro cap companies.

24 So we believe hopefully that this year, when they
25 address their management assessment of their internal control

1 system that it will be very important if they do that, and
2 they should do that.

3 They should also do it next year, because I think
4 they'll gain some benefit by doing it, which they have never
5 focused on before, especially as it pertains to any internal
6 controls which they may have within these very micro cap
7 companies.

8 Now, as AS 5 replaces AS 2, AS 2 was never
9 scalable. It was a large portion testing standard that
10 auditors converted into a percentage of assets and revenues.
11 A very high percentage, almost 80 percent, had to be covered.
12 Micro cap companies could not afford that type of an audit,
13 and neither could a lot of small companies towards that lower
14 end of the scale. So I think we really need later this year
15 to see those smaller companies, say around \$100 million of
16 micro cap, to see how they are implementing AS 5.

17 PCAOB really has to pay attention to these micro
18 cap auditors. These are not the Big 4 auditing firms. The
19 Big 4 auditing firms do a very small percentage of these
20 micro cap companies.

21 So you have a small CPA firm that's going to be
22 auditing internal control systems. They do not have the
23 training or the resources to get their people up to speed.
24 But hopefully, they will be able to do the that by the end of
25 this year.

1 And I would think that the external auditing firms
2 of these micro cap companies will work with the management
3 and their accounting and financial people to help guide them
4 and to prepare them for an audit of their internal control
5 system.

6 Personally, I want to wait and see to the end of
7 this year to see how PCAOB does with the small CPA firms and
8 how well they're trained, how well they understand AS 5 and
9 scalability and then how well the small micro cap companies
10 implement their management assessment of the internal control
11 system.

12 MS. PALMROSE: Maybe I can just provide a little
13 bit of a elaboration, too, to build on what Conrad has said.
14 We've talked a bit about the project that the PCAOB is
15 working on, on guidance for auditors of smaller companies,
16 and that guidance will actually address the concerns that
17 Conrad has raised in terms of auditing in a small company
18 context.

19 That guidance will be in place in plenty of time to
20 meet the audit requirements for the filings in 2009. The
21 other point that we've talked about that's in place -- so all
22 the components will be in place in order to do the audit in
23 the small company context.

24 But there's something that we also haven't talked
25 about that is a change from AS 2 to AS 5, and that's that AS

1 5 also focuses on an integrated audit. And this will be
2 something that will be important in this context.

3 In other words, evidence from the financial
4 statement audit informs the ICFR audit. Evidence from the
5 ICFR audit informs the financial statement audit. And this
6 is particularly important -- I mean, it's important in all
7 companies, but it's also very important in this context in
8 that these audits have tended to be substantive audits in the
9 past.

10 And so there is now this mechanism that's explicit
11 that's it's an integrated audit, and evidence from each
12 informs the other. And so that should help the
13 implementation of ICFR audits in this context, too.

14 COMMISSIONER CAMPOS: Well, in the smaller company
15 context, can't we conclude that many of these companies have
16 far fewer internal controls than what we ran into with the
17 larger companies?

18 And if you envision that you have small internal
19 staffs, whether it's one or two or even three, there aren't
20 that many moving parts in terms of internal controls. It
21 puzzles me why it should be so difficult to do everything
22 that we, essentially, designed together with the PCAOB, with
23 AS 5 and management guidance.

24 MS. PALMROSE: Yes. I think that's an important
25 point. We talk about non-accelerated filers, but there's

1 really a distribution here. It should not -- with management
2 guidance and the auditing standard, it should not be that
3 difficult.

4 COMMISSIONER CAMPOS: Okay. I'm going to stop it
5 here. I'd like to thank everyone on our staffs, the PCAOB
6 for all this time and all this effort and all this dedication
7 to get AS 5 right and, of course, before then our management
8 guidance. And I'm very, very pleased to support the
9 finalization of AS 5.

10 CHAIRMAN COX: Thank you. Commissioner Nazareth.

11 COMMISSIONER NAZARETH: Thank you. As others have
12 expressed, I would like to thank the PCAOB and their staff as
13 well as our staff in the Office of the Chief Accountant for
14 bringing this much improved auditing standard to us today.

15 I'd also like to thank the Division of Corporation
16 Finance for their work along with OCA in crafting the
17 proposed definition of "significant deficiency." And I'm
18 happy to support approving the PCAOB's proposed AS 5 as well
19 as the proposed definition.

20 With these actions today, we will address the most
21 problematic implementation issues concerns the Sarbanes-Oxley
22 Act. It is indeed a credit to the hard work of all concerned
23 that the comment letters strongly support the new Auditing
24 Standard No. 5. I believe that it is a tremendous
25 improvement over AS 2, which is currently in place.

1 To the extent that the recent comment letters
2 raised issues concerning the standard, most, if not all, such
3 issues had already been raised and considered by the PCAOB in
4 the course of its comment process.

5 I'm pleased to vote to replace AS 2 with AS 5, and
6 I think that this new standard has the potential to result in
7 lower cost than AS 2 while remaining consistent with investor
8 protection.

9 I'm also very pleased that AS 5 is aligned with the
10 interpretive guidance that the Commission issued recently for
11 management. Through the revised standard and our guidance
12 management and auditors will be directed to focus on areas
13 that matter most, including those that pose a high risk of
14 fraud.

15 Our staff has worked very closely with the PCAOB in
16 our oversight role, and I think that the outcome here has
17 been very productive.

18 At an open meeting on April 4, 2007, the Commission
19 provided our staff with direction to work with the PCAOB in
20 four particular areas -- alignment of AS 5 with the
21 Commission's management guidance, improving the discussion of
22 scalability within the standard, clarifying the auditor's
23 ability to exercise judgment and following a principles based
24 approach to determining when and to what extent auditors can
25 use the work of others.

1 I'm pleased that AS 5 responds to these concerns
2 that we raised at that meeting, and I'm optimistic that our
3 interpretive guidance and the PCAOB's AS 5 will provide a
4 useful coordinated framework for both management and
5 auditors.

6 Included in AS 5 is a definition of "significant
7 deficiency" that matches the definition the Commission
8 recently published for public comment. The comments received
9 strongly support that definition, and I'm pleased to support
10 adopting that definition as well.

11 The definition focuses squarely on matters that are
12 important enough to merit attention by those responsible for
13 oversight of the company's financial reporting. An important
14 benefit of the proposed definition is the flexibility that it
15 will provide to management and auditors to use their
16 judgment.

17 While I certainly agree with the criticism that the
18 costs and burdens of implementing Section 404 of
19 Sarbanes-Oxley have been far too high it is important to
20 remember that there are real benefits to both companies and
21 shareholders when issuers comply with Section 404, including
22 management's renewed sense of ownership over controls,
23 innovative ways to make controls more efficient, better
24 financial reporting and disclosure and the detection of
25 problems before they become more serious.

1 All of these benefits improve investor confidence
2 and the integrity of our markets. By focusing on the areas
3 of highest risk, we can best achieve meaningful investor
4 protection without excessive costs.

5 The combination of the new AS 5 and the definition
6 of "significant deficiency" that we are considering today and
7 the guidance for management that we have already published
8 will serve these important goals.

9 You've answered an awful lot of questions. I just
10 have one area that I'd like to focus on, and it's one that
11 others have expressed concern about, which is, obviously, the
12 importance of implementation in achieving the goals that were
13 intended by these important changes in AS 5.

14 Can you give us a little more specificity on how
15 you intend to monitor implementation and whether there are
16 any particular metrics that you're thinking of utilizing,
17 either our staff or the PCAOB, to assess the goals have been
18 achieved with AS 5?

19 MS. PALMROSE: We can talk about that in several
20 ways. In terms of the specifics on whether the auditing
21 standard is working, the inspection process clearly provides
22 a very useful context to do that.

23 COMMISSIONER NAZARETH: But again, even as to the
24 inspection process are there particular things that we intend
25 to look at as we inspect the inspection process?

1 MS. PALMROSE: Yes. Let me just step back for a
2 second here and say that our inspection of the inspection
3 process is at, sort of, an odd place from the standpoint of
4 AS 5 in that what is currently being done doesn't cover AS 5.

5 And so part of what we're doing here is also
6 dialoguing with the PCAOB in terms of how they are
7 implementing AS 5 through their inspection process going
8 forward. So we're actually working in terms of our oversight
9 with them on that.

10 There's multiple component to the inspection
11 process. One is somewhat historical, but what we learn from
12 that historical also informs how we think about the
13 inspection for efficiency going forward.

14 And then there's an explicit component in terms of
15 what they're doing going forward with AS 5, which has
16 included the training that the Office of Chief Accountant is
17 giving their inspection teams in terms of the standard
18 itself. So that's one component.

19 The study that the Commission has directed under
20 the leadership of the Office of Economic Analysis is another
21 component of that, and here we're not only cognizant of what
22 has been done -- we want to be cognizant of what has and is
23 being done by others including, as Conrad said, surveys and
24 evidence that's gathered by others.

25 And that's informing our, sort of, design here and

1 methodology going forward. And again, that involves data
2 that is both publicly available and there may be other
3 components to that.

4 So that's what we're working on now. So it's a
5 little premature to give actually a methodology and
6 milestones on that. Then, again, working in terms of public
7 speaking and outreach with the -- we actually work with the
8 PCAOB and present as part of their forum. So those are
9 scheduled.

10 And we have a number of speaking engagements and
11 outreach activities scheduled to help educate as well as
12 listen to the implementation of both management guidance and
13 AS 5 and then working explicitly as an observer on auditing
14 in a small business context project.

15 So that has relatively -- it's very important, but
16 it has a relatively more recent time schedule. And
17 hopefully, that will be out for exposure in the near future.

18 MR. HEWITT: I might just add to that point on how
19 we can assure ourselves that the implementation will be
20 completed as it should be when AS 2 was never completed.

21 For example, we'll be looking at the PCAOB's
22 training manual and looking at their training program of
23 their inspection teams to ensure that they stick to the
24 concept of AS 5 in terms of scalability, in terms of
25 principles based and not have items in their training program

1 that may relate to, say, significant deficiencies, which do
2 not belong in there.

3 So that will be our starting point. And as they
4 perform their inspection and write their reports, we'll be
5 looking in their reports and their working papers to see if
6 there's something that does not jive with the intent of AS 5
7 in terms of implementing that standard.

8 So there will be a lot of work for us at the end of
9 this year and next year in that regard to make sure that AS 5
10 is being implemented properly.

11 COMMISSIONER NAZARETH: Thank you. I think that's
12 a good plan. Obviously, you've done a lot of thinking about
13 it. It is, obviously, a very important part of this whole
14 process in order to achieve the goals that were intended.
15 Thank you.

16 CHAIRMAN COX: Thank you. Commissioner Casey.

17 COMMISSIONER CASEY: Thank you, Mr. Chairman. I
18 also want to commend the staff for their extensive work on
19 the significant deficiency rule change release and the AS 5
20 audit standard release. And I also want to extend my
21 gratitude to the board and staff of the PCAOB for their work
22 as well.

23 I believe that the SEC and PCAOB have made great
24 strides in retooling the audit standard and aligning it with
25 Management Guidance.

1 The Commission's consideration and anticipated
2 adoption of AS 5 today is an important milestone in our
3 efforts to achieve greater efficiency and cost savings under
4 404, but it is certainly not the final chapter, and we cannot
5 simply close the book, claim success and move on.

6 We have made necessary changes. It is now
7 incumbent upon us to ensure they are sufficient. Indeed, as
8 everyone has worked thus far to undue the unnecessarily
9 burdensome management and audit practices that have developed
10 from 404 I think there is also a strong recognition that much
11 work lies ahead to ensure these changes are implemented
12 effectively and achieve their purported benefits.

13 Our recent release of management guidance and
14 today's anticipated release of the new audit standard for
15 internal controls are designed to help undo much of the
16 burdensome consequences of 404 compliance; namely, they
17 should drop costs down and are targeted to give the most
18 relief to smaller issuers.

19 With the new guidance and standard, managements and
20 auditors are empowered and encouraged to approach internal
21 controls assessments and audits in a principled risk-based
22 manner.

23 Our efforts have been focused on changing existing
24 incentives and behavior so that mechanical and unnecessary
25 box checking becomes a thing of the past and rational

1 analysis by professionals and fiduciaries becomes the norm.

2 If this change happens, we should see the worst of
3 SOX 404 disappear and the best of it -- investor confidence
4 in financial statements -- apply to all companies. As we
5 have no doubt learned from our work in this area over the
6 last year among some of the key contributors to the 404
7 problems were the definition of "material weakness" and
8 "significant deficiencies."

9 I am hopefully that our recent guidance, today's
10 "significant deficiency" rule change and the new audit
11 standard fix these problems by focusing the audit on
12 identifying material weaknesses and ensuring that audits are
13 not scoped to look for all deficiencies however insignificant
14 or immaterial.

15 I have carefully reviewed comments about these
16 definitions, and while no one can be sure it appears that
17 those who most closely work with assessing the strength of
18 internal controls believe that cost savings can be achieved
19 but that in no event should these changes result in increased
20 cost.

21 Another key problem was the undue cost burden
22 expected to be borne by smaller companies when they are
23 required to comply with 404. We have received many comments
24 on AS 5, and while most are favorable in this regard
25 believing that the new standard allows sufficient flexibility

1 and risk-based judgment to scale audits to smaller companies
2 several commenters remain concerned that scalability remains
3 an unproven concept in the absence of clear definitions and
4 guidance.

5 Indeed, this remains a central challenge that runs
6 throughout our management guidance and is embraced in AS 5,
7 attempting to infuse greater judgment and flexibility through
8 a principles-based approach and avoiding detail checklists or
9 rigid guidelines to become the de facto rule.

10 I believe there is great value in a
11 principles-based approach and that we should resist returning
12 to the prescriptiveness of the AS 2 approach despite the
13 greater clarity that some commenters legitimately seek.

14 That being said we must gain confidence that
15 scalability works before subjecting smaller companies to the
16 costs of 404 and most particularly the audit requirement
17 under 404B.

18 In the course of considering our efforts and the
19 comments we have received on management guidance and on AS 5,
20 I have become convinced that further delaying implementation
21 of the 404 audit requirement at least for smaller companies
22 is necessary and appropriate.

23 Delaying the audit requirement would be the most
24 deliberate approach to ensuring that scalability and
25 alignment are met for smaller companies before requiring them

1 to bear the cost burdens of compliance.

2 Such a delay will ensure that the Commission and
3 the PCAOB will be able to monitor how larger companies are
4 faring under the new standard before subjecting smaller
5 companies to the specter of 404 that may or may not work for
6 them.

7 Indeed, it may not be possible to have a firm grasp
8 on how the changes of both the guidance and AS 5 at least for
9 larger issuers are affecting 404 implementation until summer
10 of next year at the earliest.

11 Many of the comments we have received have called
12 for "field testing," active monitoring and examination before
13 proceeding with at least the audit requirement for smaller
14 companies.

15 I believe these comments are consistent with how
16 the Commission has suggested we intend to monitor
17 implementation. The only question is what is a realistic
18 time frame to do so.

19 Accordingly, the Commission and PCAOB need to
20 remain engaged with this process to help users of this new
21 standard and our management guidance achieve the benefits
22 that we seek, and we must remain nimble and responsive so
23 that if we find that costs are not coming down and that the
24 unnecessary burdens of 404 are not lifting we can discover
25 the causes and provide a remedy.

1 This means that we must also be willing to consider
2 further revisions to this or related audit standards and
3 further guidance for management. Along those same lines we
4 must develop a plan for monitoring implementation of
5 management guidance and AS 5 so that we know whether we are
6 achieving our goals. We should consider how we will measure
7 success, when and how we should take those measurements.

8 Likewise, we should be mindful of how we influence
9 implementation of 404 through our inspections of the PCAOB
10 and through our Examination, Compliance and Enforcement
11 programs.

12 We do no greater harm than to ask the management
13 and auditors to use greater professional judgment and then
14 undermine that request by second-guessing that judgment if it
15 is reasonable. So I look forward very much to monitoring our
16 work in this area.

17 I would also note -- and actually, I have a
18 question on this point that I'll direct, but I think it is
19 worth noting that some commenters continue to believe that we
20 have eliminated the wrong opinion and that in order to fix
21 404 we should require management to conduct an assessment of
22 its internal controls and require the auditors to review that
23 assessment rather than perform an audit of internal controls
24 themselves.

25 These commenters argue it is the audit requirement

1 itself that imposes undue cost not necessary to ensuring an
2 adequate internal control regime. I believe that the
3 Commission has sought to faithfully interpret and implement
4 congressional intent on 404, and our approach reflects that.

5 Ultimately, only time will tell whether that
6 opinion that we have eliminated will assist in driving costs
7 down. I am hopeful that it will and committed to taking
8 necessary steps to do so.

9 So with that I would like to ask the question on
10 getting to some of the comments regarding eliminating the
11 wrong opinion. Can the staff respond to the rationale behind
12 it and why we're confident that the approach that we're
13 taking is the right one?

14 MS. PALMROSE: Yes. Let me review some of the
15 points I was trying to make in my opening remarks. This has
16 been an issue that we've closely considered, and the PCAOB
17 has, too. So there have been long and deep deliberations
18 over this issue, and we're quite confident that we have
19 selected the right opinion.

20 First of all, I think everybody agrees that it
21 makes no sense to have two and that that was contributing to
22 the problems and ambiguity. In fact, I will confess I taught
23 it wrong. So I was part of the problem, and it's nice to be
24 part of the solution.

25 But having said that, in all seriousness, we

1 believe that the report on the effectiveness of ICFR
2 satisfies the requirements of the Act, is what's necessary
3 from an investor protection standpoint for the auditors to
4 reach an opinion about the management's assessment and that
5 this serves important investor protection and that it also
6 has the side benefit of making very clear that the auditor is
7 not opining on management's process. So the auditor is not
8 driving management's evaluation process.

9 So it's a win/win from the standpoint of costs.
10 It's a win/win from efficiency. It's a win/win from the
11 standpoint of investor protection.

12 MR. HEWITT: I'd just like to add to that it's very
13 difficult to audit management's process as such. Every
14 company management will have a different process in terms of
15 trying to establish their internal control system, and to
16 audit that is not important.

17 What is important in the audit of internal controls
18 is for the auditor to look and find the high-risk key
19 internal control points within the system and test those
20 controls to see that they're functioning properly.

21 It has nothing to do with the process or
22 evaluation. So that's why the opinion is as we think it
23 should be so the focus is where it's important and what is
24 not important.

25 COMMISSIONER CASEY: As we monitor the

1 implementation, if we were to find that the cost savings and
2 the efficiencies that we were expecting were not being
3 achieved, would the staff make recommendations to the
4 Commission on any changes that need to be made?

5 And have we had discussions or have we spoken to
6 the PCAOB about having that kind of openness and ensuring
7 that the standard and the management guidance are working
8 effectively?

9 MS. PALMROSE: Well, at this stage, we're committed
10 to going forward with the implementation and acquiring the
11 evidence. So I don't think there has been any conclusion or
12 prejudgment about what that evidence would be or how one
13 would react to it.

14 I mean, one really has to see the evidence before
15 one comes up with proposals to respond to it, but we're very
16 optimistic, as I said, that with the guidance and with AS 5
17 that all the pieces are in place and we've rationalized this
18 process.

19 COMMISSIONER CASEY: One further question. Some of
20 the commenters raised concerns with management guidance or
21 for smaller companies understanding what's required under
22 management guidance. Clearly, it's voluntary, and we provide
23 a safe harbor if they follow it.

24 There has been some discussion here about their
25 ability to get input on how they should apply management

1 guidance and COSO also providing a framework.

2 There has also been the notion of providing greater
3 direction from the Commission or being able to be more
4 responsive in providing answers to questions that they might
5 have. There was some discussion about an ombudsman.

6 What challenges should we give consideration to in
7 providing additional guidance?

8 MS. PALMROSE: Well, first, as you did say, in
9 terms of more specificity about what an evaluation could
10 consist of, COSO has actually provided that in the guidance
11 that is available for small companies that came out I think
12 it was last June or July. And so that is available, and that
13 can be applied.

14 The staff does take calls in OCA, so we actually
15 are responding to any requests for additional information and
16 insights. So far the only request we've got is where is it,
17 and we were able to respond to those. So far we haven't had
18 questions develop, but we certainly are prepared to respond.

19 COMMISSIONER CASEY: Thank you very much.

20 MR. WHITE: As I mentioned, the Office of Small
21 Business in Corp Fin is working on this brochure that will at
22 least provide kind of a guide, I guess you would say. But of
23 course the real place to look is in management guidance
24 itself. I mean, it was written in a plain English workable
25 way so that you can --

1 COMMISSIONER CASEY: Can you speak a little bit
2 more about the guide again, about how it's going to work for
3 smaller companies that you're drafting?

4 MR. WHITE: It is, we hope, a plain English
5 user-friendly document that will help a smaller company when
6 they are confronting, I guess you would say, starting down
7 the road of management guidance of what's out there and the
8 steps they need to go through.

9 As I mentioned earlier, this was actually, I think,
10 a request of the chairman when he was testifying a few weeks
11 ago on the Hill. We thought it was a great idea, and we've
12 gone to work on it. I think we're going to be actually done
13 with it pretty soon.

14 COMMISSIONER CASEY: Great. Thank you. I have no
15 additional questions.

16 CHAIRMAN COX: Is there any other question or
17 discussion? If not, we'll move to a vote on the two
18 proposals.

19 First, does the Commission vote to approve the
20 Public Company Accounting Oversight Board's Auditing Standard
21 No. 5 and related Independence Rule 3525 and conforming
22 amendments?

23 COMMISSIONER ATKINS: Aye.

24 COMMISSIONER CASEY: Yes.

25 COMMISSIONER CAMPOS: Yes.

1 COMMISSIONER NAZARETH: Yes.

2 CHAIRMAN COX: And the item is approved. Second,
3 does the Commission vote to amend Exchange Act Rule 12b-2 and
4 Rule 1-02 of Regulation SX to define the term "significant
5 deficiency"?

6 COMMISSIONER ATKINS: Yes.

7 COMMISSIONER CAMPOS: Yes.

8 COMMISSIONER CASEY: Yes.

9 COMMISSIONER NAZARETH: Yes.

10 CHAIRMAN COX: And that matter stands approved.
11 Thank you all once again for outstanding work, and I want to
12 take this opportunity also to thank the chairman of the
13 PCAOB, Mark Olson, the entire Board and their staff once
14 again. This was very much a collaborative work over a long
15 period of time, and I think we all have a lot to be proud of.

16 (A brief recess was taken.)

17 CHAIRMAN COX: The next item on today's agenda is a
18 recommendation from the Office of the Chief Accountant and
19 the Division of Corporation Finance that the Commission issue
20 a Concept Release.

21 The purpose of the Concept Release would be to
22 obtain information about the public's interest in allowing
23 U.S. issuers, including investment companies, to prepare
24 their financial statements in accordance with International
25 Financial Reporting Standards as published in English by the

1 International Accounting Standards Board.

2 U.S. issuers, of course, currently prepare their
3 financial statements under U.S. Generally Accepted Accounting
4 Principles. The Commission has long advocated for globally
5 accepted accounting standards that are high quality,
6 comprehensive and rigorously applied.

7 As issuers and investors increasingly look beyond
8 our borders for opportunities to invest and raise capital
9 it's critical that the financial information they use to make
10 their decisions be accurate and timely.

11 Among the obstacles that must be overcome in making
12 investment decisions are the different ways in which
13 financial information can be reported. Often the differences
14 are due simply to the fact that the issuers are located in
15 different countries.

16 That's why virtually everyone -- issuers, investors
17 and stakeholders alike -- agrees that the world's capital
18 markets would benefit from the widespread acceptance and use
19 of high-quality global accounting standards.

20 Global accounting standards benefit investors by
21 allowing better comparisons among investment options and
22 increased access to foreign investment opportunities. They
23 reduce costs for issuers who no longer have to incur the
24 expense of preparing financial statements using different
25 sets of accounting standards.

1 And lower costs facilitate cross-border capital
2 formation as well as benefit shareholders who ultimately bear
3 the burden of the entire cost of the financial reporting
4 system.

5 Five years ago with the Commission's express
6 support the Financial Accounting Standards Board and the
7 International Accounting Standards Board formalized their
8 commitment to the convergence of U.S. and international
9 accounting standards.

10 More than two years ago we endorsed a roadmap that
11 will commit us to eliminating the U.S. GAAP reconciliation
12 requirement for foreign private issuers with the result that
13 eligible firms listing on U.S. exchanges could choose whether
14 to report under IFRS or U.S. GAAP.

15 Once the U.S. GAAP reconciliation requirement is
16 eliminated, if an issuer chose IFRS, it wouldn't be required
17 to reconcile the differences with U.S. GAAP just as today
18 issuers reporting under U.S. GAAP are not required to
19 reconcile the differences with IFRS.

20 In supporting convergence between IFRS and U.S.
21 GAAP, the Commission has recognized that progress could
22 result in IFRS and U.S. GAAP co-existing and even freely
23 competing in U.S. capital markets.

24 This commitment to convergence has meant that
25 issuers, markets and investors will some day have a choice,

1 because they, not the government, will decide between IFRS
2 and U.S. GAAP. It has also meant that the SEC was seriously
3 contemplating a system in which both foreign and domestic
4 issuers would someday have that choice.

5 In March, the Commission held a roundtable on IFRS
6 to assess the impact of the co-existence of two sets of
7 accounting standards on the U.S. markets, on the decisions
8 that investors make and on the Commission's program of
9 investor protection.

10 We heard from key participants in the
11 capital-raising process -- issuers, accountants, investors,
12 credit rating agencies, investment bankers and, of course,
13 lawyers -- on whether the benefits of eliminating the U.S.
14 GAAP reconciliation requirement for foreign private issuers
15 are, in fact, achievable in practice, and their responses
16 were resoundingly positive.

17 Today, nearly 100 countries require or allow the
18 use of International Financial Reporting Standards. Since
19 2005, when the European Union mandated the use of IFRS for
20 public companies in all of its member states, the Commission
21 has received a significant volume of financial statement
22 filings using IFRS from foreign private issuers.

23 Likewise, U.S. investors, analysts and others who
24 rely on these issuers' financial statements are becoming
25 increasingly familiar with IFRS.

1 In light of these developments and our roundtable,
2 the Commission last month proposed to eliminate the
3 requirement that foreign private issuers who submit financial
4 statements prepared using IFRS also submit a reconciliation
5 of those financial statements to U.S. GAAP.

6 This proposal, if adopted, would result in the
7 co-existence of two different sets of accounting standards in
8 the U.S. capital markets.

9 This morning we're considering publishing a staff
10 Concept Release that solicits public comment on the future
11 role of IFRS in U.S. markets and asks whether U.S. issuers
12 should be permitted to use IFRS for purposes of complying
13 with our rules and regulations.

14 In some respects, this is a mirror image of
15 allowing foreign private issuers to file IFRS financial
16 statements without reconciling their financial statements to
17 U.S. GAAP, because it would give U.S. issuers the same choice
18 that foreign private issuers would have.

19 This concept would also touch potentially every
20 aspect of the U.S. capital markets from how U.S. accountants
21 are educated and trained to how U.S. issuers prepare their
22 financial statements, to how U.S. investors understand
23 financial statements and to how accounting standards are
24 developed and interpreted to apply to U.S. companies.

25 The purpose, then, of this concept release is to

1 solicit views from a broad range of investors, issuers and
2 other market participants on the benefits and the costs and
3 the advantages and the disadvantages of allowing U.S. issuers
4 to report using IFRS.

5 This public feedback will be enormously valuable to
6 the Commission. In addition, many countries have already
7 made the change from their home country GAAP to IFRS, and we
8 would be particularly interested in hearing from issuers and
9 regulators and other affected parties in these jurisdictions
10 to understand and learn from their experience.

11 Before I recognize Conrad Hewitt and John White to
12 lead the discussion of the staff's recommendation for
13 soliciting that feedback through the proposed concept release
14 I want to thank the staffs of the Office of the Chief
15 Accountant and of the Division of Corporation Finance for
16 your excellent work, in particular, Julie Erhardt, Jim
17 Kroeker, Katrina Kimpel, Joe Ucuzoglu, Jeff Ellis, Stephen
18 Brown, Mark Barton, Craig Olinger, Paul Dudek, Michael Coco
19 and Sondra Stokes.

20 I also want to thank Ethiopis Tafara and Sarah Otte
21 from the Office of International Affairs, Richard Sennett
22 from the Division of Investment Management and David
23 Fredrickson and Zachary May from the Office of the General
24 Counsel.

25 So now I will turn it over to Conrad Hewitt and

1 John White.

2 MR. HEWITT: Thank you, Chairman Cox and members of
3 the Commission. It is truly amazing for an accountant that
4 has been in the business for as long as I have to present to
5 you today a proposed concept release to allow U.S. issuers to
6 prepare their financial statements in accordance with IFRS
7 instead of U.S. GAAP.

8 When I began my career, it was a big deal during
9 the course of any international work just to communicate with
10 or visit others around the world. There was no thought of
11 there being a practical way to work with the same set of
12 accounting standards across borders.

13 I am pleased that not only are we considering it,
14 but many others are as well throughout the world. I realize
15 this is the case only by virtue of the work you cited of both
16 the Commission and many other parties over the years.

17 All of these efforts have put me in a position
18 where I, as Chief Accountant, think that it's appropriate at
19 this time to recommend that the Commission ask investors,
20 issuers, auditors and other market participants to help the
21 Commission's exploration work by providing their views on the
22 possibility of an IFRS option for use by U.S. issuers in
23 preparing their financial statements for the purpose of
24 complying with the rules and regulations of the Commission.

25 The draft Concept Release that you have before you

1 is the document by which I recommend that the Commission seek
2 this input over approximately the next 90 days.

3 Please let me emphasize that I see this Concept
4 Release as just that, an information-seeking document, and it
5 does not conclude that U.S. issuers should be permitted to
6 report under IFRS much less provide a timeline.

7 Rather, among other things, the Concept Release
8 describes and asks several questions about, A, the
9 convergence work that has been underway for the past five
10 years to align the content of IFRS and U.S. GAAP;

11 B, the appropriateness of exploring the possibility
12 for U.S. issuers to have that option to report under IFRS
13 while the convergence work continues and;

14 C, lastly, the effects on the obvious parties,
15 investors and issuers, but also on other parties such as
16 educators, auditors, specialists such as actuaries,
17 regulators that are not security regulators and other market
18 participants whose work would be impacted by implementing
19 such an IFRS option.

20 It does not take very long in thinking about each
21 of these aspects of this policy matter for many questions to
22 come to mind since the U.S. capital markets have not
23 previously experienced the wide use of two different sets of
24 accounting standards by issuers.

25 The Concept Release would pose all those questions,

1 and I am sure commenters will let us know if we forgot one or
2 two.

3 Now, before I turn it over to John White, Director
4 of the Division of Corporation Finance, I certainly want to
5 express my thanks to all the members of our staff who have
6 worked hard to think about these matters and prepare this
7 Concept Release.

8 And I would like to especially mention to my left
9 here Rick Sennett, Chief Accountant for the Division of
10 Investment Management who is here with me at the table, for
11 the contributions of his group with respect to working to
12 make this Concept Release inclusive of the interests of the
13 possible use of IFRS by investment companies.

14 I will now turn it over to John.

15 MR. WHITE: Thank you, Conrad. Good afternoon,
16 Chairman Cox, Commissioners. As Conrad discussed, the
17 purpose of this Concept Release is to raise a series of
18 questions to solicit public input on the possibility of
19 allowing U.S. issuers to present their financial statements
20 prepared in accordance with IFRS as published by the IASB
21 instead of in U.S. GAAP in their filings with the Commission.

22 Last month we were before you, and the Commission
23 approved a proposal that we made for providing for specific
24 rule changes which would allow foreign private issuers to
25 present in their filings with the Commission financial

1 statements prepared in accordance with IFRS without
2 reconciling those financial statements to U.S. GAAP.

3 That proposal was a critical and dramatic step
4 towards the regulatory framework that we're looking out
5 towards of a single set of high-quality comprehensive global
6 accounting standards.

7 And as I guess I've said many times, consistent and
8 faithfully applied comprehensive global accounting standards
9 will provide investors with an enhanced ability to compare
10 companies and will serve to improve confidence in our
11 markets.

12 So, all of this that I've described was the primary
13 focus of a staff roundtable on IFRS that we held last March
14 where I think most of us that are here today were at that
15 roundtable.

16 What we're presenting to you today in the form of a
17 Concept Release is, I think it's really fair to say, is an
18 even more dramatic step than what you did last month, because
19 last month what you did related to certain foreign private
20 issuers.

21 Today we are talking about the possible choice to
22 use IFRS by any U.S. issuer. We're talking about tenfold the
23 number of companies that this would be available to.

24 If the Commission were to provide U.S. issuers with
25 a choice to include financial statements prepared in

1 accordance with either U.S. GAAP or IFRS, issuers would need
2 to carefully consider that choice.

3 We recognize that not all U.S. issuers would choose
4 to use IFRS. Some, including those that do not have a
5 significant customer base or operations outside the United
6 States, would likely continue to present their financial
7 statements prepared in accordance with U.S. GAAP in their
8 filings with us.

9 I think many of those companies are likely to be
10 the smaller companies that would continue to stay with U.S.
11 GAAP.

12 We recognize that providing U.S. issuers with this
13 choice would allow them to use one of two different sets of
14 accounting standards, and while this is a necessary step
15 along the road to global accounting standards, it does mean
16 that we would have two sets of accounting standards out there
17 that would have equal standing, that would be co-existing in
18 our capital markets.

19 Now, we recognize that this ability to use IFRS
20 could benefit U.S. issuers in our ever increasing global
21 capital marketplace, but we also recognize that investors and
22 other market participants would need to understand and work
23 with both IFRS and U.S. GAAP while comparing U.S. issuers,
24 particularly since we expect many U.S. issuers would
25 continue, as I said, to elect to stay with U.S. GAAP.

1 We need public input and believe this is the
2 appropriate time to go out and seek that input, and that is
3 why we're recommending this Concept Release to you.

4 We're very interested in all of the views on the
5 questions that we pose and, as Conrad alluded to, there are a
6 lot of questions in this release, particularly, or including,
7 I guess I would say, the questions related to when any
8 potential change in reporting requirements might occur and
9 how that should be implemented. So I think this is just a
10 very exciting time to see this release and to get it out
11 there to start the dialogue.

12 Finally, in closing, I'd like to echo the
13 Chairman's and Conrad's recognition of the staff's work in
14 preparing the release. I guess I at this time need to go
15 through the names myself, so I guess I will.

16 I want to individually recognize again in the
17 Office of Chief Accountant Julie Erhardt, Katrina Kimpel,
18 Gina Evan, Jim Kroeker and now I have the benefit of calling
19 him by how all of us refer to him, Joe U. I stumble less
20 with Joe U.

21 And in the Division of Corporation Finance, Craig
22 Olinger, Sondra Stokes, Paul Dudek and Michael Coco and of
23 course Rick Sennett in IM all for their invaluable
24 contributions and I guess I would even say for their global
25 vision in presenting this matter to you.

1 I guess I'd actually have to say that almost every
2 one of the people that I've named has spent a lot of personal
3 time with me teaching this topic to me and helping me
4 understand it, and I really want to say thank you to everyone
5 who has helped me with this process.

6 With that I'll turn it over to Katrina.

7 MS. KIMPEL: Thank you. The Office of the Chief
8 Accountant and the Division of Corporation Finance recommend
9 that you publish for public comment a Concept Release to
10 elicit the public's interest in allowing U.S. issuers to
11 prepare financial statements in accordance with International
12 Financial Reporting Standards as published by the
13 International Accounting Standards Board for purposes of
14 complying with the rules and regulations of the Commission.

15 The purpose of the Concept Release is to seek
16 information about the potential effects that any such change
17 may have on investors, issuers and market participants as
18 well as the accounting profession generally.

19 The Concept Release describes the Commission's past
20 consideration with respect to reducing disparity between the
21 accounting and disclosure practices of the United States and
22 other countries as a means to facilitate cross-border capital
23 formation while providing adequate disclosure for the
24 protection of investors and the promotion of fair, orderly
25 and efficient markets.

1 Accounting standard-setters have been encouraged to
2 do the same as demonstrated by the Financial Accounting
3 Standards Board and the IASB being committed for the last
4 several years to the convergence of U.S. GAAP and IFRS.

5 The Concept Release includes questions about
6 whether the Commission should allow U.S. issuers, including
7 investment companies, to prepare financial statements in
8 accordance with IFRS as published by the IASB, including the
9 anticipated effects on the U.S. public capital market of
10 doing so and not doing so.

11 If the Commission were to allow U.S. issuers to
12 file financial statements prepared using either IFRS as
13 published by the IASB or U.S. GAAP there would be
14 implementation matters. For example, the Concept Release
15 includes questions about the need for education in IFRS for
16 financial statement users.

17 We also are interested in the issues that would be
18 encountered by U.S. issuers and their auditors in the
19 application of IFRS in practice and existing Commission
20 requirements.

21 Additionally, we are interested in what issuers
22 believe the cost of converting from U.S. GAAP to IFRS would
23 be. We are recommending that this Concept Release be open to
24 public comment for a period of 90 days after its publication
25 in the Federal Register.

1 Thank you, and we are prepared to answer any
2 questions that you may have.

3 CHAIRMAN COX: Thank you very much. And thank you
4 especially, Joe Ucuzoglu. I can say it often and proudly.

5 MR. WHITE: I've never been able to say it.

6 CHAIRMAN COX: Thank you, Katrina. Thanks to
7 everyone who presented. Let me just start by jumping on a
8 point that you began to discuss about who might be interested
9 in a voluntary system in electing the use of IFRS.

10 For most of America's public companies,
11 particularly smaller public companies, almost any change in
12 regulation is viewed as a cost. They're not leaping to move
13 from Windows XP to Vista, and I don't imagine them all lining
14 up to be early adopters to completely change over their
15 entire accounting system.

16 So why would any mid-cap or small cap company
17 volunteer to use IFRS? And to put it the other way, will any
18 U.S. issuers want to prepare their financial statements in
19 accordance with IFRS, and why?

20 MR. WHITE: Why don't I at least start with some of
21 my experiences at least. And I guess I will have to say that
22 companies that have talked to me have been largely the large
23 multinational companies, and there seems to be a great deal
24 of interest among them in this possibility.

25 The two reasons that they cite are that they

1 believe it will be a lower cost and lower burden in preparing
2 their financial statements because they're already following
3 IFRS in their foreign operations, their foreign subsidiaries
4 and that they think it will be much more efficient for them
5 to be able to just prepare their financials in one standard.

6 The other obvious benefit is in terms of access to
7 capital. If other companies in their industry are also
8 reporting in IFRS, then they may well want to be able to
9 report in the same method, basically, as their competitors.
10 And so particularly if they're competing internationally, at
11 least listening to the larger companies they would like that
12 benefit.

13 I can't say I really heard it from the smaller
14 companies. At least in my experience, they have not been at
15 our door in the same way. Conrad, and Julie, you may have
16 talked to smaller companies as well.

17 MR. HEWITT: And I'll just add on to what John has
18 said. We do know there is large multi-global U.S. companies
19 that have adopted IFRS throughout the world because it's
20 easier to consolidate their financial statements monthly and
21 quarterly and annually.

22 And it would make a lot of sense for those
23 companies to certainly look at this option and adopt it if
24 they're using it worldwide already and not in the U.S. In
25 essence, they're maintaining two sets of very expensive

1 accounting records.

2 Moving on down the chain to the mid-caps and small
3 companies there's a large number of them that operate
4 throughout the world and have operations and divisions and
5 subsidiaries and plants, and so forth.

6 These are not just sales offices, but these
7 companies will have a more difficult time to move to this
8 option, because you have to have a CFO, you need a
9 controller, you need accounting staff in the U.S. that
10 understands IFRS and how to apply them. And that does not
11 exist today.

12 So it will take a while for those companies, and
13 these companies, by the way, are using U.S. GAAP throughout
14 the world as much as they can get by with. They'll be
15 required by statutory -- requirements of audit companies to
16 provide statutory audits, but they're still using U.S. GAAP
17 worldwide.

18 CHAIRMAN COX: On the subject of two systems
19 co-existing, which would be a prospect of a voluntary choice
20 between one or the other systems, isn't it essentially the
21 case we've already got that?

22 Once we lift the reconciliation requirement you've
23 got every foreign private issuer with the choice, and we can
24 imagine what that choice will be for foreign issuers, to use
25 either IFRS or U.S. GAAP.

1 They file with us their financial statements that
2 investors get to consume are prepared using IFRS. So
3 investors and analysts and we are already in the position of
4 looking at both operating already in our markets; isn't that
5 right?

6 MR. HEWITT: That's very true. IFRS is becoming
7 very popular throughout the world. Right now there is over
8 100 countries that have adopted IASB standards, and there's
9 more moving towards that direction.

10 We know Canada is moving towards that direction.
11 We met with them last month on this subject. Korea, which
12 their GAAP is very similar to our U.S. GAAP, they have told
13 us that they are moving to IFRS.

14 So the analysts and investors here in the U.S. and
15 throughout the world are becoming more and more accustomed
16 and understand IFRS as being used in the financial statement
17 reporting process.

18 And that's important, because I think it will
19 be -- it's already widely accepted, as you say, and I think
20 it will be easy for the more sophisticated investors to
21 accept IFRS financial statements. Maybe the retail
22 investors, the small ones who never understand U.S. GAAP
23 anyway because it's so complicated in certain areas, won't
24 care.

25 So I think it's here, and there will be some -- it

1 will take a while for everybody to get used to these types of
2 standards in the U.S.

3 MS. ERHARDT: I was just going to add I think the
4 point of your question is, in essence, what brings us here
5 today, which is if we, the staff, did nothing about U.S.
6 issuers using IFRS, in substance, doing nothing is doing
7 something, and it's precluding the use.

8 And as a result, if the proposal goes forward for
9 foreign issuers, we are indeed having a dividing line in our
10 market where the two GAAPs co-exist based on country of
11 incorporation outside the U.S., and they don't co-exist for
12 U.S. issuers.

13 So really, I think what's behind the staff's
14 thinking is by doing nothing you're making that dividing
15 line, and how do we know that dividing line is the right one?
16 How do we know that the co-existence dividing line should be
17 foreign choice, U.S. not?

18 So we don't know, and so this Concept Release, in
19 essence, elicits comment to say maybe that doesn't make
20 sense. Maybe it does, but we'd like to know. As opposed to
21 just continuing business as usual and by default having that
22 dividing line.

23 CHAIRMAN COX: If the dividing line is as you
24 describe, a choice of accounting systems based on your
25 jurisdiction of incorporation and that would be the regime

1 administered in the United States, might that, in fact, not
2 be an incentive for people to pick up and reincorporate,
3 leave America and come back as a foreign company?

4 MS. ERHARDT: Yes, and hence we're here today to
5 solicit input.

6 CHAIRMAN COX: Just one last question. We recently
7 announced the creation of a committee on improvements to
8 financial reporting. Are they going to look at some of these
9 questions, too?

10 MR. HEWITT: Yes. There will be, basically, five
11 segments that they'll be looking at, the five working groups.
12 And one of them is on the international convergence, and is
13 that model better than some of the the models that we're
14 using in the U.S.

15 They will have an observer present from IASB.
16 They've already named that observer. We're hoping that what
17 we do in this improvement to the financial reporting process
18 that they'll take it back and also do the same thing over in
19 Europe.

20 CHAIRMAN COX: Thank you. I don't have any further
21 questions. Commissioner Atkins.

22 COMMISSIONER ATKINS: Thank you, Mr. Chairman.
23 Just over a month ago we voted to propose that foreign
24 private issuers be permitted to file their financial
25 statements with us using IFRS without reconciling to U.S.

1 GAAP.

2 At that meeting, I asked Julie Erhardt when we
3 would see a Concept Release on whether U.S. issuers should be
4 able to file their financial statements using IFRS. Julie
5 promised to turn to that task as soon as possible, and so
6 here we are. That's great.

7 I congratulate you, Julie and Katrina Kimpel, Craig
8 Olinger, Sondra Stokes and others who have worked so hard to
9 make it possible for us to consider this release today.

10 Once we start down the road of considering whether
11 foreign private issuers can file in IFRS without
12 reconciliation, the natural question, as you were just
13 talking about, arises of whether U.S. issuers should be able
14 to do the same.

15 Some have even taken it one step further and
16 suggested that we mandate the use of IFRS by U.S. issuers.
17 Indeed, one of the panelists at our IFRS roundtable last
18 March suggested just that, a former chief accountant.

19 As more and more countries switch to IFRS the
20 pressure is likely to build on the U.S. to do the same or, at
21 a minimum, to permit it as an alternative. If IFRS becomes
22 the dominant standard, it may not be in our best interests to
23 try to swim against the tide.

24 Of course, if IFRS is not applied consistently
25 across the countries in which it's adopted, there will be

1 less of an appetite here for moving to such a standard.

2 Before taking any definitive steps, however, I
3 think it's important to look at all of the considerations
4 that apply uniquely to U.S. companies. We also must
5 thoroughly consider the direct and indirect costs of opening
6 the door to the use of IFRS by U.S. issuers.

7 The comments that we receive in response to our
8 Concept Release will assist us in determining whether to go
9 forward and, if so, how and when to do so.

10 We also will gain useful information by observing
11 how IFRS is used in practice and by participating in
12 international efforts to achieve consistency.

13 So I look forward to hearing from a wide range of
14 commenters in response to the many questions in the Concept
15 Release. One thing I should note is that input from the
16 Office of Economic Analysis will be important as we decide
17 how to proceed.

18 We will not have the benefit, unfortunately, of
19 Chester Spatt's insights. Today marks Chester's final open
20 meeting. So thank you, Chester, for all of your
21 contributions to the work of the SEC during your tenure here.

22 I just have a few questions. One, are there
23 certain types of U.S. companies for which you believe there
24 to be particular pressure to shift to IFRS?

25 MR. HEWITT: I'll go ahead. John mentioned a

1 couple items on that point. Yes. There are particular
2 industries, such as the financial institution industry, where
3 IFRS is very prevalent throughout the world.

4 U.S. large banks like J.P. Morgan, investment
5 companies will agree to have to look at it and say, you know,
6 "The rest of our competitors are using it, and it's difficult
7 not for us to use it and be competitive in the capital
8 markets throughout the world." So those types of companies
9 certainly.

10 And then, as I said before, the large multi-global
11 companies are using it now throughout the world and not in
12 the U.S., but they definitely would want to consider it.

13 COMMISSIONER ATKINS: Are there any industries or
14 sub-industries where you think it's already a competitive
15 issue for us, or is it too new?

16 MR. WHITE: I thought it was mentioned at the
17 roundtable that the airline industry was an industry that
18 U.S. companies would be quite likely to migrate to IFRS.
19 Were there other industries mentioned, Julie? That's the one
20 I remember.

21 MS. ERHARDT: No, not by name. But I think
22 generically, think of any industries where maybe the larger
23 players are domiciled outside the U.S. They would probably
24 be the first to coalesce, if you will, because they're the
25 furthest where the industry players would have moved along to

1 IFRS from other countries.

2 Whereas, in industries where the larger players
3 perhaps are more concentrated in the U.S., perhaps less of
4 the industry has moved due to developments overseas, so maybe
5 that would be a little slower to have an interest.

6 MR. WHITE: One of the things that the securities
7 analyst and the rating agency participant at the roundtable
8 said was that in industries where they analyze in IFRS they
9 take the U.S. GAAP numbers and, basically, convert them over
10 to IFRS in their analysis, in any event, today or as best
11 they can. Don't always have all the information you need.

12 COMMISSIONER ATKINS: Right. One aspect of it,
13 too, is to build competency here. So are U.S. universities
14 starting to go down that line of teaching the differences
15 between GAAP and IFRS? Obviously, discussions like this will
16 help encourage that, I suppose.

17 MR. HEWITT: No, they have not. I gave a speech at
18 the University of Washington about two month ago, and I
19 indicated that the international convergence, for example, is
20 moving along, and it was going to be possible some day in the
21 world there might be just one global standard-setter some day
22 many years away.

23 I urged them to start teaching IFRS in their
24 classroom. One of the problems is there's not even a
25 textbook as such yet. I'm sure they are being developed now,

1 but it takes a long time to get all this stuff moving.

2 And then the final end of this whole process is in
3 the U.S. here it has to be on our uniform CPA examination in
4 the 50 states. There are no questions on the exam today
5 concerning IFRS.

6 COMMISSIONER ATKINS: Right.

7 MR. HEWITT: There has to be in the future.

8 MS. ERHARDT: I was just going to say on a
9 practical level in two weeks Jim Kroeker and I are speaking
10 before the annual meeting of all the accounting professors in
11 the United States. So we will definitely cover this matter
12 and encourage them.

13 MR. WHITE: One group that I do think is moving
14 forward are the large accounting firms. I mean, in
15 discussions with them they are working quite hard on this.

16 COMMISSIONER ATKINS: That's good. Okay. Thank
17 you very much.

18 CHAIRMAN COX: Thank you. Commissioner Campos.

19 COMMISSIONER CAMPOS: Thank you. I'm also pleased
20 to support the Concept Release. I'd like to thank the Office
21 of Chief Accountant, the Division of Corporate Finance, the
22 Office of International Affairs and all the individuals that
23 are mentioned for all of their hard work.

24 Obviously, this Concept Release follows on the
25 heels of our release in which we propose to eliminate the

1 U.S. GAAP reconciliation requirement for foreign private
2 issuers who file financial statements prepared in accordance
3 with IFRS as published by the IASB.

4 Given that we have proposed allowing foreign
5 issuers to use IFRS without reconciliation this at least
6 raises a question of whether we should also, to provide
7 symmetry, allow U.S. issuers to also use IFRS.

8 That said, I don't want to minimize the fact that
9 allowing domestic U.S. issuers to use IFRS would be a very
10 significant policy decision. There are many theoretical and
11 practical issues that must be addressed before we actually
12 take such a step.

13 It does, however, seem appropriate to at least
14 present the issue for public comment in such a Concept
15 Release.

16 Over the past few years there has been increased
17 focus on the use of IFRS around the world and in particular
18 in Europe. In just a few years, the Commission has seen a
19 substantial increase in the number of filings containing
20 financial statements prepared in accordance with IFRS from
21 just a few in 2005 to over 100 in 2006.

22 That said, it is not clear how much thought and
23 attention issuers, investors and other interested parties in
24 the United States have given IFRS. Indeed, even the
25 Commission's recent proposal to allow foreign private issuers

1 to file financial statements prepared in accordance with IFRS
2 without a reconciliation is tailored to the needs of foreign
3 issuers.

4 The importance of today's Concept Release,
5 therefore, is that it seeks to highlight the use or the
6 potential use of IFRS in the United States. As with the
7 proposed release we issued last month, though, we need to
8 make sure that there are no unintended consequences of our
9 actions.

10 For example, it is important that allowing U.S.
11 issuers to use IFRS would not remove the incentive for
12 convergence between IFRS and U.S. GAAP. As I stated
13 previously, I hope that this would not occur because there
14 are huge benefits for convergence.

15 So it is imperative that we continue to be vigilant
16 with respect to the ongoing IASB and FASB convergence project
17 and ensure that it continues to move forward.

18 Protection of U.S. investors is also paramount. We
19 need to ensure that allowing U.S. issuers to prepare
20 financial statements in accordance with IFRS serves this
21 goal. There has been a great deal of talk about the fact
22 that IFRS is more principles based as compared to U.S. GAAP,
23 which is supposedly more rules based.

24 While I think this is an over simplification, the
25 critical issue is ensuring that accounting standards, be they

1 principle based or rule based, are specific enough to help
2 guide conduct in a way that protects investors yet promotes
3 and facilitates capital formation.

4 In my opinion, at least some degree of specificity
5 is required if one wants to hold people accountable for their
6 actions.

7 I have just a few questions. We've already
8 proposed to eliminate the reconciliation requirement for
9 foreign issuers, so presumably in one short year or so we
10 will be tasked with evaluating the disclosures pursuant to
11 IFRS by foreign issuers who are listed here in the U.S. and
12 judge the reporting under IFRS.

13 I take it that our agency is making arrangements to
14 have expertise to do this and to understand whether
15 enforcement -- hopefully, that's the very, very few
16 situations -- is needed. Is that correct?

17 MR. WHITE: Well, without speaking to the
18 enforcement part, in terms of the internal efforts, I mean,
19 we've already done that.

20 We went through starting the summer of a year ago
21 training, basically, I think everybody across OCA and across
22 Corp Fin, I mean, all the accountants within the agency,
23 because we started a really significant review process of all
24 of the first-time IFRS filers where their 20-Fs came in a
25 summer a year ago.

1 And that review project was, basically, completed
2 in June, and there is actually posted on the web site -- I
3 guess it came out after the meeting in June -- of a short,
4 I'll call it a summary, report from OCA and Corp Fin laying
5 out what we found in those reviews plus, by the way, links to
6 all of the Comment Letter correspondence that has now been
7 posted.

8 We've had a lot of people working first trained and
9 taught and spent a year on this project. We're, obviously,
10 now, in some cases, looking at the second year of filings
11 that have come in from these companies.

12 We're probably well ahead of most everybody else.
13 Is that fair to say, Julie, or not?

14 MS. ERHARDT: Well, I'm not exactly sure who
15 everybody else is. I can speak, perhaps, with respect to our
16 interactions with securities regulators who have jobs like we
17 have in other jurisdictions through IOSCO, the International
18 Organization of Securities Commissions, which the Commission
19 is a member.

20 In particular, they have a subcommittee on
21 Accounting and Auditing Disclosure which I happen to chair,
22 and certainly through the meetings all over the world
23 face-to-face, four-day meetings with our counterparts we
24 certainly have a very good sense from those who are from
25 jurisdictions that are further down the path in implementing

1 IFRS as to what they've been through, what issues they're
2 facing, how they are handling them.

3 So we sort of have an insider's view through our
4 interaction with other regulators as to what's in store and
5 where the rough spots might be. So that has certainly helped
6 form the work that John described, and I envision those
7 relationships and what we can take away and contribute to
8 them will certainly guide our work going forward.

9 MR. HEWITT: I just might add finally on that
10 question that after the first round of filings that we've
11 only had two real difficult issues of differences in
12 understanding how they applied IFRS out of a couple
13 hundred.

14 And we have good experience in doing that, so I
15 think we won't be doing anything differently when the U.S.
16 firms and everybody else starts using IFRS.

17 COMMISSIONER CAMPOS: Well, I'm sure investors will
18 be very reassured that we are on top of our game and that we
19 seem to have all of the experts in the U.S. on IFRS within
20 the particular agency, seeing as no one else has really
21 gotten to it.

22 Let me ask another question, and that is that we've
23 recently been asked or at least the question has been posed
24 that the U.S. insisting, our agency insisting that IFRS in
25 terms of foreign issuers be the IFRS that's issued or

1 promulgated by the IASB and not what may be adjusted by
2 different jurisdictions such as the EU that by so requiring
3 we are meddling in sovereign concerns.

4 And I am wondering if that is an issue over time.
5 What does it mean to domestic issuers in terms of what
6 version of IFRS they will use? If they want to get the
7 benefit of IFRS and they use the version that we find
8 acceptable on our shores, which is what is being published by
9 the IASB, but Europe has something different and has
10 carve-outs and Australia has carve-outs and Asia has
11 carve-outs, how are we going to reconcile that, and why is
12 that an advantage?

13 It seems like we will then have various versions of
14 IFRS and possibly various versions of standards yet again.

15 MR. WHITE: Well, we won't have various versions in
16 the U.S. reporting, because foreign private issuers will be
17 required to follow the IASB version, and U.S. issuers would
18 be following the IASB version. So at least at that level you
19 wouldn't have different standards.

20 MS. ERHARDT: I think it's a little better than
21 that in the sense that, to my knowledge, the countries that
22 have moved to IFRS, while they may have carved out and
23 created options locally, at the same time they have not
24 precluded use of IFRS in the form issued by the IASB.

25 So what we're proposing, which is to have issuers

1 prepare under IFRS as issued by the IASB, in essence,
2 dovetails with the same type of approach other countries have
3 gone, to allow it.

4 The step that they've taken that you refer to is
5 after some experience under their belt they've, for various
6 reasons, found the need to make certain provisions optional
7 but not preclude use of IFRS as published by the IASB.

8 I have no way of knowing what those pressures are
9 and if they have any analogy to what we experience in the
10 U.S. and if we were to get to the point of accepting IFRS for
11 U.S. issuers whether we might feel the same. That's a
12 question I can't possibly predict.

13 I think in pursuit of the idea that a company and
14 their investors can work with one set of standards globally
15 the same content, and, in essence, your financial statements
16 can serve as a passport to various markets, and your
17 investors will see the financial statements whether they buy
18 your shares, you know, in London or in the U.S., that is
19 coalescing, we think, around IFRS as published by the IASB.

20 So the national versions, while they may serve
21 national purposes, doesn't shut out the idea that the global
22 passport would coalesce around the version that the IASB
23 issues, and, in essence, that's the aspect of the policy
24 matter that we're pursuing.

25 COMMISSIONER CAMPOS: So we don't need to worry

1 about that?

2 MS. ERHARDT: I'm not stressed.

3 COMMISSIONER CAMPOS: Okay. I'm sleeping well at
4 night, too. All right. These are interesting issues, and I
5 guess, if there are concerns, we'll certainly hear from
6 commenters on this.

7 Again, I think it's a worthwhile release. It's
8 timely. It's not often that we get a chance to think ahead
9 and anticipate issues. Certainly, regulators are always
10 accused of not anticipating.

11 I think this is one case where we are, and we're
12 actually asking, at least domestic players, to get involved
13 and to give us their thoughts about this, which I think is a
14 very, very good move. Thanks.

15 CHAIRMAN COX: Thank you. Commissioner Nazareth.

16 COMMISSIONER NAZARETH: Thank you. I'd like to
17 thank the Office of Chief Accountant and the Division of
18 Corporation Finance whose staffs have worked extremely hard
19 in crafting this release.

20 This topic was part of a discussion at our March
21 2007 roundtable, and I'm interesting in hearing from a wider
22 pool of commenters about the idea and especially about the
23 timing of any possible proposal.

24 While I think that the idea of allowing U.S.
25 issuers to file using IFRS is appealing and may be

1 appropriate at some point in the future, we must carefully
2 think through all of the implementation issues and all the
3 implications before making a proposal in this area.

4 In particular, we might want to wait until we have
5 gained greater experience with foreign issuers using IFRS
6 before proposing it as an option for U.S. issuers.

7 As I said at our open meeting last month, investors
8 need high-quality comparable financial information to make
9 informed investment decisions.

10 Allowing U.S. issuers to file using IFRS, as with
11 last month's proposal to eliminate the U.S. GAAP
12 reconciliation requirement for foreign private issuers filing
13 using IFRS would mean that investors would need to be
14 familiar with two sets of accounting standards, U.S. GAAP and
15 IFRS as published by the IASB.

16 I'm interested in hearing from commenters about
17 whether this is a significant burden for investors or not.
18 The IASB is a standard-setter that is outside of the
19 Commission's regulatory jurisdiction. I'm interested in
20 learning what impact commenters think this should have on
21 whether the Commission should accept IFRS filings from U.S.
22 issuers.

23 I'm also very interested in what commenters expect
24 the impact of such a proposal on the convergence process
25 between U.S. GAAP and IFRS. Would there still be an

1 incentive to continue convergence if U.S. filers are allowed
2 to file using IFRS?

3 What would be the impact on U.S. GAAP? Is the
4 convergence process far enough along to allow U.S. issuers to
5 file using IFRS?

6 I would hope that our actions would not slow or
7 halt the convergence process, because I think that investors
8 would greatly benefit if we can achieve a high-quality global
9 set of standards used consistently throughout the world.

10 So again, thank you for your continued hard work,
11 and I look very forward to hearing from all parties about how
12 they think that the Commission should proceed in this area
13 and on what time frame.

14 Again, I do think that it's a very fulsome release,
15 a huge amount of questions, very, really, ideal way frame the
16 dialogue so that we can get significant input.

17 I just have one or two questions some of which
18 relate to those that I've, hopefully, inspired some of the
19 public to respond to.

20 One is that the Commission's relationship with
21 IASB, obviously, is quite different from our relationship
22 with FASB. How do you think that should impact our
23 consideration on whether U.S. filers should be able to file
24 using IFRS?

25 MS. ERHARDT: I think it's a relevant

1 consideration. In other words, in the end of the day, the
2 Commission has responsibility for the accounting and
3 disclosure practices that registrants use.

4 Certainly, in carrying out that responsibility in
5 the U.S. for many, many years, we have looked to the private
6 sector to help us execute that.

7 But helping us execute does not change the fact
8 that ultimately we are responsible, and therefore we can't
9 help but make very relevant to our considerations what our
10 relationship is with the private sector body that's doing the
11 work, whether it be the Financial Accounting Standards Board
12 or, under this idea, the International Accounting Standards
13 Board.

14 So it certainly is a matter that we are
15 considering. It's certainly a topic that we propose the
16 Concept Release solicit some feedback on.

17 But having said that, I'd also like to say that the
18 International Accounting Standards Board is not an unknown
19 commodity to us.

20 Certainly, through the Commission's work for many
21 years on promoting reducing disparity in accounting standards
22 the staff have worked with the International Accounting
23 Standards Board, its predecessor the committee to develop the
24 standards.

25 And the Concept Release describes the nature of our

1 interactions and our service on their advisory council,
2 participation at their interpretation committee meetings, our
3 monitoring their projects in the same manner that we do those
4 of the Financial Accounting Standards Board, our work through
5 IOSCO with whom they do consult in some of their selections
6 of trustees, et cetera.

7 So there is a large degree of interaction, but that
8 does not change the fact that, as you acknowledge, it is
9 different, and it's certainly something that we are
10 considering.

11 COMMISSIONER NAZARETH: And again, those
12 differences go to also investors' ability to understand the
13 financial statements since they have no experience with IFRS.
14 Again that would, I assume, be another important
15 consideration.

16 MS. ERHARDT: Very much so. Education, when people
17 say that, maybe immediately they tumble to thinking
18 accounting classrooms and accounting professors and future
19 accountants.

20 The release tries to put first order of business
21 investors understanding of IFRS, because if they have
22 concerns about their level or their ability to understand,
23 that's first and foremost what we want to know about.

24 Then, certainly, it's not unimportant whether those
25 accountants preparing the financial statements understand it

1 as well. If investors see rough spots in working with the
2 product, that's first and foremost what we'd like to
3 understand.

4 COMMISSIONER NAZARETH: Okay. Thank you.

5 CHAIRMAN COX: Thank you. Commissioner Casey.

6 COMMISSIONER CASEY: I'm also very pleased to
7 support the issuance of this Concept Release. Last month we
8 published a proposal to eliminate the reconciliation
9 requirement to U.S. GAAP for foreign private issuers that
10 file financial statements in the U.S. prepared on the basis
11 of the IASB version of IFRS.

12 Given that proposal, issuing a Concept Release to
13 solicit broad comment on whether U.S. issuers should be
14 offered a similar choice is a logical and appropriate next
15 step.

16 The purpose of such a Concept Release would be to
17 seek comment on whether U.S. issuers should be afforded the
18 choice of preparing their financial statements under U.S.
19 GAAP or IFRS, and, if so, what the implications would be for
20 investors, issuers and our markets.

21 Clearly, our consideration of whether to permit
22 U.S. issuers to prepare financial statements using IFRS is
23 taking place in the context of other important developments.
24 The growing acceptance of IFRS in jurisdictions around the
25 world, the progress of convergence efforts by the FASB and

1 the IASB, the increasingly international scope of many U.S.
2 issuers' business operations and our own proposal to
3 eliminate the reconciliation requirement are chief among the
4 factors that compel the Commission to begin consideration of
5 whether U.S. issuers should be permitted to use IFRS in
6 preparing their financial statements.

7 The Concept Release raises numerous questions about
8 the use of IFRS by U.S. issuers, some theoretical, some more
9 practical.

10 For example, there are numerous questions designed
11 to elicit information on the degree to which U.S. issuers
12 would have an interest in filing in IFRS, how investors and
13 market participants would react to a marketplace in which
14 some companies would file in U.S. GAAP and others using IFRS
15 and what the effect would be on the ongoing convergence
16 process of permitting U.S. issuers to file in IFRS.

17 On the more practical side, the Concept Release
18 asks for input on the critical steps that would be needed in
19 terms of investor education and auditor training to prepare
20 for U.S. issuers' financial statements.

21 I think no one underestimates the significance of
22 such a move or the challenges that it might entail, but the
23 more informed we are about the advantages, disadvantages and
24 ramifications of such a change the better prepared we will be
25 to respond appropriately given our statutory mandates of

1 investor protection, capital formation and fair and efficient
2 markets.

3 For this reason, I urge issuers, investors, market
4 participants and other affected parties to assist the
5 Commission in this important area by responding to the
6 questions raised in the Concept Release.

7 I am pleased to see that we have allowed for a
8 90-day comment period to provide sufficient time for
9 commenters to prepare their comments. I'd also like to thank
10 the Office of the Chief Accountant and the Division of
11 Corporate Finance for their excellent work, and I'm very
12 pleased to support this Concept Release. I have no
13 additional questions.

14 CHAIRMAN COX: Thank you very much. Does any
15 Commissioner have any additional questions? If not, we'll
16 move to the vote.

17 Does the Commission vote to publish a Concept
18 Release to solicit public comment on allowing U.S. issuers,
19 including investment companies, to prepare financial
20 statements in accordance with International Financial
21 Reporting Standards, as published in English by the
22 International Accounting Standards Board for purposes of
23 complying with the Commission's rules and regulations?

24 COMMISSIONER ATKINS: Aye.

25 COMMISSIONER CAMPOS: Yes.

1 COMMISSIONER CASEY: Yes.

2 COMMISSIONER NAZARETH: Yes.

3 CHAIRMAN COX: And the matter is approved. I want
4 to thank everyone once again. And before you rise, because
5 the Office of Economic Analysis was a significant contributor
6 to this and because this is going to be Chester Spatt's last
7 open meeting, I want to take this opportunity to thank on
8 behalf of all of us our chief economist, Chester Spatt for
9 your outstanding service.

10 The SEC was very fortunate to attract you in the
11 first place from Carnegie Mellon. We were doubly fortunate
12 when you re-upped for a second tour of duty.

13 You have distinguished this Agency with your own
14 outstanding academic and professional reputation. You've
15 added to the reputation of the SEC with your own luster.
16 You've been an outstanding leader, a valued colleague and a
17 giant in the ranks of investor protection.

18 So on behalf of all of us on the Commission and on
19 behalf of all the professional staff here in the home office
20 and the thousands of us across the country not to mention
21 America's investors and everyone who depends upon free and
22 efficient capital markets, thank you very much for your
23 outstanding service for a job well done. And we wish you God
24 speed on your return to academia.

25 MR. SPATT: It has been a privilege to serve at the

1 Agency. Thank you, Chairman Cox, for your very kind words.

2 CHAIRMAN COX: Well, thank you very much.

3 (Applause)

4 CHAIRMAN COX: Thanks again.

5 (A brief recess was taken.)

6 CHAIRMAN COX: The final item is a recommendation
7 from the Division of Corporation Finance concerning
8 amendments to the federal proxy rules governing shareholder
9 proposals and shareholder communications.

10 The most significant of the proposed amendments
11 concern the question of a shareholder's ability to propose
12 procedures in a company's bylaws for the nomination of
13 directors.

14 Current Exchange Act Rule 14a-8(i)(8) provides that
15 a company may exclude from its proxy materials a proposal
16 that relates to an election for membership on the company's
17 board of directors.

18 The purpose of this provision is to prevent the
19 circumvention of other proxy rules designed to ensure that
20 shareholders receive adequate disclosure and that they have
21 an opportunity to make informed voting decisions in election
22 contests.

23 In applying this provision, the Commission staff
24 has determined that companies may exclude from their proxy
25 statements proposals that would establish a process for

1 conducting contested elections outside of the Commission's
2 detailed disclosure and regulatory regime governing contested
3 elections.

4 Last September, the U.S. Court of Appeals for the
5 Second Circuit invalidated the SEC staff's long-standing
6 interpretation of Rule 14a-8(i)(8). That interpretation had
7 been applied since 1990, but the Court found it inconsistent
8 with a prior interpretation.

9 The Court said that it would, "take no side in the
10 policy debate regarding shareholder access to the corporate
11 ballot," noting that "such issues are appropriately the
12 province of the SEC."

13 Since the effect of the decision is to create
14 uncertainty about the application of Rule 14a-8 in the Second
15 Circuit on the one hand and in the 11 other judicial circuits
16 in America on the other hand, the Commission is required to
17 act.

18 Moreover, the effect of applying the Court's
19 decision as a rule of general application would be to permit
20 director election contests without the disclosures required
21 by the election contest rules.

22 In light of this opinion and the paramount
23 importance of meaningful disclosure to investors in election
24 contests, we've undertaken a careful and extensive review of
25 the proxy process, including the provisions of Rule 14a-8.

1 This review included three roundtables this past
2 May that focused on the relationship between the federal
3 proxy rules and state corporation law, on proxy voting
4 mechanics, and on shareholder proposals.

5 Today we're formally considering two different
6 proposed resolutions to this question so that as we continue
7 to evaluate the legal, economic and policy aspects of all
8 that's involved here we will continue to have choices.

9 I've stated previously and will repeat again today
10 that it's my intention as chairman to have a clear,
11 unambiguous rule in place in time for the next proxy season.

12 The Government in the Sunshine Act requires that
13 whenever more than two commissioners are gathered to discuss
14 policy-making on a matter such as this it must be at a public
15 meeting. So unfortunately, the obvious way to work through
16 tough technical and policy issues is off limits to us.

17 That is, as commissioners, we can't get together,
18 roll up our sleeves, sit around a table and brainstorm about
19 potential ideas. Still, that's what this issue calls for,
20 and so we'll be doing some of that work right here during
21 this open meeting just as the Government in the Sunshine Act
22 would have us do it.

23 As you'll hear, we don't all agree. And when the
24 dust settles today, we won't be finished. We won't be making
25 any fateful decisions just yet, but instead we'll open up

1 these topics for formal comment from the entire country.

2 By advancing two very different proposals, we'll
3 have the benefit of the full breadth of commentary about
4 different ways of attacking the issue. By considering
5 serious alternatives, we'll have the benefit of a thorough
6 analysis of a variety of ways to accomplish our intended
7 objectives.

8 This approach will also give us a richer context in
9 which to evaluate public comment concerning the potential
10 costs and benefits of any new rule, and exposing both of
11 these proposals to public comment will enable us to better
12 understand the impact that any new rule would have on
13 competition, an analysis that we're required to undertake
14 pursuant to Section 23(a)(2) of the Exchange Act.

15 For all of these reasons, it's my intention to
16 support both releases at the proposing stage. Having said
17 that, the Commission's analysis of shareholder participation
18 in the nomination and election of directors hardly begins
19 with our proposals today.

20 This issue and its several offshoots have a long
21 and storied history, and many previous chairmen and
22 commissioners have attempted to tackle them. As Chairman
23 John Shad put it during the Reagan Administration, "The
24 Commission has always encouraged shareholder participation in
25 the corporate electoral process," and he added, "The SEC's

1 responsibilities for regulating proxy solicitation have been
2 premised on a need to assure `fair corporate suffrage' for
3 every security holder."

4 He advanced an idea to use the Commission's
5 jurisdiction over the Self-Regulatory Organizations to
6 standardize listing standards regarding shareholder voting.
7 We have a different approach before us today, but the
8 objective remains the same.

9 Fair corporate suffrage is just as important now as
10 it was in the 1980s, and several commentators from all across
11 the spectrum have recently been making the case.

12 The distinguished group of securities experts,
13 market professionals and academics that comprise the
14 Committee on Capital Markets under the direction of Professor
15 Hal Scott of Harvard Law School and the co-chairmanship of
16 Glenn Hubbard, President Bush's former Chairman of the
17 Council of Economic Advisors and John Thornton, the former
18 president of Goldman Sachs, devoted an entire section of
19 their recent report to shareholder rights.

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

1 The Committee on Capital Markets observed that,
2 "Overall, shareholders of U.S. companies have fewer rights in
3 a number of important areas than do their foreign
4 competitors." And they added that, "This difference creates an
5 important potential competitive problem for U.S. companies."

6 As one way of addressing that need, the committee
7 recommended to the SEC that we take the opportunity of the
8 Court's decision in the AIG case to ensure "appropriate
9 access by shareholders to the director nomination process."

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

17 There are several lessons to infer from that
18 experience. First, the federal proxy process must be
19 respectful of the preeminent role of state law in determining
20 shareholder rights.

21 Second, as we heard repeatedly at our three May
22 roundtables on the proxy process, changes to the existing
23 system, even changes that everyone agrees are improvements,
24 should be measured and incremental to ensure that, first, we
25 do no harm.

1 Third, the federal proxy rules should not embellish
2 shareholders' state law rights or create new ones but,
3 rather, vindicate their existing rights under state law, the
4 company's charter and its bylaws.

5 And finally, the federal interest is preeminent
6 when it comes to disclosure. Ensuring that shareholders get
7 full and fair disclosure in connection with proxy contests is
8 a fundamental concern of the Exchange Act and of this Agency.

9 So neither of the proposals that we're considering
10 today takes the approach of the aborted rule 14a-11, which
11 for all intents and purposes would have imposed a national
12 bylaw on every public corporation in America.

13 Instead, today we're considering whether, if
14 shareholders in companies wish to propose their own bylaws,
15 should those proposals be allowed in the company's proxy
16 materials and, if so, under what circumstances.

17 And just as the many roundtable participants
18 advised us to do, we will conduct this analysis on a
19 foundation of respect for state law and for the fundamental
20 principles of shareholder choice and private ordering that
21 are the genius of our free enterprise system.

22 At bottom, a share of stock is private property,
23 and the law's enforcement of private property rights is what
24 gives it its value. America's investors currently entrust
25 over \$20 trillion of their assets in exchange for these

1 property rights as holders of equity securities, and yet a
2 common stockholder has precious few specific rights that
3 under-gird this fantastic investment.

4 And so it's of the utmost importance that what the
5 stockholder does have is jealously guarded by our legal
6 system. The stockholder is said to own the company, but he
7 or she cannot direct management or the board to do anything.

8 Indeed even 100 percent of the shareholders acting
9 in concert couldn't do so. Instead, they must rely on the
10 directors. Only after every unsecured creditor is taken care
11 of does the common shareholder receive a penny in assets upon
12 liquidation.

13 A common stockholder can receive dividends, but
14 only if the company decides to declare them. But the
15 shareholders do have the ironclad legal right to do one thing
16 for themselves, and that's to choose the company's directors.

17 And yet some say the company's proxy materials,
18 which are produced at the shareholders' expense, should under
19 all circumstances be inaccessible to the shareholder when it
20 comes to nominating directors.

21 That would seem to stand the principle of fair
22 corporate suffrage on its head, and that harsh conclusion
23 would seem especially warranted if what's being considered is
24 not the shareholder's opportunity to use the company's proxy
25 to nominate a director but, rather, only to propose a bylaw

1 that would set up a procedure by which that could happen, but
2 that would itself have to first be approved by a majority of
3 the company's shareholders.

4 Beyond all of this, as so many participants at our
5 roundtable described, it's an irony that the federal proxy
6 rules force many other things onto the corporate proxy that
7 are at the periphery of the shareholder's rights, if they are
8 within the scope of their state law rights at all.

9 If a proposal has nothing to do with the ordinary
10 business of the company, if it's nonbinding and even
11 superfluous, then the proxy rules might well require its
12 inclusion on the company's proxy.

13 But if the proposal concerns the most fundamental
14 of shareholder rights, the most unqualified, unbridled right
15 that the shareholder has, then in the current system the
16 answer is no and indeed no under all circumstances.

17 As Chairman Shad observed in 1984, "under our
18 corporate form of enterprise, more not less equity capital is
19 essential to growth and development. The disenfranchisement
20 of shareholders poses a present and real issue that must be
21 debated and addressed." And I would add protecting the
22 private property rights of America's shareholders is the only
23 way to ensure that boards of directors remain accountable to
24 the interests of investors. It's the check and balance on
25 boards and management that's built into the corporate form

1 under state law, and its proper functioning is essential to
2 our free enterprise system.

3 Still some would say that any incremental
4 improvement in the way the proxy system vindicates the
5 shareholder's state law right to choose the directors will
6 threaten capitalism.

7 To that I would reply by all means we should be
8 cautious and measured when we adjust the workings of our
9 proxy system, and this process of soliciting public comment
10 we're embarking upon today will ensure that.

11 But we should also keep first principles firmly in
12 mind. We cannot have capitalism without capital. There
13 could be nothing more central to our mission of promoting
14 healthy capital formation than defending the rights of
15 capital and the property interests of shareholders.

16 Ensuring that the proxy system respects the state
17 law rights of shareholders is essential to maintaining the
18 balance of federalism, and upholding the rights of ownership
19 is fundamental to the maintenance of investor confidence and
20 the workings of our entire free enterprise system.

21 At this point, let me thank and congratulate my
22 fellow commissioners for their diligent, professional and
23 responsible investigation into these issues for the better
24 part of a year.

25 While the proposals we're considering today only

1 begin a process of public comment that will consume several
2 more months they also mark the culmination of ten months of
3 sustained work.

4 Commissioners faithfully attended each of the
5 roundtables on these subjects and devoted countless hours to
6 study, to meetings, to research and to collaborative learning
7 with our professional staff and many other participants in
8 our capital markets.

9 And during the last month since the Division's
10 initial draft of its recommended release was circulated to
11 all commissioners, they've contributed many useful comments
12 and shepherded through many changes. I have no doubt that
13 this process will continue during the weeks and months ahead.

14 It's been a hallmark of our work over the last
15 two years on many, many difficult subjects that we've sought
16 whenever possible to reach a unanimous result, because we
17 knew that by first considering one another's viewpoints we
18 would inevitably improve our own understanding and the final
19 result even if in the end we didn't agree.

20 Today, despite the difficulty that the Commission
21 has had in wrestling with this issue over several decades all
22 of us -- Commissioner Atkins, Commissioner Campos,
23 Commissioner Nazareth, Commissioner Casey and I -- agree
24 unanimously that the objective of this rule-making is to
25 protect investors' interests and to promote capital formation

1 for the benefit of the entire nation.

2 I hope and expect that all of us will continue to
3 work to get it right. So before I turn it over to John White
4 for a detailed explanation of the two alternatives, let me
5 offer a very brief summary.

6 The first proposal would amend Rule 14a-8(i)8) to
7 codify the interpretation of the election exclusion since
8 1990. That approach would ensure that in all proxy contests
9 shareholders would receive the disclosures currently required
10 under the other proxy rules, and it would permit the
11 exclusion from the company's proxy materials of all
12 shareholder-proposed bylaws concerning director nominations.

13 The second approach would expressly permit the
14 inclusion of such shareholder-proposed bylaws in the
15 company's proxy materials. This approach would also ensure
16 that shareholders received the disclosures currently required
17 under the other proxy rules, and it would require important
18 new disclosures about the shareholder or shareholders who are
19 proposing the bylaw.

20 The disclosures would be made under the schedule
21 13D/G regime, which requires that shareholders who own more
22 than 5 percent of the company's shares provide certain
23 information about themselves.

24 The shareholder proponent would have complete
25 freedom to structure the bylaw so long as the procedure for

1 director nominations that it sets out complies with
2 applicable state law and the company's charter and bylaws.

3 This reflects the decision not to impose a federal
4 one-size-fits-all approach, but rather to promote shareholder
5 choice and private ordering. For this reason, the current
6 proposal differs sharply from what the Commission proposed in
7 2003.

8 In addition, the second approach includes important
9 new features to facilitate greater online interaction among
10 shareholders and between shareholders and management. It
11 would amend the proxy rules to remove obstacles to electronic
12 shareholder communications.

13 It would clarify that a company or shareholder who
14 maintains an electronic shareholder forum is not liable for
15 statements by any other participant in the forum, and it
16 would also eliminate any ambiguity concerning whether
17 participation in an electronic shareholder forum could
18 constitute a proxy solicitation.

19 I'd like now to thank the Division of Corporation
20 Finance and the staff for your excellent work on these
21 proposals. In particular, I want to thank John White, Marty
22 Dunn, Lily Brown, Tamara Brightwell, Steve Hearne and Ted Yu.

23 I also want to thank Brian Cartwright and the
24 Office of General Counsel as well as Chester Spatt and the
25 Office of Economic Analysis for your excellent work.

1 And now I'll turn it over to John White to explain
2 the two proposals in more detail.

3 MR. WHITE: Thank you again, Chairman Cox. As
4 you've described, we are recommending this afternoon that the
5 Commission publish two releases related to Rule 14a-8, the
6 Shareholder Proposal Rule.

7 In a moment, I'll turn this over to Lily Brown to
8 describe the details of the two releases, but first just a
9 comment. I'm going to be reiterating some of the things you
10 just said in terms of the long process that we've gone
11 through.

12 The staff and the Commission has been studying and
13 discussing this topic in a lot of detail since last
14 September. We've looked at -- discussed many of the
15 alternatives in a quite arduous process.

16 And as you know, last May we had three roundtables
17 that were attended by all of the Commissioners in which we
18 heard a wide variety of views expressed by the participants.
19 I should also mention that transcripts and video archives of
20 those roundtables are available on the SEC web site for
21 anyone who would like to see them.

22 There has really just been a great deal of study,
23 discussion and thought by everyone at this table and by the
24 five of you.

25 So after engaging in this process, as I say,

1 for almost a year now, we have decided to recommend that you
2 publish for comment two releases which contain, as you
3 describe, alternative and different approaches.

4 This should allow a full range of public comment
5 while still permitting the Commission to adopt a new final
6 rule before the next proxy season, which you quite forcefully
7 stated a few moments ago as your goal.

8 So that's kind of where we're at in terms of what
9 we've done here. Before I turn it over to Lily let me just
10 thank the team, because it has really been an incredible
11 effort by them during this long period not just getting these
12 releases ready for you today but just the whole idea of
13 putting on three roundtables in a single month.

14 Some people don't realize what it is to put a
15 roundtable on. I don't think anybody has ever put on three
16 of them in one month on one topic. So it really is an
17 incredible job the team has done here.

18 Just to go through the key players, in Corporation
19 Finance, Lily Brown, Tamara Brightwell, Ted Yu, Steve Hearne,
20 and I left to last Marty Dunn, who I think has pretty much
21 spent - he's been involved with this topic all of his
22 professional career or most of it.

23 MR. DUNN: Five or six years flew by.

24 MR. WHITE: A long part of his professional career.

25 I mention that because you're going to hear from Marty as

1 we're answering the questions today.

2 Others that are here at the table, in some cases
3 behind us, in General Counsel's Office, David Fredrickson,
4 Alex Cohen and Meredith Mitchell. In the Office of
5 Investment Management, Susan Nash, Brent Fields, Tara
6 Buckley. In the Office of Economic Analysis, Cindy
7 Alexander.

8 And I won't read through all the individual
9 Commissioner's counsels, but there have been tremendous
10 effort put in by the counsels of all five of you in inputting
11 on this process. All of us in Corporation Finance and
12 elsewhere on the staff are very appreciative of all their
13 efforts.

14 So with that I will turn it over to Lily to go
15 through more details than I guess you did a moment ago.

16 MS. BROWN: Thank you. Good afternoon. Today we
17 are recommending that the Commission publish two releases
18 related to Exchange Act Rule 14a-8, the shareholder proposal
19 rule.

20 The first release would propose amendments to Rule
21 14a-8 that would enable shareholders to include shareholder
22 nomination bylaw proposals in the company proxy materials
23 where the proposal relates to a change in the company's
24 bylaws that would be binding on the company if approved, the
25 proposal is submitted by a shareholder or a group of

1 shareholders that has continuously held more than 5 percent
2 of the company's securities for at least one year, and the
3 shareholder or group of shareholders is eligible to and has
4 filed a Schedule 13G that contains all required information.

5 There would be no limitations in our rules as to
6 the content of those proposals. They would need only to
7 comply with applicable state law and governing corporate
8 documents.

9 However, critical to allowing this access to the
10 company's proxy materials would be comprehensive disclosure
11 regarding the shareholder proponent and the shareholder
12 proponent's relationship and prior interactions with the
13 company.

14 As proposed, Regulation 14A and Schedule 13G would
15 be amended to provide shareholders with additional
16 information about the proponents of shareholder nomination
17 bylaw proposals. These additional disclosures would be
18 required by the shareholder proponents as well as by the
19 company.

20 The proposals also would assure that the existing
21 disclosure requirements for solicitations in opposition would
22 apply to nominating shareholders and their nominees under any
23 such shareholder nomination procedure with the nominating
24 shareholder being liable for any false or misleading
25 statements in that disclosure.

1 Nominating shareholders and their nominees as well
2 as the company would be subject to the additional Regulation
3 14A and Schedule 13G disclosures as well.

4 We also recommend that this release propose
5 revisions to the proxy rules to promote greater online
6 interaction among shareholders by removing obstacles in the
7 current rules to the use of electronic shareholder forums and
8 clarify the application of the liability provisions of the
9 federal securities laws to statements or information on such
10 a forum.

11 The release also asks for public comment on a range
12 of questions related to the shareholder proposals process
13 under Rule 14a-8.

14 Finally, we recommend that the Commission approve a
15 second release in which it would propose amendments to the
16 text of Rule 14a-8(i)(8) regarding proposals that relate to
17 an election. These amendments are designed to clarify the
18 operation of the exclusion in Rule 14a-8(i)(8) in a manner
19 that is consistent with the Agency's prior interpretation of
20 that exclusion.

21 Under that interpretation, companies may permit the
22 exclusion of proposals that would result in an immediate
23 election contest or would set up a process for shareholders
24 to conduct an election contest in the future by requiring the
25 company to include shareholders' director nominees in the

1 company's proxy materials for subsequent meetings.

2 Thank you. We would be happy to answer any
3 questions you may have on the two releases.

4 CHAIRMAN COX: Well, thank you. Because of,
5 obviously, the way this works with respect to shareholder
6 bylaws is the center of discussion, I want to ask about
7 something that might otherwise not get quite as much
8 attention.

9 In one of the two alternatives there is the
10 proposal that you just described to open up the space that
11 we're roughly describing as electronic shareholder fora. I
12 wonder if you could help describe what it is that we're doing
13 and what we're not doing with this proposal.

14 For example, would the federal proxy rules mandate
15 a particular kind of online forum, or would this be,
16 essentially, a free form opportunity for shareholders and
17 companies to try out new ideas and be creative?

18 MR. DUNN: Okay. I'll start with that. The key to
19 it is that what we're making clear here is that folks can do
20 it and that there's no particular way that we would say you
21 can run a forum.

22 The goal is to not inhibit how they develop. The
23 purpose for this is to look through the proxy rules and try
24 to think of things in there that careful people might look to
25 to find ways not to that might inhibit them and to eliminate

1 those concerns; for example, the concern that there might be
2 liability for one person for the statements of another on
3 such a forum. And we provide clarity regarding liability is
4 on the speaker.

5 Questions about whether participation there might
6 be deemed a solicitation under the proxy rules. In the
7 proposals, very basically it would say that if it's 60 days
8 before the meeting -- and there's a little bit if you
9 announce later than that -- but, basically, 60 days before
10 the meeting and you're not soliciting a proxy, then you'd be
11 out of that definition. So folks don't have to worry about
12 that part of it.

13 Similarly, there would just be a statement in there
14 saying that companies are allowed to do this. Shareholders
15 are allowed to do this, which I think is very useful for
16 folks to know.

17 So the goal would be simply to get out of the way
18 and let whatever technology, whatever ability folks have to
19 come up with any way to interact, do petitions, look amongst
20 each other, figure out ways to interact amongst each other
21 and with the company. We'd let that flourish.

22 CHAIRMAN COX: Existing federal law provides broad
23 protections from liability for online access providers
24 generally for statements of others on internet forums of
25 various kinds.

1 So I take it what we're doing is we are adding to
2 those liability protections specific coverage that in
3 addition to not violating any other federal laws you're not
4 violating the federal proxy rules.

5 MS. DUNN: Yeah. I'm not sure who was in Congress
6 at the time they got passed, so I don't know anybody who
7 knows anything about that. But that is very clear with
8 respect to other things, and because folks tend to be very
9 cautious when the securities laws liability come around we're
10 trying to take the same approach here. Exactly.

11 CHAIRMAN COX: Just quickly, if you would -- we've
12 discussed a lot at the three roundtables, which really were
13 superb -- how do the Division's recommendations reflect or
14 respond to the participants' statements at those roundtables?

15 MR. DUNN: The three main things that I took away
16 from those discussions were the need to make sure that the
17 federal securities laws and particularly the proxy rules are
18 aligned with state law rights. The other was to make sure
19 that no matter what you do disclosure has got to be
20 paramount. And the third thing I saw was that, really,
21 technology needs to be taken into account.

22 So what we believe these do is do all three of
23 those, actually. The proposals would definitely look more to
24 the state law ability of folks to raise bylaw provisions. It
25 would in conjunction with that recognize the overriding need

1 for disclosure, regardless.

2 And the forum part definitely looks at technology,
3 and the Commission has taken some other recent actions that
4 go that direction as well, the e-proxy and the various things
5 there.

6 So to my mind, a lot of what we learned at the
7 roundtables goes into this. I think we learned more at that
8 than is done here, but what we do here I think fits within
9 those areas.

10 CHAIRMAN COX: All right. Thank you. I haven't
11 any further questions, and so I'll recognize Commissioner
12 Atkins.

13 COMMISSIONER ATKINS: Ok. Thank you very much,
14 Mr. Chairman. The topic before us today is one that's long
15 vexed many of our predecessors. It seems that at least once
16 a decade we engage in a significant review of the proxy
17 rules.

18 Just look at what we did in 1976, 1982, 1992 and
19 1998. I had a personal and intimate experience with the 1992
20 changes, as did Marty Dunn, when I worked here with Marty.
21 And now, during the first decade of the 21st Century this is
22 already the second time that we've engaged in an extensive
23 review and discussion of our proxy rules.

24 The key question is how do we address the competing
25 problems of collective action versus the tyranny of the

1 minority? How do we permit shareholders to effectively
2 exercise their state corporate franchise rights without
3 allowing a shareholder who may have only a nominal economic
4 interest to highjack the agenda of all shareholders?

5 We've tried to bridge this problem with Rule 14a-8,
6 a rule that while far from being perfect has at least created
7 a framework for dealing with this problem.

8 Today we have proposed a couple of actions on this
9 issue. The need to address this issue has been precipitated
10 by the Second Circuit's decision last year in AFSCME v AIG.
11 That decision has created an air of uncertainty as to what is
12 the current state of our regulations with respect to the
13 election exclusion of Rule 14a-8.

14 This uncertainty must be cleared up. It is unfair
15 to both companies and shareholders alike to keep the current
16 murky situation in place. By doing nothing, we invite costly
17 and fruitless litigation.

18 It's further unfair to create an environment where
19 contested elections could occur for seats on the boards of
20 directors outside of the disclosure regimen imposed by our
21 own Rule 14a-12. Thus, the current situation is simply not
22 acceptable.

23 So as to the two proposals to be published for
24 comment today, one I can support, and the other I cannot.
25 There are aspects of the latter that I can support, but

1 overall I have significant questions regarding our authority
2 to take some of the steps proposed to be taken.

3 In particular, while I agree with the statements in
4 the release emphasizing that it is substantive state law that
5 governs shareholder rights I have concerns whether some of
6 the proposals may conflict with that principle.

7 I also worry about the slippery slope of some of
8 the provisions in the proposal. Moreover, I do not believe
9 that the second proposal takes into account all of the recent
10 changes in corporate governance generally.

11 It does not consider more measured steps that we
12 can take to continue to drive down the costs and improve the
13 efficiency of running a short slates of directors, even a short
14 slate of one that may lead to the attaining of the goals of
15 responsible long-term shareholders concerned with the
16 financial performance of their companies. Nevertheless, I
17 look forward to the debate that certainly lies ahead.

18 As the Chairman said, a lot of discussion and
19 thought has transpired among the Commissioners and the staff
20 on this issue, especially during the past couple of weeks
21 leading up to this meeting.

22 I want to recognize especially the efforts of the
23 staff who have literally sacrificed their weekends and their
24 nights during this period in order to respond to the various
25 ideas and suggestions being put forth by the Commissioners.

1 So your efforts are really tremendously appreciated by I'm sure
2 all of us up here on the table. Thank you very much.

3 I just have one question, and that's for our
4 General Counsel. Just exactly what are we voting on now? I
5 just want to make sure that it's a draft as to the
6 interpretation and proposal with respect to 14a-8(i)(8) that I
7 guess I received last night about 11 p.m. give or take a few
8 minutes.

9 And then as to the longer one, again it's a draft
10 dated last night. I got it about midnight, and it's marked
11 from changes from the 11th of July.

12 MR. WHITE: I'll let Brian finish the answer, but
13 you received an action memo, as you described, last night
14 around 11:50 that had attached to it both of the releases. And
15 those are the two releases you'd be voting on.

16 MR. CARTWRIGHT: Just to complete the answer, I
17 think, as in all matters that are brought before the
18 Commission, the draft that is most recently before the
19 Commission at the time of the vote is the draft on which the
20 Commission is voting.

21 And I believe, if I understand, and I think my
22 colleagues in the Division agree the drafts that you refer to
23 are the drafts before the Commission.

24 COMMISSIONER ATKINS: Okay. I just wanted to make
25 sure. Okay. With that, thanks. I look forward to hearing

1 the comments of my fellow Commissioners.

2 CHAIRMAN COX: Thank you. Commissioner Campos.

3 COMMISSIONER CAMPOS: Thank you very much. Let me
4 also add my thanks to the staff and in particular Corp Fin
5 and all the individuals who have participated and worked long
6 hours on these two proposals. It's been a mighty chore,
7 and tremendous labor has been put into it. Let me echo my
8 appreciation as well.

9 These issues have been around since I joined the
10 Commission five years ago, and it's incredible how, as time
11 goes by, how we keep reflecting and dealing with the same
12 issues in many respects.

13 I do think the world has moved, and I do think the
14 latest three roundtables have added to the record and the
15 investigation that the Commission has done in this particular
16 area.

17 Essentially, it seems to me that all of this
18 effort, essentially, boils down to a situation that exists in
19 America that is very different than any other developed
20 market in the world. That is, only in the United States - as
21 compared to other developed markets - are shareholders who hold
22 a voting class of shares, prevented from voting yes or no for
23 directors.

24 As we all know, shareholders can only vote yes or
25 withhold their votes. Some have called this system -- we've

1 often heard this - "Soviet-style voting."

2 As the Chairman said, this system seems to fly in
3 the face of basic ownership rights under our capitalist
4 system for property. Do shareholders have a right to vote
5 and influence the selection of directors, or is that simply
6 an illusion?

7 Under our laws, shareholders are not entitled to
8 manage the day-to-day operations of a corporation. That is
9 clear. Instead, however, they rely on management efforts of
10 the board of directors who owe them fiduciary duties.

11 So again it would seem logical and rational that
12 shareholders who owned voting stock have the right to vote
13 for directors or influence their selection in a meaningful
14 way.

15 It seems that there are greater issues and problems
16 with the opponents who fear shareholder access. I think part
17 of it is philosophical. Part of it is a view that
18 shareholders are not really owners, which I think flies in
19 the face of our corporate law. That view, sort of, maintains
20 that shareholders are free riders who can, essentially, use
21 the Wall Street rule and simply walk when they don't like
22 what's going on.

23 Of course, what this particular proposition ignores
24 is that the time to walk is when the share price is at its
25 lowest, and it seems hardly an option to sell your stock when

1 it's the lowest instead of trying to influence the company in
2 a meaningful way to improve itself and have the share price
3 go up.

4 Further, large institutions today are heavily
5 invested in indexes and cannot simply move large blocks of
6 shares. If they do, that affects the price. So this is a
7 serious issue, and that particular view I don't think deals
8 with reality.

9 Another reason that's often cited is that
10 shareholder access will somehow disrupt the conduct of
11 business at companies and boards. In my view, this
12 particular argument doesn't hold water.

13 Essentially, shareholders, in my evaluation and in
14 my study, don't want to do the day-to-day business of boards.
15 They intervene only when they have to and when there is
16 repeated failure of performance and failure to take into
17 account shareholder suggestions.

18 So a company that is consistently underperforming I
19 think quite naturally under a capitalist system should expect
20 the attention of shareholders.

21 So our proxy proposal or any proposal, frankly, in
22 this particular area would not affect any company that is
23 responsive to shareholders, I would submit.

24 Finally, I hear the argument that: "There is so much
25 to deal with with respect to SOX. Please don't add another

1 requirement." Well, I think that the world today moves fast.
2 The Commission didn't create the global economy. The
3 Commission didn't create activist funds.

4 The Commission didn't create all of the pressures
5 and all of the financial competitive situations that exist.
6 We didn't create the effort of private equity and hedge funds
7 who are interested in this particular world.

8 So I think it belies the issue. This is not
9 something that a board can avoid by simply not having a rule
10 that allows for shareholder proposals. Shareholder activism is
11 something that occurs here today in spite of whatever the
12 Commission may do.

13 So, essentially, I think it comes down to is
14 accountability, and I think under our capitalist system
15 boards need to be accountable. That's the way they were
16 designed under our basic laws from the premises and from the
17 history of Anglo-Saxon law.

18 There needs to be accountability to shareholders.
19 Our particular proxy proposal today, and I'm talking about
20 the first one that has to do with the 5 percent, would be a
21 simple and elegant way of trying to accomplish under state
22 law the means for a proposal to be made for a framework for
23 shareholder access.

24 Whatever that might be would be ultimately between
25 the shareholders and the company and be governed by state

1 law.

2 Having said that, I do support the -- let me be
3 clear -- I support the proxy proposal today that involves the
4 proposition to allow shareholder proposals to go forward, but
5 I do have some deep reservations.

6 I'm aware that many investors have said very
7 publicly that a 5 percent ownership threshold is too high.
8 This is especially the case, they argue, in large companies,
9 in our large accelerated filer community, and the reason for
10 that is very simple.

11 If you put together the holdings of all of the
12 major institutional investors that make up one of the large
13 organizations, the Council of Institutional Investors, with
14 respect to large companies, their combined holdings do not
15 equal 1 percent. There may be some exceptions, but that's
16 generally the rule.

17 So investors have posed the question: is a rule
18 in which a 5 percent threshold is proposed useful to
19 investors? Is this threshold, essentially, too high so that
20 the proposal is, essentially, useless and more optical and,
21 in fact, an illusion?

22 Several questions are asked in the release which I
23 think promote or at least elicit responses from investors and
24 commenters and academics about this particular question.

25 In particular, one of the questions has to do with

1 whether the Commission should consider some sort of
2 differentiated standard for large companies, which might mean
3 that the percentage should be substantially lower than 5
4 percent, maybe even 1 percent -- or lower, who knows -- or
5 whether it should be higher.

6 Also asked is whether a different set of standards
7 should apply in terms of a threshold for smaller companies,
8 mid-cap and small caps.

9 So I today want to encourage investors and other
10 commenters, academics, to make their views known and to give
11 us their thoughts as to this particular proposal that has
12 been offered.

13 Separately, I also have great reservations about
14 the question raised in this longer proposal that would allow
15 the opting out, my terminology, of the SEC's 14a-8 procedures
16 for non-binding or precatory proposals.

17 The question poses a situation in which either
18 shareholders or management through a bylaw proposal could
19 eliminate the non-binding proposals being considered at all
20 by a company. I mean, that could be the ultimate result of a
21 proposal that is ultimately adopted by shareholders.

22 I think the question is open as to whether such a
23 proposal would require shareholder approval if the company or
24 the board made it.

25 I'm very concerned about whether it is good policy

1 to eliminate a particular opportunity that nuns, rabbis,
2 Christian sects, environmentalists and others have used for
3 placing non-binding proposals -- I'm sure I left someone
4 out -- for consideration by management.

5 As stated in the roundtables, this particular
6 procedure under our oversight and under 14(a) often presents
7 ideas that eventually get traction, get legs and turn into real
8 proposals that are adopted by the company.

9 So I'm interested in knowing what investors and
10 commenters think about this particular question and the
11 possible rule that may come out of this.

12 Is it good policy to allow a system to take away
13 this particular practice and force those types of activists
14 to use other tactics? I look forward to those comments.

15 As to the second release, I find myself in a
16 position of not being able to support it. The second
17 release, to my analysis, has many problems not the least of
18 which is that it, essentially, puts investors in a position
19 where they can no longer make any proposals if it were
20 followed by the letter of the law, by the letter of this

proposal.

21 However, I find that it seems to me to be somewhat
22 deficient in that it doesn't really answer many of the
23 questions that the Second Circuit put.

24 Without doing a legal analysis here, which I think
25 others might be interested in doing, the Second Circuit did

1 state that: "The SEC fails to so much as acknowledge a
2 changed position let alone offer a reasoned analysis of this
3 change. The amicus brief," referring to our submission, "is
4 curiously silent on any division action prior to 1990 and
5 characterizes the intermittent post-1990 no-action letters
6 which continue to apply the pre-1990 positions as mere
7 mistakes."

8 For that and for other reasons, I believe that this
9 particular proposal will not change the status quo. As I
10 read it, there's nothing in this release apart from the
11 proposed rule that is really new.

12 Thus, the interpretation of this release without
13 more is, to quote the Second Circuit, "plainly at odds with
14 the interpretation the SEC made in 1976."

15 Given this, I hope and expect that the Agency will
16 not be taking the position in the upcoming proxy season that
17 this release without adopting a final release of some sort
18 changes the current situation.

19 But let me ask a couple of questions about that.
20 Brian, perhaps you can help me. In your opinion, does this
21 interpretive release have any current legal effect?
22 Specifically, in your view, is it sufficient to effectively
23 reverse the Second Circuit's decision and change our views as
24 respect to what we do with no-action letters?

25 MR. CARTWRIGHT: Well, the release, if adopted,

1 includes a provision that restates yet again the Agency's
2 position under the existing 14a-8(i)(8).

3 As was mentioned, 14a-8(i)(8) was adopted in 1976,
4 and at that time the Commission said that Rule 14a-8 was not
5 the proper means for effecting reforms in elections. And at
6 least since 1990 the Agency through the Division of
7 Corporation Finance in the no-action process that 14a-8
8 itself sets forth has on countless occasions reiterated that
9 position.

10 Perhaps the most recent and full statement of that
11 position was the statement the Commission made in the Second
12 Circuit itself in which the Commission authorized -- it was
13 actually under the signatures of John White and myself -- the
14 submission after a request for an amicus brief from the
15 Second Circuit of a very full explication of the
16 Commission's, the Agency's long-standing position.

17 What this proposed release would do would restate
18 that conclusion. I thin I know that there are many who care
19 very much about that restatement or not.

20 Nonetheless, I think that the whole record of the
21 Agency's position going back to 1976 would be before any
22 court that would be considering this, or reconsidering it in
23 the case of the Second Circuit, and saying it one more time.

24 Well, one could ask the extent to which that would
25 have a decisive effect on any judge or panel that might

1 consider it. So that's, I think, what it does.

2 COMMISSIONER CAMPOS: So just to try to phrase it
3 in a little bit my plainer version of English, you don't
4 think this particular release, if adopted, the shorter
5 release, would control any other court who is looking at this
6 particular situation?

7 MR. CARTWRIGHT: Well, it's a restatement of the
8 Commission's existing position. So we might, assuming that
9 it's adopted this afternoon, look at the state of affairs
10 yesterday and the state of affairs tomorrow.

11 What we would have tomorrow if it were adopted
12 would be one more statement of the Agency's position, which
13 it's had for a very long time now.

14 And as I say, I think can you ask how much effect
15 that would have on a court in the Second Circuit or a court in
16 any of the eleven other circuits. It's incremental. It's
17 saying it again one more time, but that's all it is.

18 COMMISSIONER CAMPOS: And this statement was,
19 effectively, already before the Second Circuit the first
20 time, wasn't it?

21 MR. CARTWRIGHT: Yeah. The Second Circuit, of
22 course, as everyone who has been following this is well
23 aware, did not accept the Agency's long-standing
24 interpretation.

25 So the current state of the law in the Second

1 Circuit is contrary to the Agency's interpretation. One
2 would assume that another court in the Second Circuit would
3 feel bound by that precedent. It's always possible that
4 there would be some way to argue that it shouldn't be bound,
5 but, presumably, it would be.

6 So I think saying the same thing again one more
7 time without precluding any possibilities here is probably
8 not highly likely to have an effect in the Second Circuit,
9 and I think courts outside of the Second Circuit considering
10 it have the whole record before them.

11 This is one more occasion, if adopted, in which the
12 Agency would have made that statement. Perhaps that would be
13 persuasive to a judge, but you have to look at the whole
14 package, and it's just one more iteration.

15 COMMISSIONER CAMPOS: Thank you. Let me go to John
16 or Marty, whoever wants to handle this one. So, what is, how
17 is the Division of Corp Fin going to handle -- if we assume we
18 adopt this second shorter release today, how is Corp Fin going
19 to handle a request for a no-action position by the division
20 with respect to excluding a bylaw proposal that would put a
21 shareholder access process in place?

22 MR. WHITE: Let me start by saying I think that's a
23 very hypothetical question, because as Chairman Cox has
24 described a few minutes ago we have every expectation that
25 prior to the upcoming proxy season one of these proposals or

1 the other or some combination would be adopted so we will
2 actually have a final rule in place. So we would not be in a
3 situation to ever face a proposal --

4 COMMISSIONER CAMPOS: So the shorter proposal is
5 not a final rule, in your view if adopted today? Is that
6 what you're saying?

7 MR. WHITE: It contains a rule proposal. A rule
8 proposal is, obviously, not being adopted today. It's a rule
9 proposal.

10 COMMISSIONER CAMPOS: On the short interpretive
11 release?

12 MR. WHITE: Both releases are rule proposals or
13 contain rule proposals.

14 COMMISSIONER CAMPOS: Okay. All right. I just
15 want to make clear that that was the case. So you're
16 saying -- you're punting a little bit, because you're saying
17 we'll have a final rule, and the division won't have to worry
18 about that?

19 MR. WHITE: Well, I started by saying it was
20 a -- as you were posing it, it was a hypothetical question or
21 quite likely to be hypothetical.

22 If we were to have a no-action letter request prior
23 to a final rule being adopted, based on our current thinking
24 and the advice of the General Counsel's Office, which you
25 just heard Brian's description, and remembering that any

1 shareholder proposal is very fact specific in terms of how
2 you analyze it -- I mean, there are all kinds of different
3 factors that may come into play with respect to a particular
4 proposal -- we would be analyzing it and approaching it the
5 same way as we did last season.

6 COMMISSIONER CAMPOS: The same way as we did last
7 season, which would be that we take no view, or words to that
8 effect? You will not issue a no-action letter?

9 MR. WHITE: We only put out a letter one time last
10 season which we said we had no view. It was not a matter
11 that was subject to the Second Circuit, or at least the
12 company said it was not subject to the Second Circuit.

13 COMMISSIONER CAMPOS: So you would expect to have
14 the same view based on your current thinking as you did last
15 season, correct?

16 MR. WHITE: Based on our current thinking and based
17 on our discussions with the General Counsel's Office, yes.

18 COMMISSIONER CAMPOS: Okay. Now let me push you a
19 little bit more. This is even more hypothetical. So assume
20 we never go to a final rule. What would be the position of
21 Corp Fin with respect to requests for no-action positions in
22 a shareholder access bylaw proposal given today's adoption of
23 the short release or putting it out?

24 MR. DUNN: If we never adopt a rule, I'd be really
25 disappointed in everybody. Where we are now what this says

1 is where we've thought -- and how is that for the dad in me
2 coming out -- but it is where we've been all along --

3 COMMISSIONER CAMPOS: We'd all be disappointed.

4 MR. DUNN: -- is what this says is this is the view
5 of the Commission which the Commission has expressed before.
6 That didn't hold sway in the Second Circuit in the recent
7 decision.

8 So where we are left with following this, following
9 the discussion Brian just had as to how this plays, while it's
10 an interpretation, it's a restatement of the interpretation.
11 It's not a final rule, because it's a rule -- it's a current
12 interpretation. It's not a final rule. It's a proposed
13 rule.

14 Based on what Brian just said I think we're in the
15 same spot whether it's a week from now or six months from now
16 is that we are still faced with this is the view of the
17 Commission. There's an opposite view of the Second Circuit.

18 There's not a final rule clarifying it or not
19 another action clarifying it for us, and so that places us in
20 the same spot we were last year regarding the level of
21 certainty we can have.

22 MR. CARTWRIGHT: I think that the division would be
23 very much in the same position it was last time, and so it
24 would be not inappropriate for it to take the same position.

25 I think it would be very disappointing if the

1 Commission were unable to come to some resolution here,
2 because I think what would happen is what started to happen
3 but didn't quite happen in the last proxy season is that we
4 would end up with litigation by private parties.

5 This is litigation to which the Commission is
6 typically a party, if at all, only as an amicus -- so not
7 technically a party -- in other circuits. We would end up
8 with a situation where there was great uncertainty around the
9 nation, and that I think we all agree is not desirable.

10 From our narrow view in OGC, it's not desirable. I
11 think it's probably not desirable more generally. So I hope
12 that, as Marty and John said, this turns out to be
13 hypothetical only.

14 COMMISSIONER CAMPOS: Well, I think we'll all be
15 disappointed if we don't have a meaningful final rule. All
16 right. I'm happy for those clarifications. I appreciate the
17 thought that went into them.

18 And again, I really am appreciative -- I know every
19 other Commissioner and our staffs are -- of all the hard work
20 that Corp Fin has done and all the other divisions that have
21 weighed in as well. Thank you.

22 CHAIRMAN COX: Thank you. Commissioner Nazareth.

23 COMMISSIONER NAZARETH: Thank you. As it was
24 originally contemplated, the proxy access proposal, which
25 I'll call the first proposal, was intended to recognize the

1 legitimate interests of shareholders in the governance of the
2 corporations they own.

3 This proposal is designed to enable a meaningful
4 percentage of shareholders to come together to propose a
5 bylaw amendment regarding the procedures for nominating
6 candidates to a company's board of directors.

7 It would facilitate shareholders' exercise of their
8 fundamental state law and company ownership rights to elect
9 the board of directors. It would largely eliminate the
10 artificial barriers that the federal proxy rules have erected
11 to the exercise of these state law rights.

12 The proposal would also mandate robust disclosure
13 regarding the background and interaction of the proposing
14 shareholders and the company, providing information necessary
15 for shareholders to determine the extent to which the
16 proposing shareholders may be acting in their own
17 self-interests.

18 The proposal was designed to balance the rights of
19 shareholders with the legitimate goal of leaving the
20 management of companies largely to the board and the
21 managers, whose primary focus should be on profit generation.

22 One key element of the proposal that was designed
23 to achieve this goal were the thresholds that were set to
24 trigger access; namely, that the proposing shareholder or
25 group of shareholders have 5 percent or more of the stock and

1 that they have held the stock for at least one year.

2 Whether these exact percentages and holding periods
3 achieve the correct balance may well be an open question, and
4 I would certainly encourage comment on this point, but the
5 concept of requiring a meaningful percentage of ownership and
6 a holding period to trigger the access to the proxy seemed
7 very sensible to me.

8 Today's proposal is based on another perfectly
9 logical economic tenet. In a free market system, a majority
10 of the shareholders will generally behave in their economic
11 self-interest.

12 When it comes to share ownership, their goals are
13 profitability and integrity of the enterprise. In the vast
14 majority of instances, these incentives will be consistent
15 with those of a company's management.

16 Unfortunately, there are notable instances,
17 however, in which management acts in its own economic
18 self-interest or chooses to ignore the express will of the
19 shareholders and is unresponsive to them.

20 In these instances, shareholders should have the
21 ability to effect changes more effectively through the proxy
22 process.

23 Currently, shareholders have virtually no chance to
24 do so through access to the company ballot. Our proxy rules
25 do not facilitate it, and shareholders are forced to solicit

1 proxies on their own ballot, which is more costly and much
2 less effective.

3 This proposal appears to be responsive to many of
4 the constructive comments we received at the roundtables on
5 proxy access that were held over the past several months. We
6 received very insightful input from a host of panelists many
7 of whom focused on both the tension between federal proxy
8 rules and the rights afforded shareholders under state law.

9 Another area of focus at the roundtables and one on
10 which we ask a variety of questions in this release relate to
11 precatory proposals.

12 In this release, we ask a number of
13 thought-provoking questions on possible changes to Rule 14a-8
14 rights concerning precatory proposals, including the
15 possibility that shareholders could vote to establish access
16 procedures concerning precatory proposals that differ from
17 those in our rules.

18 Now, unfortunately, after all this effort, I'm now
19 concerned that all of this work towards greater shareholder
20 democracy may not be realized and that the chances of
21 effecting meaningful shareholder access may be minimal.

22 Yesterday, I received for the first time an
23 entirely different, indeed diametrically opposite
24 alternative, to this shareholder access proposal. That is
25 the second proposal that we are being asked to vote on today.

1 This one is probably best called the shareholder
2 non-access proposal. I was previously told verbally that we
3 should expect to be asked to vote on proposing a confirmation
4 of the staff's pre-AFSCME position on proxy access.

5 It was expressly understood that during the
6 pendency of the comment process on these two proposals that
7 we would maintain the status quo and not issue any
8 interpretation that purported to move the starting line, so
9 to speak, back to where we started, but that is exactly what
10 was produced yesterday.

11 Thus, we're being asked today to vote on two
12 proposals, the second of which, at least on its face,
13 purports to immediately return us back to our pre-AFSCME
14 posture.

15 What concerns me more, however, is that this
16 shareholder access proposal could in fact -- although I don't
17 think that it was the intention, it could, in fact, be turned
18 on its head.

19 There's at least a possibility given now that we
20 have two proposals that the Commission could pick and choose
21 from each of these diametrically opposed proposals and thus
22 put shareholders in even a worse position than they are
23 currently.

24 And let me give you an example. Although I
25 previously supported including the Discussion and Question

1 section on shareholder procedures for precatory proposals in
2 this release partly because it is consistent intellectually
3 with state law rights and the free market concepts in the
4 access release, and it was coupled with increased access in the
5 access release, it could now potentially be split from the
6 shareholder nomination access proposal and coupled with the
7 non-access proposal, at least potentially.

8 So one can imagine a final rule-making in which we
9 then are asked to consider both pre-AFSCME non-access and
10 potentially more restrictive precatory proposal procedures.

11 Indeed, one of the possible outcomes under this
12 scenario could be the adoption by a board of directors
13 without a shareholder vote at all of procedures concerning
14 shareholder precatory proposals that are more restrictive
15 than our current 14a-8 as long as this action was consistent
16 with state law.

17 Now again, I don't think that that was anybody's
18 intention, but because we have these two proposals that is a
19 possibility. And so it's for that reason that I'm extremely
20 concerned about where we find ourselves having these two
21 proposals today.

22 A vote against the shareholder access proposal
23 would make non-access a virtual certainty, but a vote for
24 it does leave open this possibility of some problematic
25 results.

1 So it's going to be very incumbent on all
2 commenters to firmly establish what their positions are and
3 how important these issues are to them as we deliberate on
4 these incredibly important issues.

5 So needless to say, this has been, I think, one of
6 the more challenging issues that I've worked on since I've
7 been here at the Commission, and I've worked on a few of them
8 that were a little complicated.

9 The challenges have undoubtedly also been extremely
10 taxing and challenging for our staff as well, who throughout
11 this process have acted with extraordinary energy and
12 professionalism.

13 And I really want to specifically recognize the
14 staff for their countless hours that they've devoted to this
15 exercise, particularly John White, Marty Dunn, Lillian Brown
16 who I don't even want to think about how little sleep she's
17 gotten in the last week, Tamara Brightwell and Steven
18 Hearne and obviously our friends as well in the Office of
19 General Counsel.

20 So with that I do just want to ask Brian to address
21 a little bit because of my caution and concern about this
22 precatory discussion.

23 My reading of this is that the discussion was so
24 fulsome and the questions in the release now are, in fact, so
25 specific that at least as a technical matter we could move to

1 an adoption on the precatory section even though it's not
2 drafted as a proposal but as questions.

3 Could you comment on that, please?

4 MR. CARTWRIGHT: Yeah. Let me sound like a lawyer,
5 since I am, at the outset and say that it, obviously, would
6 depend on the specifics of whatever was proposed to be
7 adopted in the end, and careful analysis would have to be
8 done there.

9 The set of questions is, I think, dense. There are
10 a lot of questions that are asked. I think the world is
11 fairly on notice that the Commission could act in this area.
12 So I think the Commission will have a great deal of
13 flexibility when the time for adoption comes to take any one
14 of a broad range of courses. When we get to the point where
15 we're starting to crystallize down to one, then we'll have to
16 take a close look and make sure that it fits with what has
17 been proposed.

18 COMMISSIONER NAZARETH: Thank you.

19 CHAIRMAN COX: Thank you. Commissioner Casey.

20 COMMISSIONER CASEY: I would also like to start by
21 thanking the staff for all of your hard work. The process
22 leading to today's votes on two proxy related releases has
23 required quick work by the staff and has sought rapid
24 response by the Commission.

25 Today's larger proxy proposal that which would seek

1 to fundamentally change our proxy process presents a difficult
2 challenging issue, and you have been able to work under
3 extraordinary time pressure, often sacrificing much of your
4 personal time and turning your attention away from other
5 important work as you press forward with this work.

6 Unfortunately, despite your hard work I find that I
7 am only likely to be able to support one of the proposals
8 before us today. I remain unable to support the broader
9 proxy proposal offered today that would fundamentally change
10 our proxy process.

11 While I have supported the Commission's efforts to
12 evaluate the operation and effectiveness of our proxy rules
13 with an eye to considering whether changes to our rules are
14 advisable or warranted, I have also firmly believed since the
15 Second Circuit decision in the AFSCME v AIG case that the
16 Commission must provide clarity and certainty by first
17 reaffirming its long-standing interpretation that Rule 14a-8
18 is not the proper means to wage a contested election and that
19 bylaw proposals such as the AFSCME proposal are excludable
20 under 14a-8(i)(8).

21 I believe now, as I did in the months following
22 that decision and leading up to this past proxy season, that
23 that long-standing policy, a policy that we recently
24 confirmed just last March in our submission to the Second
25 Circuit, is sound and that it preserves a carefully crafted

1 disclosure regime for the protection of all shareholders.

2 Further, recognizing the long history, sensitivity
3 and significant import of these issues for shareholders and
4 companies, I felt strongly that an open and deliberative
5 process was necessary to inform the Commission's
6 consideration and provide valuable input and context
7 regarding the current state of the operation of our rules and
8 whether they effectively serve the interests of all
9 shareholders.

10 The roundtables held two months ago were intended
11 to bear these questions out and test assumptions about
12 whether the appropriate balance in our rules continues to be
13 struck appropriately.

14 Unfortunately, I cannot support the broader proxy
15 rule release before us today because I think it fails to
16 adequately address both of these interests.

17 I am, however, pleased -- and I want to discuss
18 this a little bit more in some of my questions -- that the
19 Commission is considering separately a release that reaffirms
20 our long-standing position, clarifies our long-held view and
21 proposes clarifying language should such language be
22 necessary.

23 Given the fundamental changes that would be
24 proposed to our carefully crafted proxy regime, the
25 challenges presented by any alterations to this regime and

1 the controversial nature of proposals in the proxy area
2 generally, I do not think that the proposing release offering
3 a new bylaw approach is appropriate at this time.

4 The proposal suggests that the Commission believes
5 that the option offered by the release is the best or
6 preferred option, and I have no such confidence that this is
7 so.

8 Further, I do not believe that the single-option
9 proposal makes a sufficient effort to rationalize the
10 Commission's long-held positions on 14a-8 and instead offers
11 an abrupt change of course with little explanation.

12 In three weeks during May, the Commission hosted a
13 series of roundtables to consider the role of our proxy rules
14 and whether any changes to the rules should be considered. I
15 viewed the roundtables and all of the work conducted before,
16 during and after the roundtables as a fact-finding effort to
17 inform the Commission on whether or not additional changes
18 were necessary or desirable.

19 The schedule included a roundtable considering the
20 different federal and state rules in the proxy process, two
21 weeks later a roundtable discussing the mechanics of the
22 current process and the very next day a roundtable on
23 shareholder proposals that could vindicate state law rights.

24 Although this process was, in my mind, intended to
25 inform our judgment the aggressive schedule suggested that it

1 was laying the foundation potentially for a predetermined
2 proposal, and so I fear that much of what we learned during
3 this process is not contained in the single-option bylaw
4 proposal before us today.

5 I understand that in the draft we received late
6 last night there were additional questions added intended to
7 elicit comments in an attempt to be responsive to these
8 concerns, and I appreciate those changes very much, although
9 I still believe they do not go far enough.

10 Instead, today's bylaw proposal approach presents
11 an abrupt change to our long-standing proxy process and fails
12 to meaningfully discuss or offer alternatives that could
13 potentially achieve the same or even better results.

14 I have no confidence that this is the only
15 direction that we can go, but I fear that the Commission's
16 release of a single option proposal forces us in this one
17 direction to the exclusion of other potentially viable
18 alternatives.

19 As I noted a moment ago, proxy access issues have
20 historically been challenging to the Commission. We've
21 considered similar proposals in the past as recently as in
22 2003, as previously been noted, but the Commission has always
23 stopped short of endorsing a fundamental change to the rules
24 because such change alters the entire construct of our proxy
25 rules, has the potential to skirt our careful disclosure

1 regime, touches fundamental notions of corporate governance
2 and reaches the federal/state division of responsibility.

3 This process has a 60-year history, and given the
4 stakes, change has largely been measured and incremental.
5 While the bylaw approach is at least theoretically
6 intellectually appealing and compelling to me, the release's
7 base assumption and practical implication continue to pose
8 some real policy concerns.

9 One of the key failures of previous proposals in
10 this area is that the Commission sought to establish a
11 federal access rule that pushed the envelope, in my view, of
12 SEC authority into more substantive state law territory and
13 also may have been inattentive to disclosure concerns.

14 The bylaw proposal before us today attempts to
15 address these concerns by hewing to state substantive law and
16 by enhancing disclosure requirements for proponents, and
17 while I find these considerations meritorious and necessary,
18 the release before us still remains flawed.

19 As I noted earlier, my view is shaped in part by
20 the many views discussed at the roundtables. In these
21 roundtables, participants discussed the role of the federal
22 government in the proxy process and the important role of the
23 states in defining shareholder rights and responsibilities.

24 Many participants also described binding proposals
25 as the most important shareholder rights, viewing precatory

1 proposals as less important. Still others asserted that
2 precatory proposals, though largely a creature of federal not
3 state law, constitute important shareholder rights.

4 Participants discussed that the precatory process
5 has evolved over the years into a process that certain
6 shareholders view as important to exercising their voice to
7 the company on a range of matters not all of which are
8 related to the economic value of the company.

9 According to many roundtable participants, it also
10 has created a system in many cases whereby proponents use
11 precatory proposals to engage management in discussions that
12 result in real change. In some cases, these discussions and
13 changes are hidden from the view of other shareholders.

14 I question whether our proxy rules should be
15 facilitating such conduct, and today's single-option proposal
16 does not squarely address this condition.

17 One over-arching theme I did take from the
18 roundtables, however, was the need for caution and careful
19 balance in considering any changes we might seek to make.
20 And my view is that the bylaw change today is much more of a
21 sea change.

22 Other roundtable participants also addressed the
23 absence of fiduciary responsibilities in non-management
24 proponents and the effect this condition might have on other
25 shareholders.

1 The single-option proposal, the bylaw proposal
2 offered today, announced only today only briefly visits this
3 question and only addresses it through disclosure. And
4 again, there were many other topics that were discussed,
5 including the role in the proxy process of advisory services,
6 broker voting, majority voting, empty voting and over-voting.

7 The release, in my view, does not seriously address
8 many of these considerations, nor does it speak to or take
9 stock in some other changes that have been going on in the
10 market, including the rise of institutional investors and
11 their ability to effect management and the new changes on
12 e-proxy as far as bringing down costs for proxy solicitations.

13 The natural next step we should be taking in light
14 of all the considerations advanced in our fact-finding
15 roundtable is, in my view, a release that posits several
16 different approaches and seeks comment upon those approaches
17 but that also invites different ideas.

18 As I noted earlier, I understand that some effort
19 was made in the last few hours to elicit such comments
20 through questions, but the clear implication of today's
21 single-option release is that the option is the preferred
22 choice of the Commission.

23 And without a more informed discussion it cannot be
24 my preference, and I cannot support the narrow bylaw proposal
25 in its current form.

1 With that said, I'd like to just further inquire
2 from the general counsel regarding the Second Circuit's
3 decision. Can you please articulate exactly what the Second
4 Circuit found in terms of our need to further explain our
5 position?

6 MR. CARTWRIGHT: I don't think the Second Circuit
7 found anything that was mandatory on the Commission.

8 COMMISSIONER CASEY: Okay.

9 MR. CARTWRIGHT: The Second Circuit did not accept
10 the Commission's long-standing interpretation of existing
11 14a-8(i)(8), and therefore at the present time in the Second
12 Circuit the Commission's interpretation does not stand. That
13 was the conclusion.

14 COMMISSIONER CASEY: I'm sorry. Could you repeat
15 that? I just couldn't hear you Brian.

16 MR. CARTWRIGHT: I'm sorry. And that was the
17 outcome of that case. We participated as, in the view of the
18 Second Circuit, as an amicus.

19 We're not a party, as we would not normally be in
20 these circumstances, and they did not choose to adopt the
21 view that the Agency propounded and which was consistent with
22 the Agency's long-standing position. We lost.

23 COMMISSIONER CASEY: I appreciate that. So in your
24 view, it was incumbent upon the Commission to do what in
25 order to clarify its approach?

1 MR. CARTWRIGHT: Well, that's not strictly a legal
2 question, I guess.

3 COMMISSIONER CASEY: Okay.

4 MR. CARTWRIGHT: If you were asking me what would
5 be needed to minimize legal uncertainty, I would say a clear
6 Commission rule-making. There's two proposals before the
7 Commission today. The outcome, if either of those are
8 adopted, will be a much greater clarity than exists at the
9 moment where we have a single circuit at variance with the
10 position of the Agency.

11 And as you know, within particularly what we've
12 around here called the long release because it has more pages
13 there's a fulsome set of questions. So there's lots of
14 possibilities that remain open.

15 I think my colleagues in the Division of
16 Corporation Finance expressed the view that they would be
17 disappointed if the Commission were unable to come to some
18 conclusion.

19 I think the Chairman has said very forcefully that
20 he expects that the Commission will be able to reach a
21 rule-making outcome. And if that happens, then we will have
22 legal clarity, and the 2008 proxy season will be less
23 potentially chaotic than it might otherwise be.

24 COMMISSIONER CASEY: Thank you.

25 CHAIRMAN COX: Commissioner Atkins.

1 COMMISSIONER ATKINS: I just wanted to follow up on
2 that. With respect to the shorter release, I'll just read
3 the one sentence of the summary up front.

4 "The Commission is publishing its interpretation of
5 and proposing amendments to Rule 14a-8(i)(8) to provide
6 certainty regarding the meaning of exclusion in that rule."

7 So I think there is a significant difference. The
8 Second Circuit -- I guess I, sort of, disagree with the
9 sweeping conclusion that you came to, Brian.

10 But I think they ask for an explanation clearly.
11 They parse carefully the deference to be given between an
12 amicus and a rule-making. I think we're answering that
13 question today in setting it out.

14 And I guess my question to the Corporation Finance
15 Division is in administering Commission rules do you believe
16 that you should follow Commission rules and views, or do you
17 think you should be free to disregard those?

18 MR. CARTWRIGHT: Can I jump in just to respond for
19 half a second before they answer? And that is the Second
20 Circuit made it clear in its opinion that it considered the
21 ultimate policy decisions in this arena to be the
22 Commission's choice, not for the judiciary.

23 So that's why the Commission can adopt a new
24 revised 14a-8, the old 14a-8. The Commission has a great deal
25 of freedom. I didn't mean to suggest anything to the

1 contrary.

2 COMMISSIONER ATKINS: Okay. All right. And as to
3 the explanation that they were looking for, I think that's
4 being provided.

5 But I guess my question is in view of the action
6 that I guess we're going to take today, would you follow
7 Commission interpretation in administering our rules?

8 MR. WHITE: We would follow Commission
9 interpretations.

10 COMMISSIONER ATKINS: Okay. Thanks.

11 CHAIRMAN COX: Is there any further question or
12 discussion? If not, we'll move to the vote.

13 Having designated these to everyone's satisfaction
14 as the long release and the short release, the question will
15 occur first on the long release. All those in
16 favor?

17 (Chairman Cox and Commissioners Campos and Nazareth
18 voted in favor. Commissioners Atkins and Casey voted
19 against.)

20 And the recommendation is approved.

21 The question next is on the short release. All
22 those in favor?

23 (Chairman Cox and Commissioners Atkins and Casey
24 voted in favor. Commissioners Campos and Nazareth voted
25 against.)

