

1 THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION

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5 UNOFFICIAL TRANSCRIPT OF THE OPEN MEETING

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WEDNESDAY, MAY 23, 2007

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13 BEFORE: CHAIRMAN CHRISTOPHER COX

14 COMMISSIONER PAUL S. ATKINS

15 COMMISSIONER ROEL C. CAMPOS

16 COMMISSIONER ANNETTE L. NAZARETH

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P R O C E E D I N G S

CHAIRMAN COX: Good morning. Thank you for bearing with us. This is a meeting of the Securities and Exchange Commission under the Government Sunshine Act being conducted at our Headquarters in Washington, D.C., and also electronically connected to Zurich. Commissioner Atkins will be joining us shortly.

The first item on our agenda today is the Commission's interpretative guidance for management in evaluating and assessing internal controls over financial reporting as required by Section 404 of the Sarbanes-Oxley Act, and related rule changes.

It was over a year ago that the Commission and the Public Company Accounting Oversight Board announced a road map to improve the reliability of financial statements, while making compliance with Section 404 of the Sarbanes-Oxley Act more efficient and cost effective for public companies of all sizes.

Last December, the Commission proposed for public comment interpretative guidance for management to follow in conducting Section 404 evaluations.

The guidance was designed to focus management's attention on those internal controls that pose the greatest risk for a material financial misstatement.

At the same time, as a companion to our proposal,

1 the Public Company Accounting Oversight Board proposed an
2 extension revision of its existing standard for Section 404
3 audits.

4 After the comment periods for these proposals
5 ended, the Commission held an open meeting on April 4th. At
6 that meeting, we received a report on SEC staff's progress in
7 working with the Public Company Accounting Oversight Board's
8 staff to address the issues in the comment letters, and to
9 coordinate and align the standard with our interpretative
10 guidance.

11 At the end of that meeting, the Commission voted to
12 support the staff's approach in all respects.

13 Our meeting this morning is to consider the
14 recommendations by the Office of the Chief Accountant and the
15 Division of Corporation Finance to approve the interpretative
16 guidance for management, as well as tomorrow's PCAOB meeting
17 in which the Board will consider the adoption of its new 404
18 auditing standard. This is a significant achievement.

19 Our efforts to reach this point have been
20 considerably aided by the public comment process and by our
21 staff's interaction with the PCAOB staff, and by the feedback
22 and report that we received from the Congress.

23 If we continue to proceed as we have, our time
24 table established for the Commission and the PCAOB last May
25 will be able to positively and significantly affect the 2007

1 audit cycle.

2 Despite the high costs over the last four years of
3 implementing Section 404 of the Sarbanes-Oxley Act, I believe
4 that Sarbanes-Oxley overall, including Section 404, may
5 fairly be credited with correcting the serious problems that
6 beset our securities markets just a few years ago.

7 SOX fairly can be credited with restoring investor
8 confidence in our markets.

9 The challenge has been to find the right balance
10 between financial reporting and efficiency in achieving it.
11 Congress never intended that the 404 process should become
12 inflexible, burdensome and wasteful. The objective of
13 Section 404 is to provide meaningful disclosure to investors
14 about the effectiveness of the company's internal control
15 systems, without creating unnecessary compliance burdens or
16 wasting shareholder resources.

17 The Commission's interpretative guidance for
18 management on the evaluation and assessment of its internal
19 controls over financial reporting is intended to right size
20 the evaluation and assessment efforts of management, and it
21 is intended to do that for companies of all sizes.

22 With this guidance, management will be able to
23 scale and tailor their evaluation procedures to fit the facts
24 and circumstances, and investors will benefit from reduced
25 compliance costs.

1 While the guidance is intended to help public
2 companies of all sizes, smaller companies should particularly
3 benefit from its scalability and its flexibility.

4 When we announced our Section 404 extension for
5 non-accelerated filers last December, we stated that we would
6 consider further postponing the compliance date for
7 management's report on internal controls if the Commission
8 did not issue its guidance in time to be of sufficient
9 assistance in connection with annual reports filed for fiscal
10 years ending on or after December 15, 2007.

11 In light of the excellent progress that's been made
12 and the flexibility and scalability that the new provisions
13 add, it would not appear that additional postponement is
14 necessary.

15 Section 404 and compliance with it by smaller
16 companies will further the primary goal of Sarbanes-Oxley,
17 which is to enhance the quality of financial reporting and
18 increase the confidence of investors in both small and large
19 companies alike.

20 Before we hear from the staff, I want to
21 particularly call out for recognition of the extraordinary
22 efforts by the Office of the Chief Accountant and the
23 Division of Corporation Finance. Your work and your
24 leadership in developing the interpretative guidance for
25 management and your work with the Public Company Accounting

1 Oversight Board staff to align the PCAOB's proposed auditing
2 standard with our management guidance has been exemplary.

3 Particular in the Office of Chief Accountant, I
4 want to thank Conrad Hewitt, currently in Zurich, Zoe-Vonna
5 Palmrose, Nancy Salisbury, Mike Gaynor, Brian Krodo, and Josh
6 Jones.

7 In the Division of Corporation Finance, I want to
8 thank John White, Carol Stacey, Elizabeth Murphy, Sean
9 Harrison, Kimberly Drexler. Obviously, there is an Army
10 here, men and women who deserve thanks standing right behind
11 those that I've already mentioned.

12 Now I would like to turn the meeting over to John,
13 Director of the Division of Corporation Finance, and to
14 Conrad Hewitt, electronically connected, as I mentioned, for
15 a presentation of the staff's recommendations.

16 ITEM 1

17 COMMISSION GUIDANCE REGARDING MANAGEMENT'S REPORT ON INTERNAL
18 CONTROL OVER FINANCIAL REPORTING UNDER SECTION 13(a) OR
19 SECTION 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 AND
20 AMENDMENTS TO RULES REGARDING MANAGEMENT'S REPORT ON INTERNAL
21 CONTROL OVER FINANCIAL REPORTING

22 MR. WHITE: Thank you, Chairman Cox. Chairman Cox,
23 members of the Commission, we are here today to recommend to
24 you that you approve and publish in final form interpretative
25 guidance regarding the planning and conduct of management's

1 evaluation of internal controls.

2 I must say that it has been an exciting and
3 important journey to arrive at today's recommendations to the
4 Commission, a journey that started soon after I arrived and
5 began with the SOX 404 Roundtable and the Next Steps press
6 release last May.

7 I was told when I arrived that addressing the
8 implementation of SOX 404 was perhaps the most pressing issue
9 facing the Commission at the time, and it should be given our
10 highest priority.

11 The decision announced in your press release last
12 May to have the Commission provide so-called management
13 guidance is something the Commission had actually chosen not
14 to do when SOX 404 was being implemented three years earlier,
15 and was a critical element in this plan to improve the
16 implementation of SOX 404.

17 In a very intense effort on this front, I believe
18 that the Commission, all of you, have moved forward in its
19 best traditions, working extraordinarily hard, collecting
20 extensive public comments, first on a concept release and
21 then on a proposing release, and then holding an open meeting
22 to discuss alignment of your proposed management guidance
23 with the current efforts of the PCAOB to provide a new
24 auditing standard, AS-5.

25 In the process, the Commission and the staff has

1 created something that simply did not exist before in one
2 place, guidance for management in implementing SOX 404.

3 Today is the culmination of that effort. I must
4 say for all of us on the staff, at the table here and behind
5 us, we are very pleased and really very proud to make these
6 recommendations to you.

7 In a moment, Conrad Hewitt and Zoe-Vonna Palmrose
8 are going to set out the core principles that have guided us
9 in the last year and lay out the details of our
10 recommendations to you.

11 First, I will take a few minutes to lay out the
12 structure of our recommendations and how we got there.

13 An important initial decision for us was whether
14 management guidance should be issued as an interpretation or
15 instead codified as a Commission rule.

16 Over two-thirds of the commentators preferred that
17 the guidance be issued as an interpretation. We agree with
18 that, and we are following that advice and recommending that
19 you issue the final version of the guidance in the form of an
20 interpretative release.

21 This will permit the guidance to be more easily
22 updated and modified than if it were incorporated right into
23 the Section 404 rules themselves.

24 In addition to this interpretative guidance, we are
25 recommending that you approve in a separate release today

1 amendments to the Section 404 rules.

2 At the proposing stage back in December, the
3 interpretative guidance and the proposed rule amendments were
4 actually combined in a single release. We believe at this
5 stage, it is more practical and really user friendly if you
6 adopt two separate releases.

7 One setting forth the guidance and the other the
8 final rule amendments. That way, when codified, the rule
9 amendments will appear in their appropriate places
10 interspersed with our other 404 related rules, and for ease
11 of use by all issuers, including particularly small issuers
12 who will be complying with 404 for the first time this year.
13 The interpretative guidance will be a free standing release
14 on its own. The two releases will appear together in the
15 Federal Register.

16 Zoe-Vonna will be describing the guidance in detail
17 in a moment. Let me outline for you the rule amendments.

18 First, one of the amendments states that while
19 there are many ways to conduct an evaluation of effectiveness
20 in internal control, an evaluation conducted in accordance
21 with the interpretative guidance will satisfy our rules.

22 There is an important aside to this because we
23 understand obviously that many of the larger public companies
24 have already been complying with Section 404 for the past
25 three years, and they have established evaluation processes

1 that may differ from the approach described in the
2 interpretative guidance.

3 Please understand, that's okay. There is no
4 requirement for these companies to alter their procedures
5 from the last three years to align them with our new
6 interpretative guidance unless they choose to do so.

7 Second, we are also recommending that you revise
8 two regulation S-X provisions pertaining to the auditor's
9 attestation report on internal control to clarify going
10 forward that the auditor will be required to express only one
11 opinion in the audit report, directly on the effectiveness of
12 internal control.

13 Under the existing requirement, as you know, the
14 auditor must express two opinions, two separate opinions.
15 One on effectiveness and another on management assessment.

16 Finally, we are recommending that you codify the
17 definition of the term "material weakness" substantially as
18 it was proposed last December in the interpretative guidance.

19 The final rules would define a "material weakness"
20 as a deficiency or a combination of deficiencies in internal
21 control or financial reporting, such that there is a
22 reasonable possibility that a material weakness in the
23 company's annual or interim financial statements will now be
24 prevented or detected on a timely basis.

25 We anticipate that the PCAOB's revised auditing

1 standard will include the same definition.

2 One further recommendation on the rule. We think
3 it makes sense to also include a definition of the term
4 "significant deficiency" in the Commission's rules. We,
5 therefore, are recommending that you issue a third release
6 today to seek additional public comment on the proposed
7 definition of this term.

8 Although the Commission's July 2006 concept release
9 sought comment on definitions of both "material weakness" and
10 "significant deficiency," the proposed interpretative
11 guidance last December defined only the term "material
12 weakness."

13 Several commentators on the guidance indicated that
14 the Commission should also define the term "significant
15 deficiency" and we agree with those comments.

16 We actually have three releases, separate releases
17 we are recommending to you.

18 That is kind of the outline. Let me get to the
19 thank you part. Chairman Cox has already thanked the many
20 members of the staff who have worked on these releases as
21 well as the staff and Board of the PCAOB who worked with us,
22 and I certainly very much echo those thanks.

23 I will not read off the names again. I really want
24 to say to everyone here that I sincerely appreciate the help
25 we had by every one of you.

1 Before I turn things over to Conrad, I do want to
2 extend special thanks to a key member of the Section 404
3 team, to my right, Carol Stacey, Corporation Finance's Chief
4 Accountant for the past five years. She will be leaving the
5 Commission this week to return to the private sector.

6 Carol has been a major force in shaping the
7 Section 404 policies ever since 2002 when Sarbanes-Oxley
8 first became law. It is actually very fitting that she is
9 here at the table today as we reach this important milestone
10 and work to improve the implementation of 404.

11 Carol, I said those other words at your private
12 good-bye, but I now want to publicly express the deep
13 appreciation for your 11 years of service to the Commission
14 and extend our best wishes to you in the future.

15 You will be greatly missed by all of us in Corp
16 Fin and by all of the Commission. Thank you very much.

17 Now I'd like to turn the meeting over to Conrad
18 Hewitt, the Commission's Chief Accountant, for what I guess
19 is a first, participation from Zurich. Now we are going to
20 find out whether our electronics work.

21 Conrad, are you there?

22 MR. HEWITT: Yes, I am, John. Thank you.

23 Chairman Cox and members of the Commission, I am
24 pleased to be able to participate in this important open
25 meeting of the Commission on the proposed interpretative

1 guidance to management via video conference.

2 Last October I was asked and I accepted to be the
3 keynote speaker at the Annual International Accounting
4 Standards Conference here in Zurich. I will present my
5 speech in about an hour and a half from now.

6 Obviously, I had a tremendous conflict to be at the
7 Commission hearing and also be in Zurich at the same time.
8 However, through technology, I am able to be in both places
9 at the same time.

10 As Chairman Cox mentioned, the Commission proposed
11 the interpretative guidance for management on the evaluation
12 and assessment of internal control over financial reporting
13 and the related rule changes last December.

14 The comment period for these proposals ended
15 February 26th. My staff and I have been working very
16 diligently to address the comments received and finalize the
17 proposals to you. Today, we are here to present for your
18 consideration our finalized interpretative guidance for
19 management and the related rule changes mentioned by John.

20 An overall objective of Section 404 and the
21 Commission rules are to foster the preparation of reliable
22 financial statements. Another objective is that the
23 Commission rules implementing Section 404 are intended to
24 bring information concerning material weakness into public
25 view.

1 We believe the interpretative guidance we are
2 presenting here today maintains both of these objectives. At
3 the same time, the guidance provides a principle based
4 framework to management of how they may complete their
5 assessment in a more efficient and effective manner.

6 We believe the guidance will be beneficial to
7 companies of all sizes, but especially smaller companies,
8 including those who have not yet completed their first
9 evaluation.

10 The majority of the comment letters we received on
11 our proposing release expressed overall support for the
12 principle based nature of the Commission's interpretative
13 guidance. Many commentators believed that this guidance will
14 encourage a healthy use of judgment and common business sense
15 in formulating the procedures companies use to evaluate
16 whether material weaknesses exist in their internal control
17 systems.

18 Further, over 70 percent of the commentators that
19 were smaller companies or representatives of smaller
20 companies expressed support for the guidance. Many
21 commentators indicated the guidance would allow management to
22 focus on areas most important to reliable financial
23 reporting. Also, the commentators said the guidance would
24 allow management to tailor their evaluations to each
25 company's facts and circumstances.

1 Interpretative guidance reiterates the Commission's
2 position that management must bring its own experience and
3 informed judgment to bear in order to design an evaluation
4 process. The evaluation process needs to provide a
5 reasonable basis for its annual assessment of whether ICF is
6 effective. The guidance is intended to allow management
7 sufficient and appropriate flexibility to design such an
8 evaluation process.

9 Smaller public companies which generally have less
10 complex internal control systems than larger public companies
11 should use this guidance to scale and tailor their evaluation
12 methods and procedures to fit their own facts and
13 circumstances.

14 We encourage smaller public companies to take
15 advantage of the flexibility and scalability afforded in the
16 guidance to conduct an evaluation of ICFR that is both
17 efficient and effective at identifying material weaknesses.

18 The core principles of the interpretative guidance
19 have not changed from our proposing release. However, we
20 have made certain clarifications and modifications to the
21 proposed guidance as a result of the comments received.

22 In a moment, Zoe-Vonna Palmrose will overview the
23 more significant changes made.

24 At this point, I would like to reiterate the
25 Chairman's thanks to the staff who worked tirelessly on this

1 important effort. During this process, we have worked
2 closely with the PCAOB. I would like to add my thanks to the
3 Board and staff of the PCAOB.

4 We would also like to thank the Commissioners and
5 their staff for their countless hours that they have worked
6 with us on this topic over the past several months providing
7 their insight and guidance.

8 Finally, we believe that the interpretative
9 guidance for management when adopted by the Commission will
10 provide for many years in the future a more effective and
11 efficient ICFR evaluation process for existing and future
12 public companies.

13 The guidance will allow companies of all sizes to
14 comply with our rules while reassuring investors that
15 material weaknesses in internal controls will be brought to
16 light, disclosed and corrected.

17 Stated simply, we believe that the interpretative
18 guidance will play an important role in achieving the
19 cost/benefit balance that must be brought to the Section 404
20 compliance for all companies.

21 Because this guidance to management did not exist
22 before the approval of the Commission of this interpretative
23 guidance to management, it will provide additional protection
24 and transparency to investors for many years in the future.

25 I would like to turn it over to Zoe-Vonna Palmrose,

1 and thank you very much.

2 MS. PALMROSE: Thank you, Conrad. The Commission
3 received over 200 comment letters on its proposed
4 interpretative guidance and related rule changes.

5 As Conrad noted, the majority of the comment
6 letters expressed overall support for the principles based
7 nature of the Commission's interpretative guidance.

8 Based on the support expressed, the staff
9 determined that wholesale changes to the proposed guidance
10 were not warranted. However, commentors did provide
11 invaluable feedback on areas in which the interpretative
12 guidance could be clarified or improved, and I would like to
13 touch on some of this feedback.

14 The Commission's proposed interpretative guidance
15 was centered around two broad principles. These principles
16 have not changed in the guidance we are presenting today.

17 The first principle is that management should
18 evaluate whether it has implemented controls that adequately
19 address the risk that a material misstatement in the
20 financial statements would not be prevented or detected in a
21 timely manner.

22 The second principle is that management's
23 evaluation of evidence about the operation of its controls
24 should be based on its assessment of risk.

25 Under the guidance, management can align the nature

1 and extent of its evaluation procedures with those areas that
2 pose the highest risks to reliable financial reporting. That
3 is whether the financial statements are materially accurate.

4 As a result, management may be able to use more
5 efficient approaches to gathering evidence such as self
6 assessments in low risk areas and perform more extensive
7 testing in higher risk areas.

8 By following these two principles, we believe
9 companies of all sizes and complexities will be able to
10 implement our rules effectively and efficiently.

11 While commentors expressed support for this
12 principles based approach, some requested that the proposal
13 be revised to include additional guidance and illustrative
14 examples in areas such as the identification of controls that
15 address financial reporting risks, including IT general
16 controls, the assessment of risk, and how risk impacts the
17 nature, extent and timing of evidence needed to support the
18 assessment.

19 However, we believe additional specificity and
20 examples in the areas requested would likely have a negative
21 unintended consequences of establishing bright lines or one
22 size fits all evaluation approaches.

23 We have seen that an overly prescriptive set of
24 rules can lead to inefficiencies, and we want to avoid ending
25 up with evaluations more concerned with forms than substance

1 and which are inefficient to implement, ineffective at
2 detecting material weaknesses or both.

3 The guidance that you are considering here today
4 maintains the view that effective and efficient evaluation
5 require company management to make reasonable judgments that
6 reflect each company's individual facts and circumstances.

7 Nonetheless, based on comments received, we did
8 make modifications to the proposed interpretative guidance in
9 a number of areas. For example, we made revisions to better
10 align it with the PCAOB's proposed auditing standard, to
11 provide clarification on the role of entity level controls,
12 as well as on the nature of ongoing monitoring activities in
13 relation to management's evaluation, and to enhance the
14 guidance on fraud risk consideration.

15 I would like to briefly highlight the changes that
16 we made in each of these areas as a result of the comment
17 process.

18 Regarding alignment, as discussed at the open
19 Commission meeting on April 4th, commentors expressed concern
20 that confusion and inefficiencies may arise from differences
21 between the Commission's proposed guidance for management's
22 evaluation of ICFR and the PCAOB's proposed auditing
23 standard.

24 Commentors cited a lack of alignment in the
25 terminology and definitions used, as well as differences in

1 overall approaches. For example, some commentors while
2 supportive of our principles based approach to the
3 interpretative guidance expressed concern that improvements
4 in the efficiency of management's evaluation of ICFR would be
5 limited by what they viewed as comparatively more
6 prescriptive guidance for external auditors in the PCAOB's
7 proposed auditing standards.

8 In response to the comment letters and the guidance
9 provided by the Commission of the open meeting on April 4th,
10 we worked with the PCAOB staff to more closely align our
11 respective documents.

12 These revisions include aligning the definition of
13 "material weakness" and the related guidance for evaluating
14 deficiencies, including the indicators of material weakness.

15 We also considered differences and improved the
16 alignment around guidance for evaluating whether controls
17 adequately addressed financial reporting risks, the factors
18 to consider when identifying financial reporting risks, and
19 the factors for assessing the risk associated with individual
20 financial reporting elements and controls.

21 These represent key areas of judgment for both
22 management and auditors in determining whether ICFR is
23 effective and in determining the nature, timing and extent of
24 evaluation and audit procedures.

25 Even so, some differences are expected to remain

1 between our final interpretative guidance for management and
2 the PCAOB's audit standard. These differences are not
3 necessarily contradictions or misalignments, rather, they
4 reflect the fact that management and auditors have different
5 roles and responsibilities with respect to evaluating and
6 auditing ICFR respectively.

7 Management's daily involvement with its internal
8 controls system provides it with knowledge and information
9 that may influence its judgments about how best to conduct
10 the evaluation, and the sufficiency of evidence it needs to
11 assess ICFR's effectiveness.

12 Differences in the respective approaches are likely
13 to exist because the auditor does not have the same
14 information and understanding as management, and because the
15 auditor will integrate its test of ICFR with the financial
16 statement audit.

17 Next, commentors requested further clarification of
18 how entity level controls can address financial reporting
19 risks in a top down risk based approach. Commentors also
20 suggested that the guidance place more emphasis on entity
21 level controls, given their pervasive impact on all other
22 aspects of ICFR.

23 We revised the proposal to expand the discussion of
24 entity level controls and how they relate to financial
25 reporting elements.

1 This discussion further clarifies that some entity
2 level controls, such as controls within the control
3 environment, have an important but indirect effect on the
4 likelihood that a misstatement will be prevented or detected
5 on a timely basis.

6 Further, the revised guidance clarifies that some
7 entity level controls may be designed to identify possible
8 breakdowns in lower level controls, but not in a manner that
9 would by themselves adequately address financial reporting
10 risks.

11 In these cases, management would identify the
12 additional controls needed to adequately address financial
13 reporting risks such as those that operate at the transaction
14 or account balance level. However, management would consider
15 both the entity level and transaction level in designing the
16 nature and extent of the evaluation procedures, including
17 those procedures for transaction level controls.

18 We have also revised the guidance to further
19 clarify that the controls management identifies should
20 include entity level and pervasive elements of ICFR that are
21 necessary for reliable financial reporting.

22 This revision is intended to emphasize that
23 management's evaluation of ICFR should consider the control
24 environment and other entity level activities that are
25 necessary to have an internal control that is effective at

1 providing reasonable assurance regarding the reliability of
2 financial reporting.

3 Another area where we made modifications to the
4 proposed guidance to reflect the comments received relates to
5 how self assessment, including ongoing monitoring activities,
6 were addressed in the proposal.

7 Commentors expressed concern that as defined in the
8 proposal, some ongoing monitoring activities would not be
9 deemed to provide sufficient evidence. Other commentors
10 suggested that self assessment can provide a significant
11 source of evidence when their effective operation is verified
12 by direct testing over varying periods of time based on the
13 manner in which the self assessments were conducted and based
14 on the level of risk associated with the controls.

15 Commentors also requested the guidance be revised
16 to clarify how based on the definitions provided in the
17 proposed guidance self assessments differed from direct
18 testing.

19 We agreed with a number of comments received, so we
20 revised the guidance regarding ongoing monitoring activities,
21 including self assessment and direct testing to clarify how
22 the evidence obtained from each of these activities can vary.

23 These revisions are important as they demonstrate
24 that management's assessments can be supported by information
25 management obtains from its normal monitoring activities that

1 will often times be built into the daily responsibilities of
2 the employees involved in the processes, rather than from
3 consultants hired for testing purposes.

4 The revisions included discussion of how management
5 should consider the objectivity of the individuals performing
6 the activities when determining the evidence obtained from
7 each of these activities.

8 As part of this discussion, we clarified that when
9 evaluating the objectivity of personnel, management is not
10 required to make an absolute conclusion regarding the
11 objectivity but rather should recognize that personnel will
12 have varying degrees of objectivity based on among other
13 things their job function, their relationship to the subject
14 matter, and their status within the organization.

15 Management should consider the risks to reliable
16 financial reporting when determining whether the objectivity
17 of the personnel involved in the monitoring activities
18 results in sufficient evidence.

19 Finally, commentors suggested that further guidance
20 in the area of fraudulent financial reporting would improve
21 the proposal. We agreed and revised the proposal
22 accordingly.

23 For example, while the proposal provided general
24 directions to assess the risk of fraud and to focus
25 evaluation procedures on controls that address such risks, we

1 have enhanced the final guidance by explaining that the risk
2 of fraudulent financial reporting will exist in virtually all
3 companies. Rigorous evaluations require management to
4 recognize that the existence of a fraud risk does not mean
5 fraud has occurred. Likewise and importantly, it should not
6 take an incident of fraudulent financial reporting to
7 recognize the existence of fraud risk.

8 Further, the guidance clarifies that the risk of
9 management overrides, particularly in the period end
10 financial reporting process, is something that virtually
11 every company needs to consider. Effective control systems
12 ought to take steps to manage this risk, and we believe that
13 companies of all sizes, including smaller companies, can do
14 so.

15 Clearly, fraudulent financial reporting was a
16 primary motivation for the Sarbanes-Oxley Act, including
17 Section 404. From an investor protection standpoint, we
18 agree with commentors on the importance of emphasizing
19 management's responsibility to identify and evaluate fraud
20 risks and the related controls to address such risks.

21 Overall, these modifications to the proposed
22 guidance are consistent with our objective of rationalizing
23 the planning and conduct of the ICFR evaluation process for
24 all companies regardless of size, by allowing companies to
25 focus their efforts on those areas that management has

1 identified as posing the greatest risks of material
2 misstatement in the financial statements not being prevented
3 or detected on a timely basis.

4 This is what investors care about and what is
5 important for achieving reliable financial reporting.

6 The key objectives of Section 404 and the
7 Commission's implementation rules are to foster more accurate
8 financial reporting as well as provide investors with useful
9 and important information about the adequacy of a company's
10 internal controls.

11 The interpretative guidance we are recommending the
12 Commission adopt today we believe will assist management in
13 meeting these objectives in a cost efficient manner while
14 providing the intended investor protection benefits for many
15 years to come.

16 In closing, I would like to reinforce the
17 appreciation expressed by others to the Commission, including
18 their guidance to the staff at the April 4th open Commission
19 meeting, the PCAOB Board and staff, and the Office and
20 Division staff that have worked so long and hard on this
21 project, including my staff, in particular, Nancy Salisbury,
22 Brian Krodo, Josh Jones, Mike Gaynor, Kevin Stout, and Katy
23 Scarborough.

24 Mike Gaynor, who along with others has played a key
25 role in developing and drafting the guidance, is with us at

1 the table today to help answer your questions.

2 That includes our opening remarks. Chairman Cox
3 and the Commissioners, the staffs of OCA and the Division of
4 Corp Fin are ready and happy to address any comments you
5 would have.

6 CHAIRMAN COX: Thank all of you, including those of
7 you electronically from Zurich, thank you for a very
8 elaborate and complete presentation. This is another
9 opportunity for me to observe a great deal of effort, a lot
10 of intellectual fire power was brought to bear on this, and
11 the whole purpose, of course, was to make sure that as
12 regulators we are implementing the Sarbanes-Oxley Act as
13 Congress intended it.

14 We have had a lot of participation from the
15 Congress in our efforts. We have had formal hearings devoted
16 to this and a lot of informal give and take and
17 collaboration.

18 I think we have been extraordinarily successful in
19 getting it right as Congress intended.

20 As Congress has been very attentive to our efforts
21 to align Sarbanes-Oxley implementation to the intent of the
22 law in the first place, one particular remaining focus has
23 been the impact on smaller companies.

24 Since SOX was enacted, they have not had to comply
25 with 404. This will be the first time they do. You have

1 recommended that the Commission not provide any further
2 delays for non-accelerated filers.

3 Can you elaborate on how the guidance within this
4 release will assist smaller companies as they in many cases
5 for the first time complete the evaluation of internal
6 control of financial reporting and putting this in language
7 that small companies will understand, why should they not be
8 concerned that there will not be enough time to comply with
9 404?

10 MS. PALMROSE: I'd be delighted to do that. We do
11 believe that the interpretative guidance will allow companies
12 of all sizes to appropriately tailor their evaluation efforts
13 in response to their own facts and circumstances.

14 We made a specific effort to highlight important
15 areas where the evaluation at a smaller company might be
16 different than that for a larger company, including the
17 nature of the efforts management undertakes to evaluate,
18 whether it is controls designed in a way to provide
19 reasonable assurance about the reliability of its financial
20 reports, how management can obtain information about whether
21 those controls as designed are operating and the
22 documentation needed to provide reasonable support for both.

23 At the core, our guidance for conducting the
24 evaluation suggests that certifying officers ask themselves
25 two questions. Do my employees understand what they need to

1 do to prepare reliable financial statements and what
2 information do I need to be sure they have done those things.

3 For many small companies, the answer to these two
4 questions need not be complicated or costly, and we believe
5 complying with our guidance will not make them so.

6 Yes, we do believe not only that it is doable for
7 smaller companies, but doable in 2007.

8 MR. WHITE: I might add just in terms of the phase
9 in here, in 2007 or year end 2007, only the management
10 assessment is required for the smaller companies. They will
11 not have to do the audit requirement until the end of 2008.

12 CHAIRMAN COX: What that means, since you are
13 talking about 2008 financials, is for calendar year filers,
14 March or thereabouts in 2009; is that correct?

15 MR. WHITE: Correct, March 2009 would be the first
16 time they would provide an audit report under 404.

17 CHAIRMAN COX: There were some commentors that
18 suggested that further revisions be made to the definition
19 that we proposed for "material weakness." The final release
20 adopts a definition substantially as proposed.

21 Can you explain in a more elaborative fashion why
22 that is so?

23 MS. PALMROSE: Yes, once again, we would be
24 delighted to do that. We actually received comments on this
25 issue from about 24 commentors as to the definition in

1 general.

2 About half supported the proposed definition and
3 indicated that it was actually a revision from the previous
4 one, the proposed definition was a revision from the previous
5 one, and they supported that revision and its clarified
6 meaning.

7 However, some commentors did acknowledge that the
8 wording of the likelihood standard within the prior
9 definition as "more than remote" was misunderstood to mean
10 something less than reasonably possible. The proposed
11 definition represents a meaningful clarification.

12 Other commentors noted that while the change in the
13 proposed wording of the likelihood standard within the
14 definition for "more than remote" to "reasonable possibility"
15 might represent what was meant all along, not actually using
16 the term "remote" in this new definition may still have an
17 important psychological benefit of getting auditors and
18 managements' mindset out of the weave.

19 CHAIRMAN COX: Apart from the specifics of the
20 definition, part of the substance of what this is all about,
21 where are we seeing these material weaknesses coming from and
22 how does this guidance interact with that?

23 MS. PALMROSE: Actually, most of the material
24 weaknesses that we are seeing do involve areas that -- let me
25 step back and say we do rely on audit analytics for their

1 analysis of the disclosures of material weaknesses.

2 The categories there, to say that the majority of
3 them involve accounting related issues would be sort of
4 obvious because this is about financial reporting.

5 The real question is to drill down into what is the
6 nature of those weaknesses within the accounting areas, and
7 we do see some within the areas of more complex accounting
8 standards.

9 For example, we do see taxes and the tax area as
10 being a major area of material weaknesses. We also see some
11 but a much lower percentage in the area of derivatives.

12 What we have tried to do is provide some additional
13 guidance that focuses on the higher risk areas and that could
14 include accounting complexity and the more complicated
15 accounting areas.

16 CHAIRMAN COX: The weaknesses we are seeing are
17 tied to the misapplication of generally accepted accounting
18 principles which in turn might be tied to the complexity of
19 those?

20 MS. PALMROSE: Yes, that is one dimension of it.
21 There is another dimension, too, which involves the expertise
22 and competence and training of accounting personnel, which is
23 another category that gives rise to about half of the
24 material weaknesses that were seen. Again, that probably
25 interacts with more complicated accounting standards, but

1 also gets into areas that we touched on in the guidance in
2 terms of the control environment and those aspects.

3 I do not know if Mike would like to elaborate on
4 that a little, or if that is sufficient.

5 MR. GAYNOR: I think she has covered the water
6 front. I will just add that one of the things that we are
7 trying to achieve in the guidance and in particular with our
8 discussion around the importance of being risk based is
9 particularly now that we have several years of reporting of
10 material weaknesses behind us, we see where the problems are,
11 and that should allow people to sharpen their risk focus.

12 If it is the complicated areas of GAAP, revenue
13 recognition perhaps, income taxes, derivative, what not,
14 those are known facts. They are things that accountants can
15 react to, go in and put some controls in those areas and
16 hopefully tighten up the reliability of the financial
17 recording.

18 Hopefully, we can use what we are learning from the
19 disclosures to enhance the risk based approach that we are
20 prescribing in the guidance.

21 CHAIRMAN COX: Just a couple of quick final things
22 I want to ask about. Our December proposing release had as
23 one of its main goals making it clear, as the Sarbanes-Oxley
24 statute makes clear, that the management assessment needs to
25 be driven by the auditing standard. One of the most frequent

1 complaints that we were hearing from accelerated filers was
2 that the auditors were driving the process.

3 What I would like to ask publicly is based on the
4 comments that you received and the revisions that we have
5 made, do you believe that this issue has been addressed?

6 MS. PALMROSE: Yes. That was something that was
7 very important as we were developing the initial guidance.
8 It was actually something obviously that both the staffs of
9 the PCAOB and our staff were cognizant of.

10 What we have done is we have further refined that
11 in this guidance that is with you today. One of the
12 important elements of that is around the alignment. We think
13 in our initial proposed guidance, we got it right in terms of
14 what we needed to focus on and the PCAOB's proposed standard
15 took the management's assessment -- the auditor's role in
16 evaluating management's process out of their standard.

17 That was the first phase we discovered, so the
18 comment process has been enormously useful to us in helping
19 us understand how these two documents need to work together,
20 and that is part of the alignment that we are talking about.

21 That has really been a major focus for our efforts
22 here in the last few months in working with the PCAOB staff,
23 too, to make sure that these documents work together, and
24 that management looks to the interpretative guidance and is
25 able to rely on it for their evaluation process and that

1 auditors can then look to the auditing standard.

2 CHAIRMAN COX: Last week, the FEI released a study
3 and their new study on the costs of implementing Section 404
4 of Sarbanes-Oxley indicated that the average cost of year
5 three compliance had dropped 23 percent from the two year
6 cost, but that the auditor attestation fees hadn't dropped on
7 average.

8 How do you believe this guidance and the related
9 rule changes that we are considering here today will impact
10 the cost of year four efforts?

11 MS. PALMROSE: Let me start out and maybe others
12 would like to add in. Certainly our focus today is on
13 management guidance. We do expect, as did the FEI expressed
14 in their press release, that further efficiencies should be
15 achieved as we go forward under our new guidance, so they not
16 only documented that costs have declined but they expect them
17 to continue to do so because there would be opportunities
18 provided to the accelerated filers under our guidance for
19 further cost efficiencies, and some of the fine tuning that
20 we have done on the guidance during this process.

21 In terms of the audit side, the PCAOB will be
22 proposing their standard tomorrow -- the Board will be
23 meeting tomorrow on this.

24 CHAIRMAN COX: Assuming that what happens tomorrow
25 is they adopt what we think they are going to adopt, the very

1 document we have been closely coordinating with in our
2 management guidance, what is the answer to that?

3 MS. PALMROSE: I was just going to say having said
4 that they are meeting tomorrow, we would like to re-affirm
5 that we have been working very hard during this process just
6 to achieve exactly what you are asking about, to make sure
7 that auditors are able to achieve efficiencies through a more
8 judgment based standard, and not have to do work for work's
9 sake or ask management to do work for work's sake.

10 That is actually what we have been spending a great
11 deal of time on to make sure that each individual document
12 works on its own as well as works together, so we get
13 effective results here, but in the evaluation phase as well
14 as the audit phase, but that it is not work for work's sake.
15 It is really substance and not form.

16 CHAIRMAN COX: That really is the bottom line of
17 what we are trying to do here. John?

18 MR. WHITE: Probably also worth commenting, we are
19 certainly hopeful that the auditors will be able to begin the
20 preliminary processes after tomorrow of incorporating the
21 changes that the PCAOB has put in place into their
22 procedures.

23 As you know, it does get sent over here. There is
24 a process over here before their new standard will actually
25 become final. We are certainly hoping that the auditing

1 firms will be able to start the initial process.

2 CHAIRMAN COX: The entire Commission has had this
3 in mind all along, the reason for our trying to work hand and
4 glove with the PCAOB is so we do not have a serial process in
5 which everyone has to wait until first the PCAOB and then the
6 SEC conducts all of this. I think we all have a pretty high
7 degree of confidence about what we are seeing in the PCAOB
8 standard.

9 I would say that the most striking them to me in
10 that FEI study was that 78 percent of the respondents said
11 the cost of compliance with Section 404 under the old system
12 exceeded the benefits. We really do need to focus on that
13 performance metric for our own efforts.

14 MS. PALMROSE: We agree that is a really important
15 data point and it certainly is something that has been upper
16 most in our minds as we have worked on this guidance from the
17 beginning.

18 I thought it might be also beneficial to add some
19 other statistics from their survey, that in spite of that
20 particular frequency, it is also worth noting that 60 percent
21 of the accelerated filers that responded to their surveys did
22 agree that compliance with 404 has resulted in more investor
23 confidence in their financial reports and nearly half of the
24 respondents agreed their financial reports are more accurate
25 and reliable given this effort.

1 CHAIRMAN COX: That, of course, is the part we want
2 to keep and indeed enhance.

3 MS. PALMROSE: Yes, exactly. That is exactly what
4 we are striving for here to accomplish.

5 MR. WHITE: I just want to reiterate a point that
6 we made earlier, that for the smaller public companies that
7 will be involved for the first time with 404, they will have
8 yet a whole another year in the audit cycle because their
9 first reports, as you described a moment ago, will be coming
10 in in March of 2009.

11 CHAIRMAN COX: Just as they got to watch and learn
12 from the experience of all those filers over the last few
13 years, but not filing themselves, they will under this new
14 guidance that we are proposing and new auditing standard from
15 the PCAOB get to watch, as there is a full year of experience
16 that others have with their auditor involvement, and they
17 will wait until their 2009 filings to come into compliance.

18 MR. WHITE: That's correct. That is exactly the
19 point.

20 CHAIRMAN COX: Speaking to that audience in truly
21 plain English, because we have talked a lot about definitions
22 and how our guidance interacts with PCAOB standards and so
23 on, and we have been beating a lot of auditorese, in plain
24 English, what are the inefficiencies that are being washed
25 out? What was happening under the old system that the SEC

1 did not want to see happening that diverted resources from
2 genuine investor protections that won't be happening any
3 more?

4 MS. PALMROSE: I can start and then maybe others
5 would like to join in. I think clearly one of the areas that
6 has received a lot of attention in terms of that is the
7 extent of testing of controls.

8 The fact that controls irrespective of their risk
9 of failure or the financial reporting risk they were related
10 to, you tested them all the same. Once you identified the
11 control was in, it beat them all essentially.

12 What we have really tried to do here is recognize
13 that the risks associated with those will vary and the level
14 of testing then will vary, including some of these new tests
15 automatically in your daily activities, and there is no
16 needed incremental effort.

17 It is a combination of moving up what needs to get
18 tested, refining how you think about testing, and the
19 sufficiency of the evidence that you need to satisfy yourself
20 they are operating effectively, and recognize that in lower
21 risk areas, what you are already doing can provide you with
22 that evidence.

23 The second thing is extensive documentation for
24 documentation sake. We have tried to refine that so that
25 documentation is what is necessary, not what is not

1 necessary.

2 The third thing is to recognize in smaller
3 companies there is an element of daily interaction that
4 occurs, so that you do not have to go out and ask somebody to
5 tell you what you already know and duplicate that effort in
6 some other way.

7 It is those three things I think I would start with
8 as being areas that we focused on in terms of trying to
9 obtain efficiencies.

10 My comments really focused on the management
11 guidance, what we did in management guidance.

12 CHAIRMAN COX: As I pass it to Commissioner Atkins
13 for his opening remarks and questions, how would investors be
14 better off?

15 MS. PALMROSE: Their resources will be spent in a
16 cost effective way and they will have the disclosures that
17 the Act identified were important for them, and they will
18 have transparency around disclosure.

19 CHAIRMAN COX: Excellent. I really do appreciate
20 the extraordinary amount of work that has gone into this and
21 completing this work. Perhaps this is my last opportunity to
22 say thanks again.

23 I pass to Commissioner Atkins. Thanks again.

24 COMMISSIONER ATKINS: Thank you, Mr. Chairman. I
25 also appreciate really the remarkable efforts of the folks in

1 the Office of Chief Accountant and Division of Corporation
2 Finance, and our economic analysis group and general
3 counsel's group over the last several months.

4 You have worked hard to address the many helpful
5 recommendations that commentors made in response to our
6 proposal and to align the SEC's guidance with that of PCAOB.

7 The guidance that we are reviewing today should
8 allow management to apply a risk based approach to evaluating
9 and testing internal controls over financial reporting and to
10 tailor that approach to the specific characteristics of their
11 companies.

12 The matters before us today are of course only one
13 part of the solution to the Section 404 implementation
14 problems that have arisen over the last few years. The
15 actions that PCAOB is planning to take as we have discussed
16 tomorrow to replace the failed Audit Standard No. 2 are also
17 critical.

18 After soliciting comment on the new standard, we
19 will determine whether the auditing standard will solve the
20 problems caused by its predecessor. If we do approve the new
21 standard, auditors' implementation of the standard and
22 PCAOB's oversight of auditors' implementation also will be of
23 great importance.

24 Likewise, the SEC will have to continually monitor
25 the manner in which PCAOB carries out its oversight.

1 Auditors will need to be cognizant of the fact that
2 management is not required to perform its assessment in
3 accordance with the audit standard.

4 In short, the puzzle of how to meaningfully
5 overhaul the implementation of Section 404 has many moving
6 pieces. Solving the puzzle will not be easy, but I believe
7 that the recommendations before us is a step in the right
8 direction. As far as Audit Standard No. 5 is concerned, I am
9 anticipating that what PCAOB will adopt tomorrow will be
10 consonant with the word and the spirit of what we do today,
11 so that we can finally close the loop expeditiously and
12 without re-writing the standards over time.

13 Therefore, I support the recommendations we have
14 before us today, but I do have several questions, and before
15 I get to that, I wanted to also like John extend a thanks and
16 gratitude to Carol Stacey who has done so much over the past
17 several years with a steady hand and a level head with so
18 much change swirling all around her, at times, some very
19 difficult calls to make. Thank you very much and good luck
20 in your future endeavors.

21 First, one of the problems that cropped up during
22 the inaugural years of Section 404 is that companies have
23 been driven by their auditors to identify and test sometimes
24 hundreds of thousands of key internal controls. This has
25 made the whole process extremely costly with little

1 corresponding benefits to customers.

2 How will this new management guidance make this
3 problem better?

4 MR. GAYNOR: There are several moving parts, if you
5 will, one of which is important that is actually outside of
6 the guidance that we proposed and that is the PCAOB in its
7 December proposals removed some paragraphs in AS-2 that
8 required the auditors to evaluate aspects of management's
9 process.

10 It appears from feedback through the comment
11 process and the roundtables that had a lot of unintended
12 consequences as to auditors' roles in how management arrived
13 at its own conclusions.

14 The December proposal from the PCAOB removed those
15 paragraphs. We think that is immensely helpful relative to
16 this problem.

17 The second piece that I think is important is what
18 we have tried to recognize in management guidance, and that
19 is that in certain instances, particularly in companies of
20 any size, there may be a lot of controls that are required in
21 order to get the financial statements right, but the
22 likelihood that those controls fail or the likelihood that
23 those controls represent a material weakness isn't equal
24 amongst all of them.

25 What is really important at the end of the day is

1 whether or not management has the information that it thinks
2 it needs to support a disclosure to investors about whether a
3 material weakness exists.

4 We have provided some principles based guidance
5 that allow management to put itself in that position in a way
6 that it believes best suits its needs.

7 In order to maintain discipline in the evaluation
8 process, we describe certain areas that we would expect to
9 ordinarily be high risk. I do not think there is any sort of
10 question or concern about whether in fact those areas do
11 represent high risk areas, but outside of those areas,
12 management can implement whatever methods and procedures for
13 gathering that evidence that they think are appropriate in
14 the circumstances, and sort of traditional audit like testing
15 that often times requires audit departments or consultants to
16 be brought in from outside to perform testing in areas where
17 people believe there is actually low risk to the reliability
18 of financial reporting, we have really sort of freed
19 management up to make decisions not to do that, and we hope
20 that is allowing them to comply most cost effectively.

21 COMMISSIONER ATKINS: Another problem has been
22 failure of people to focus on the entity level and on the
23 consolidated financial statements as far as the work that is
24 being done.

25 How would the interpretative guidance affect the

1 approach that management takes in evaluating the operation of
2 controls say across multiple locations or across business
3 units?

4 MR. GAYNOR: One of the ways that we talk about it
5 internally and like to think about it is that heretofore, the
6 implementation, you probably have not seen one of these, but
7 a lot of times, consolidating schedules, it will have ten
8 divisions going across, ten individual columns, and you get
9 to a consolidating total on the right.

10 Heretofore, the implementation has been very
11 columnar focused. If a division was deemed to be material
12 and all controls of that division got tested in a manner that
13 was sort of indiscriminate relative to the risk, what we have
14 tried to do in the management guidance and the PCAOB has made
15 similar revisions to AS-5, is to get people to think about
16 the risk sort of more in a vertical -- in a horizontal level
17 as opposed to a vertical level where they are looking at the
18 element of financial reporting and thinking about the risks
19 of that and less about sort of the consolidation process and
20 coverage in percentage terms.

21 We think that will allow people to spend less time
22 in areas where the time is not warranted.

23 COMMISSIONER ATKINS: Thank you for that. You had
24 made that point the other day in my office. I wanted to make
25 sure we got you on record. I think that is the clearest

1 explanation of how people should be approaching this, so it
2 does not get into granularity like we were seeing before.

3 Conrad is off, and I'm sure he's getting questions
4 posed by foreign issuers. I was wondering what some of the
5 issues were that foreign commentators raised and how you
6 addressed them. The draft guidance notes that a Frequently
7 Asked Questions document might be necessary to address some
8 of the issues that are of unique concern to foreign private
9 issuers.

10 I was wondering what sort of issues you anticipate
11 might be addressed for that document.

12 MS. PALMROSE: Yes, let me start. First of all,
13 I'd like to say we did receive comment letters from a number
14 of foreign private issuers and we very much appreciate their
15 participation in the comment process. They were all
16 informative to us. Some really broadened and deepened our
17 thinking. Again, thank you very much to the foreign private
18 issuers for participating.

19 In all honesty, many of the comments were very
20 similar to what we heard from others. There was a high
21 degree of overlap here on comments from them.

22 However, let me just talk about two areas. In the
23 proposing guidance, we had two footnotes that were directed
24 at issues unique to foreign private issuers. We received
25 some comments on those footnotes requesting a little bit

1 further elaboration.

2 It was really hard to expand within the guidance on
3 those, so the staff is currently drafting a series of
4 Frequently Asked Questions. Basically, we are going to
5 update the Frequently Asked Questions and include in them
6 some that are specific to foreign private issuers.

7 Those will be coming out shortly.

8 COMMISSIONER ATKINS: We look forward to reading
9 that. A number of commentors asked for more specific
10 examples. We have discussed this back and forth over the
11 last few months, and in the last public meeting we had.

12 When you compare it to PCAOB's -- it is a very
13 prescriptive standard with lots of must's and should's and
14 things like that in it. How do we say that the PCAOB's more
15 specific prescriptive standard is not going to serve as a de
16 facto standard for management?

17 MS. PALMROSE: Again, we have spent a lot of time
18 on this issue. What we have tried to do is obviously
19 eliminate any confusion over terminology and definitions. We
20 have also thought about how the two approaches for
21 management's evaluation and the auditors work together.

22 We have thought a lot about that. Again, the
23 comments informed our thinking. There were some easy fixes
24 that were suggested and there were some more substantive or
25 difficult fixes, but we did challenge what we were doing in

1 order to make sure we synced up.

2 I will say that we did obviously stay principles
3 based. We did get requests, as I said, for additional
4 examples. Paradoxically, what makes this work and what makes
5 it scaleable is the principles based nature of this guidance.

6 The key here is to provide enough context to
7 understand and apply it, but not let that become sort of a
8 checklist or that kind of approach. We stayed with the
9 principles based guidance that really recognizes the
10 importance of judgment and the facts and circumstances of
11 each individual company, and then put structure around that
12 in terms of those processes.

13 COMMISSIONER ATKINS: I applaud that. Hopefully,
14 that will work out.

15 Another one of the concerns that I have with the
16 manner in which Section 404 is currently being implemented is
17 that management produces reams and reams of documentation,
18 which I've seen for a number of companies, which seems to be
19 of little value and auditors do not take it into account, and
20 in fact, often, it is almost out of date shortly after it is
21 produced.

22 How is today's rule going to address that problem?

23 MS. PALMROSE: Let me start again and maybe Mike
24 would like to weigh in here. We actually in terms of
25 documentation have empowered essentially through our guidance

1 that it is not necessarily necessary to create additional
2 documentation just for the evaluation process. We have
3 talked about where existing documentation can work.

4 We have also talked about this notion for smaller
5 companies where daily interaction -- you don't need somebody
6 else to tell you what you already know, although on the other
7 hand, you have to be able to communicate that to others.
8 There may be some documentation in the form of a memo rather
9 than binders and binders and binders.

10 We have talked about how you can document that you
11 have sufficient evidence based on your facts and
12 circumstances and recognize that sort of some of these
13 traditional things aren't mandatory at all.

14 I think Mike will add in a little about the process
15 and a little bit more on the technicalities here.

16 MR. GAYNOR: One of the things the Advisory
17 Committee for Smaller Public Companies noted in their report
18 was the process maps in small companies are often times a
19 waste of time because of the dynamic nature of those
20 environments, they are often outdated as of the time they are
21 completed.

22 In thinking about the requirements around
23 documentation and management guidance, I guess sort of our
24 overall principle was the idea that when management says to
25 an investor my internal controls over financial reporting are

1 effective, included in the books and records ought to be some
2 reasonable amount of documentation of what the controls were
3 that were the basis for that disclosure.

4 This is not unlike a disclosure in the financial
5 statements for accounts receivable. Investors expect and
6 understand that there is details supporting the amount of
7 accounts receivable included in the company's financial
8 statements.

9 The notion of controls is really not that much
10 different. It is not an exacting standard, if management has
11 written down 200 controls and they figure out after the fact
12 that it is actually 210, it is not an automatic fail. You
13 don't immediately have ineffective internal controls.

14 It is just this general idea that when you make
15 disclosures that your internal controls on reporting were
16 effective, included in the company's books and records ought
17 to be some reasonable amount of evidence as to what in fact
18 those controls were that were the basis for that disclosure.

19 COMMISSIONER ATKINS: Commissioner Campos and I
20 have been around the block before. Back in 2003, in
21 connection with the initial adoption of the requirements that
22 companies include in their audit reports a report on internal
23 controls.

24 The SEC estimated compliance costs of about \$91,000
25 per company. This number didn't include auditor expenses or

1 indirect costs such as the cost of public capital markets.

2 Even so, it represented a significant under
3 statement of the costs that companies actually incur.

4 The cost/benefit analysis in today's package simply
5 asserts that the costs are uncertain. I would like to ask
6 our economists to elaborate on this.

7 MS. MURPHY: We have looked at the costs and the
8 benefits relating to the proposing release. I think your
9 citing that earlier number is certainly a striking fact and
10 has been the source of some chagrin to the entire staff as we
11 have seen something that everyone thought would be less
12 consequential turn out to be a big difficulty.

13 What we have done in looking at the consequences of
14 the proposing release is do what we are supposed to be doing
15 in the benefit/cost analysis which is looking at the
16 incremental effects of the proposed rule relative to what it
17 would be otherwise.

18 The incremental benefits and costs of this
19 particular rule are relative to what would happen without the
20 guidance that is being provided to management and the change
21 in the requirements of the auditor to do interpretation that
22 they are now not going to have to do, and so from that
23 perspective, there is uncertainty.

24 Compliance is voluntary or the adoption of the
25 management guidance by management is voluntary. It is a

1 principles based approach.

2 The idea is to inform managers, as you have heard
3 people say that managers are being given a tool that they can
4 use. The question about the benefit is really what is the
5 information value to the managers in complying with the rule
6 relative to what they already have.

7 There, I think we do have some uncertainty. We
8 have appropriately framed up what we have said in the release
9 to reflect that, and also to emphasize -- I guess this is in
10 the spirit of the principles based nature of the guidance.

11 I think we really laid out what we think are the
12 principles that are going to guide in the marketplace the
13 magnitude of the costs and benefits. Those really go to how
14 different parties in the process will respond, managers,
15 auditors, and others.

16 COMMISSIONER ATKINS: I agree. I think the up shot
17 of it with differences between hopefully what AS-5 is going
18 to look like and AS-2 and then management guidance that the
19 costs should come down. If they don't, I think all things
20 being equal, an issuer needs to really think about whether or
21 not he should put out the work for another competing bid.
22 That is a problem where we probably have to look at the
23 accounting profession if there is something more that needs
24 to be done on the competitive side to increase competition.

25 Many commentators called for the elimination of

1 references to "interim" in "material weakness." I was
2 wondering why you have determined not to alter the
3 definition.

4 MS. PALMROSE: I would be glad to answer that. Our
5 guidance for management's evaluation of ICFR makes clear that
6 scoping is based on annual materiality. That is what is
7 appropriate when making judgments about the nature and extent
8 of the evaluation procedures.

9 Pulling "interim" out of the definition will not
10 necessarily reduce in a meaningful way the number of controls
11 being tested by management or auditors or their level of
12 effort. Rather, it would just impact the size of errors we
13 would expect those controls to prevent or detect and the real
14 problem in this area is just that, what is considered
15 material to a quarter.

16 Essentially, "interim," as it relates to
17 materiality, it is largely driven by financial statement
18 materiality considerations, not ICFR. In other words, issues
19 around interim materiality for financial reporting bleed into
20 the ICFR assessments and attestations.

21 In this regard, it might be helpful to note that
22 the staffs of OCA and the Division of Corporation Finance are
23 currently considering questions around materiality in the
24 context of financial reporting, including interim
25 materiality, but back to ICFR, if control deficiencies are

1 identified, management guidance does require they be
2 evaluated as to their effect on annual and interim financial
3 reporting.

4 In addition, controls over quarterly reporting are
5 within scope. Yet, another point for considering the
6 inclusion of "interim" within the "material weakness"
7 definition is that under our rules implementing SOX,
8 companies reporting under 404 must include in their quarterly
9 certifications that they have designed their ICFR to provide
10 reasonable assurance that their financial statements filed
11 through their Form 10-Qs are prepared under GAAP.

12 Finally, "interim" we maintained in the definition
13 of "material weakness" because the staff thinks it is
14 important from an investor protection standpoint. The staff
15 does not believe that it is appropriate to have management
16 assessments of ICFR under 404 that essentially would be
17 telling investors you can't necessarily count on our
18 quarterly's but our annual financial statements will be okay.

19 COMMISSIONER ATKINS: I guess ultimately on the
20 other side of this is ICFR is a critical part of financial
21 auditing, auditing of financial statements. They can't
22 necessarily be separated.

23 MS. PALMROSE: Yes, for financial reporting. From
24 the auditor's perspective, scoping is on annual. That is the
25 key, we are talking about financial reporting covering

1 interim and annual.

2 COMMISSIONER ATKINS: Good. You are recommending
3 that we put out a release to solicit comments on the
4 definition of "significant deficiencies." I support going
5 out for comment on this definition.

6 Because I have not seen the draft release language,
7 I was wondering if you could briefly discuss the distinction
8 between significant deficiencies and material weaknesses and
9 how the evaluation processes for material weaknesses and
10 significant deficiencies differ.

11 MS. PALMROSE: Again, I will start. Let me just
12 give the definition. "Significant deficiency" is a
13 deficiency or a combination of deficiencies in ICFR that is
14 less severe than a material weakness yet important enough to
15 merit attention by those responsible for oversight of a
16 registrant's financial reporting.

17 Note that it does not include a probability
18 threshold. Having said that, the evaluation that we are
19 talking about here and the guidance for that is really around
20 material weaknesses, but we do remind issuers that if you
21 identified controlled deficiencies, because they do have
22 certification requirements under 302 that require that they
23 certify they have communicated significant deficiencies to
24 the audit committee and the auditors.

25 There is just a reminder of that existing

1 communication requirement, but again, this guidance is around
2 material weakness and that is what the ICFR evaluation
3 process is intended to identify, and that is what the
4 disclosures to investors are based on, material weaknesses.

5 COMMISSIONER ATKINS: This is a point that I
6 consider extremely important. At our last public meeting, we
7 talked about significant deficiencies. I think it is a very
8 important definition. It is important who is going to deal
9 with it and Audit Standard No. 5, if at all. I know we are
10 still discussing that.

11 I reserve judgment on all of this and I look
12 forward to comments with respect to your definition and with
13 respect to what they may or may not do tomorrow. I think
14 that will affect my ultimate view of AS-5, whether or not it
15 will be a standard that I can vote for.

16 MR. WHITE: Just as a procedural point, the
17 definition that Zoe-Vonna just read to you and I think was
18 supplied to you yesterday, those are the words for the
19 "significant deficiency" definition that we are recommending
20 you put out for proposal.

21 COMMISSIONER ATKINS: Senators Kerry and Snow on
22 the House Committee on Small Business and others have called
23 for the SEC to grant non-accelerated filers a further
24 extension in order to give them a chance to consider and
25 absorb all of this new guidance.

1 Why do you not think that such an extension is
2 necessary at this time?

3 MS. PALMROSE: Let me just reiterate that we think
4 this guidance is doable and doable in 2007 for companies of
5 all sizes. We have spent a good deal of time and effort
6 thinking about applying it for smaller companies, the comment
7 process and the feedback we have received has informed that
8 thinking, and the guidance that was proposed in December
9 provides a good spring board for non-accelerated filers to
10 think about their evaluation process, and we are just
11 refining it to help them a little bit more here.

12 They essentially have the information they need to
13 go forward. We think it is doable. That is the basis for
14 our conclusion on that.

15 COMMISSIONER ATKINS: Ultimately, nothing that we
16 do today precludes our taking action later if it turns out it
17 is really unreasonable, it is going to be difficult for
18 people. You never know what is going to happen. There are
19 always uncertainties in life. I think we should play it by
20 ear.

21 CHAIRMAN COX: Fair enough. Commissioner Campos is
22 recognized for his opening remarks and questions.

23 COMMISSIONER CAMPOS: First let me add my
24 congratulations to the entire staffs. I won't go into
25 everyone's name again. I think all of you have been

1 recognized and heard your name at least twice. In the
2 interest of time, I just want to congratulate you and also
3 add my very, very sincere appreciation for all the work.

4 Beyond work, I think, you have shown extraordinary
5 creativity, thinking out of the box, all the terms, but it is
6 very applicable here. I for one am very, very appreciative.
7 I think investors and our public companies, if they do not
8 know it, will be very grateful at some point in the near
9 future.

10 I have a short statement and a few questions.

11 In one respect, 404 is one of the toughest
12 challenges for regulation in general. Everyone acknowledges
13 the huge potential benefits for investor protection that 404
14 provides. Indeed, there is evidence of that every day from
15 executives who reflect benefits from the studies they have
16 done of their internal controls.

17 However, as we all know, 404 also has brought
18 unreasonably high costs for implementation. The key question
19 today it seems is whether after all this effort and all this
20 time the SEC and its colleagues at the PCAOB have found a way
21 to maintain the investor protections of 404 that Congress
22 intended to provide and to also find a way to make 404 more
23 efficient and reasonable in its costs.

24 The approach recommended today essentially tries to
25 find that elusive sweet spot that accomplishes both goals of

1 investor protection or effectiveness and efficiency.

2 In one respect, the approach today is the ultimate
3 application of principles over rules. It also tests whether
4 a principles based approach can actually work in this
5 particular environment. Effectively, it is where the
6 principles essentially are the rubber that meets the road in
7 terms of this area of regulation.

8 There has been much talk so far today about the
9 efficiencies and the risks based approach, so I will not deal
10 with that as much in my particular statement today.

11 I will focus on some of the concerns that I believe
12 investors may have and I would focus the staff also to
13 provide assurances where they think it appropriate after my
14 comments.

15 Many investors, it seems to me, and I have been
16 told, are worried that in this effort, our management
17 guidance has focused too much on efficiency over
18 effectiveness.

19 Ultimately, only time will prove what we have done
20 to be correct. However, I can say because I have been part
21 of the process and I have observed it, I know that our SEC
22 staff has worked mightily with the PCAOB and its staff and
23 members to find the right balance. I am confident that
24 balance has been struck.

25 To those who worry about whether efficiency has

1 been over played here, I would point out a few items that are
2 in this particular management guidance, and of course, there
3 is more to come tomorrow with the final AS-5.

4 First of all, if we stay with our current approach,
5 we will have the majority, the vast majority of public
6 companies, that is the smaller companies, that will be
7 subject to 404 for the first time in fiscal year 2008 with a
8 report due in 2009. That is a major milestone. That has not
9 occurred up to this particular point in time.

10 Investors will have the benefit of having 404
11 applied to that huge sector of American public companies.

12 A few quick items that are in the guidance, and I
13 can't cover them all, but let me mention a few that I think
14 should also provide some degree of comfort to investors.

15 The management guidance states that the flexibility
16 provided is not meant that evaluations for smaller public
17 companies be conducted with less rigor to provide anything
18 less than reasonable assurance as to the effectiveness of the
19 ICFR of such particular companies.

20 I note that in the management guidance, the term
21 "professional skepticism" on the part of auditors is used,
22 and it is pointed out that is expected to remain. The
23 profession is not being asked to be less professional and
24 less substantive in their particular audits.

25 I would also point out that the definition of

1 "material weakness," "significant deficiencies," have been
2 strengthened and clarified in my view, and auditors are still
3 required to pay attention to the management assessments
4 report to the audit committee and to be aware and note if
5 there are inaccuracies stated therein.

6 Let me mention one other item that has to do with
7 management or with investor concern. Many believe that the
8 most crucial and important risk to reliable financial
9 reporting is the risk of a very specific breakdown in
10 internal controls, namely intentional fraud by senior
11 management who have overridden internal controls.

12 As one commentor noted, history has shown that
13 senior management cooking the books has been the most costly
14 of control failures. While no system of controls is perfect,
15 indeed, our rules seek to compel reasonable assurance,
16 internal controls should seek to substantially decrease the
17 likelihood that intentional fraud by senior management will
18 concur.

19 Let's not forget that Sarbanes-Oxley was passed in
20 the wake of massive frauds perpetrated by senior management
21 at Enron, Worldcom, Adelphia and other companies. When the
22 House passed SOX by a vote of 423-3 and the Senate by 99-0, I
23 don't think they were too concerned with honest errors by
24 lower level accounts receivable clerks.

25 To that end, a number of very thoughtful commentors

1 suggested that our guidance be revised to more strongly
2 emphasize management's responsibility to identify and
3 evaluate fraud risks and the controls that address those
4 particular risks.

5 I am pleased to see that our final guidance has
6 been improved to respond to this comment. In keeping with
7 the principles based approach, the guidance does not contain
8 a list of fraud risks expected to be at companies. This
9 should not be seen as suggesting that we view fraud risks as
10 unimportant. To the contrary, they are too important to be
11 relegated to a "check the box" type of approach, and the
12 guidance, as requested by commentors, specifically cites the
13 significant existing guidance for assessing fraud risks and
14 controls.

15 Notably, however, what the guidance does do is
16 state that management should recognize that fraud risks exist
17 in every organization and that identification of fraud risks
18 does not mean fraud has occurred. In some respects, this may
19 be obvious. In other respects, it is very important to be
20 stated.

21 It should give management the confidence to
22 confront the risk of fraud which is the biggest risk that a
23 manager must consider. Management must ask itself how are we
24 going to design controls to prevent fraud by senior
25 management and how are we going to ensure that these controls

1 operate effectively.

2 I am not suggesting that the answers to these
3 questions are easy, far from it. If management spends less
4 time worrying about whether their controls ensure that every
5 receivable is reconciled, they should have more time, it
6 seems to me, to consider appropriate fraud controls and
7 testing those fraud controls.

8 If we take a step back and look at the forest
9 instead of trees, this is what management should be doing. I
10 believe that our particular management guidance goes a long
11 way in encouraging and hopefully producing that result.

12 Let me ask a few questions and then I will have one
13 final summary item. As you have heard, I have focused here
14 on fraud controls. The staff has indicated that as one of
15 the areas where the guidance has been modified in that area.

16 Can you highlight further, John or someone else,
17 the impact you think those changes will have on management's
18 evaluations, specifically it is obviously very important to
19 establish controls regarding management's override. Is it
20 realistic to think companies can establish effective controls
21 in this area?

22 MS. PALMROSE: Let me start and say yes, we
23 recognize there are challenges, but the answer to that is
24 yes. As you mentioned, we did focus greater attention in the
25 area of fraud risks and direct management not just to

1 implement robust evaluation procedures for those controls
2 that address the risk of fraudulent financial reporting, but
3 we have modified the guidance to clarify that as you said, we
4 would expect all companies to ordinarily have fraud risks for
5 which controls are needed.

6 We expect that will increase the rigor of our
7 evaluation, but the key here is in a targeted way that
8 focuses on areas that matter most, that is where the fraud
9 risks are present.

10 Given that management override is one of those
11 risks, we do talk a little bit about that, and it is
12 important to recognize that there are inherent limitations
13 here. They do exist. One of the reasons they exist is
14 because you cannot eliminate all fraud risks including the
15 risk of management override.

16 Management can surely figure out how to manage that
17 risk and that is our focus. When it comes to management
18 override, the audit committee also has an important
19 responsibility here. In this regard, there are sources that
20 are available out there for more guidance if audit committees
21 would like to consult them, and we have provided some
22 references to that guidance. This gets into -- I am sort of
23 hesitant to bring it up -- it is called an Achilles Heel
24 document. I think we discussed that at our open Commission
25 meeting.

1 We have provided some references to that
2 literature. It is important to recognize that audit
3 committees have a role here and need to step up to the plate,
4 too.

5 COMMISSIONER CAMPOS: I appreciate that. That
6 answer was very thorough.

7 Let me just make a couple of more observations.
8 Our management guidance, it seems to me, is not a guarantee.
9 Instead, it provides, I think, a very, very thoughtful
10 framework that gives public companies and our audit
11 profession the very best opportunity for a system that
12 continues to protect investors through the assessment by
13 management and the attestation by the audit profession of
14 internal controls.

15 The success of our guidance, it seems to me, will
16 ultimately depend on the good faith and hard work of both
17 management and auditors. It will also depend on the
18 diligence of investors, and always will.

19 I for one am hopeful and optimistic that all of the
20 players and all the professionals will use the new guidance
21 and the new AS-5 that will be issued to accomplish the
22 purposes and the benefits of 404 and to do so in a way that
23 costs will be very, very reasonable.

24 I have often stated that the attractiveness of the
25 U.S. markets stems from our focus on reliability and

1 transparency, which actually draws capital throughout the
2 world. I am told constantly by foreign investors that it is
3 the U.S. systems of protecting capital, including the
4 benefits of 404, that attract much foreign capital.

5 I am confident that our guidance today will provide
6 both the same reliability and transparency of the financial
7 statements of U.S. issuers while as I said before, reducing
8 costs so that foreign issuers and others contemplating
9 raising capital in the U.S. will not let 404 be a
10 determinative factor as to whether they come to the U.S. or
11 not.

12 I do not believe that it is today. It certainly
13 will not be after our guidance is implemented.

14 I am very happy to support your proposal, and once
15 again, thank you for the outstanding job that all of you have
16 done and your dedication to this effort. Thanks.

17 COMMISSIONER COX: Thank you. Commissioner
18 Nazareth?

19 COMMISSIONER NAZARETH: Thank you. As others have
20 expressed, I'd like to thank the staff of both the Office of
21 Chief Accountant and the Division of Corporation Finance for
22 a job very well done. I would also like to very briefly
23 recognize Carol Stacey for her very professional service both
24 to the Securities and Exchange Commission and to the American
25 investing public. Thank you very much for that.

1 I strongly support this principles based
2 interpretative guidance. It encourages innovation instead of
3 an "one size fits all" approach. I hope that it will help
4 liberate companies by allowing them to apply the guidance to
5 their own situations. It will provide over arching
6 principles without forcing companies to fit into a prescribed
7 mold.

8 The guidance is intended to be scaleable to
9 companies of all sizes by focusing on the practical
10 application of a risk based top down assessment. The
11 scaleability concepts are not limited to smaller sized
12 companies. Both size and complexity are factors in
13 determining a company's financial reporting risks and
14 controls.

15 In some instances, large companies may not be very
16 complex and may be more akin to smaller companies as far as
17 their internal control of financial reporting is concerned.

18 The interpretative guidance makes clear that each
19 company needs to review its own facts and circumstances and
20 there is no mandated checklist applicable to all companies.

21 Although I believe that everyone realized that the
22 implementation of Section 404 would entail costs, I don't
23 believe that anyone anticipated that the costs would be so
24 high or that management's assessment would become driven by
25 the PCAOB's Auditing Standard No. 2.

1 Addressing those costs in the substantive manner
2 has been one of our primary goals. I think that the
3 interpretative guidance and the corresponding rules we are
4 considering today as well as the changes that the PCAOB is
5 considering through its auditing standard will have a
6 significant impact in achieving this result.

7 Two of these proposals, both management and
8 auditors, will be directed to focus on areas that matter
9 most, including those that pose a higher risk of fraud.

10 Our staff has worked very closely with the PCAOB in
11 our oversight role and I thought our open meeting in April
12 about proposed AS-5 was very productive. I am optimistic
13 that our guidance and the PCAOB's AS-5 will be better aligned
14 and provide an useful coordinated framework for management
15 and auditors.

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

24 All of these benefits improve investor confidence
25 and the integrity of our markets.

1 I am optimistic that issuers will be able to use
2 our interpretative guidance to have quality, well tailored
3 Section 404 evaluations. By helping management focus on the
4 areas of highest risk, I believe we can best achieve
5 meaningful investor protections without excessive costs.

6 You have answered a great many questions this
7 morning so I do not want to go on too long. I just thought I
8 would ask two very brief ones.

9 One is that I did refer in my statement to the open
10 meeting of April 4th and how helpful I thought that was. Can
11 you give us some feedback from your perspective on how that
12 open meeting impacted the proposed guidance that we are
13 considering today?

14 MS. PALMROSE: Yes. It was enormously helpful to
15 us. First of all, in terms of the alignment issue and it
16 actually set the stage for us working with the PCAOB on that
17 issue in a very collaborative and productive manner. We are
18 very appreciative of the efforts there. It did help in terms
19 of the discussion around scaling, and also the discussion
20 around evidence acquisition and judgment that the auditor
21 uses. We did go back and reconsider our guidance in those
22 areas, too, obviously, in terms of the interaction with the
23 auditor and management.

24 Finally, in terms of the use of work of others,
25 there were issues around objectivity that also sharpened the

1 way we think about objectivity in the context of management
2 guidance.

3 It was enormously helpful. We really appreciated
4 the guidance that we were able to have, and the work that we
5 were able to do with the PCAOB staff going forward because of
6 that.

7 COMMISSIONER NAZARETH: Finally, as we discussed
8 earlier, we are going to be including the definition of the
9 terms "material weakness" and I guess "significant
10 deficiencies" in Commission rules, and in the past, we have
11 basically looked to auditing literature for these types of
12 definitions.

13 Can you describe again why we decided to put these
14 definitions in our rules as opposed to elsewhere?

15 MS. PALMROSE: Yes. Again, in the spirit that we
16 want management to be able to look to our guidance rather
17 than an auditing standard. Actually, when you think about
18 it, it is kind of odd that 302 had a requirement for
19 management to communicate significant deficiencies and yet we
20 pointed management to the auditing literature to find out
21 what those were.

22 It makes sense now sort of from a housekeeping
23 standpoint to get that back into the SEC guidance. Of
24 course, this is all about material weakness. These are terms
25 that are important for us to define. Again, let me reassure

1 that the PCAOB is using the same definitions for auditors in
2 their audit standard.

3 MR. WHITE: Let me echo that. Obviously, we have a
4 situation where each CFO and each CEO of a public company has
5 to make a quarterly certification about material weaknesses
6 and significant deficiencies. It really makes sense that we
7 provide those definitions in our rules when they are going to
8 be making these quarterly certifications.

9 COMMISSIONER NAZARETH: Thank you very much.

10 CHAIRMAN COX: Thank you. Commissioner Casey?

11 COMMISSIONER CASEY: Thank you, Mr. Chairman. I
12 would also like to start my remarks by commending the staff
13 this morning. I think it would be an under statement to
14 suggest that it has not been an easy task. I know it has
15 taken tremendous effort on the part of our staff and in
16 cooperation with the PCAOB. Again, I just really want to
17 commend all of you for the tremendous efforts you have put
18 into producing the guidance today and again for the work on
19 the auditing standard that the PCAOB will adopt tomorrow.

20 Carol, I'd also like to thank you for your
21 tremendous work.

22 I am also pleased to support the interpretative
23 guidance for management and the amendments before us today.

24 I will discuss that today's release coupled with
25 the anticipated release of the proposed revised audit

1 standard by the PCAOB tomorrow are only part of the solution
2 of providing greater clarity and flexibility to issuers and
3 auditors in meeting the requirements of Section 404 of the
4 Sarbanes-Oxley Act.

5 How the regulators and the PCAOB and the Commission
6 will receive the implementation of these new provisions will
7 ultimately be vital for success.

8 It is my hope that our efforts will result in
9 helping reduce the costs and burdens associated with the law
10 and its implementation to date. This should be particularly
11 true for smaller issuers with a disproportionate cost to
12 benefit ratio.

13 Today's release and the anticipated AS-5 audit
14 standard tomorrow are designed to produce fundamental changes
15 in the way management and auditors accomplish their
16 responsibilities pursuant to the 404 ICFR review and audit.

17 Going forward, they are to avoid mechanical box
18 checking and instead they are to exercise professional
19 judgment in their efforts to ensure satisfactory ICFR systems
20 and in turn to protect investors.

21 At the outset, while we have eliminated the need
22 for a separate statement on the adequacy of management's
23 assessment, the rule amendments should provide clarity to
24 auditors that the report on the effectiveness of internal
25 control over financial reporting necessarily includes an

1 opinion on whether management's assessment is fairly stated,
2 and this should help to reduce costs associated with yet
3 another audit report while maintaining a check on the
4 objectivity of management's assessment of its own internal
5 controls.

6 In addition, I am pleased that the staff has been
7 able to work with the PCAOB to better align management
8 guidance with the proposed audit standard.

9 As the commentors made clear, without alignment,
10 the benefits for our guidance and revisions to the audit
11 standard would have been completely lost. In particular, it
12 will be most helpful that the guidance and proposed standard
13 both allow for a principles based top down approach to
14 assessing internal controls where professional judgment is
15 paramount.

16 Such an approach will allow for scalability based
17 on issuer size, which will give much needed relief for
18 smaller issuers, but scaling will also be possible based
19 upon other factors by the types of complexity of the business
20 or the factors relating to the relative risk of material
21 misstatements due to an internal control's failure.

22 I know a key area of concern associated with costs
23 of 404 has been the potential audit work and focus on
24 significant deficiencies that are not material weaknesses. I
25 believe in our proposing release related to the definition of

1 "significant deficiencies," the Commission has sought to
2 adequately address these legitimate and widely raised
3 concerns.

4 I am going to look very carefully at the comments
5 we receive on this proposal.

6 Under our proposed guidance and the related rule
7 changes, management in its judgment identifies weaknesses
8 that are less severe than material, but that nevertheless
9 should be brought to the attention of the audit committee.

10 I am hopeful that we are striking the right balance
11 between assuring the decision makers are made aware of
12 potential deficiencies that should be monitored without
13 burdening management to uncover all deficiencies however
14 remote to the risk.

15 While I am largely satisfied that these changes and
16 the anticipated AS-5 standard should address many of the
17 concerns raised, this continues to be an area of concern to
18 me, and I look forward to reviewing tomorrow's PCAOB release
19 and to the comment period that our ultimate review will
20 provide to better determine whether the proposed language
21 meets our objectives.

22 The final standard in our guidance can't be based
23 on subtle nuances as they will surely be lost on issuers,
24 auditors and investors, all of whom are relying on us to
25 provide clarity and certainty on 404.

1 I also look forward to the practical effects of
2 these changes and this brings me to perhaps my greatest
3 concern, our changes here today and the PCAOB's changes to
4 the audit standard will only be improvements if they are
5 properly implemented.

6 This will require that the audit community and
7 management respond to our changes with the right spirit.
8 Applying these principles in an honest effort to identify
9 material weaknesses and internal control functions and
10 consider potential weaknesses that can turn material while
11 avoiding unnecessary work designed to merely increase fees or
12 protect against even the most frivolous risk of error.

13 It will also require that the PCAOB adjust its
14 inspection process to allow for sound audits. Finally, it
15 will require that the Commission is nimble in our oversight
16 of management's exercise of judgment. We cannot on the one
17 hand ask people to use their good judgment and on the other
18 hand second guess that judgment if it is within the
19 appropriate range, so we have more hard work ahead of us.

20 I do believe again that we are making a very good
21 start, and I think we will get this right.

22 Again, I would like to very much commend the work
23 of the staff and also note that as we do look forward to the
24 implementation of the 404 audit requirement for smaller
25 companies, it will be extremely important that we have

1 confidence that the PCAOB auditing standard is not only
2 adopted in a satisfactory form but it is being implemented
3 properly.

4 That actually brings me to my questions. I just
5 have a few. I think you have covered the field pretty
6 nicely.

7 How will we be monitoring implementation in order
8 to gain confidence that the benefits we expect from our
9 guidance and the standard are going to be realized?

10 MS. PALMROSE: In terms of the Commission, one of
11 the things that we do is first of all we do a lot of public
12 speaking, so we will be out talking about our guidance and
13 educating and explaining, and in those forums, we do receive
14 feedback, too. That certainly will be one way.

15 Obviously, I could have started off with the
16 comment process that we are going to have for the definition
17 as well as the PCAOB's standard itself. I am assuming those.

18 Then there are other ways that we could technically
19 use -- we don't have any of them scheduled at this
20 point -- we do have mechanisms such as roundtables, et
21 cetera, if we wanted to use those.

22 The other thing that we do is in our oversight of
23 the PCAOB, we do have oversight that involves inspection of
24 the PCAOB's activities. We are inspecting the inspection
25 activities this year, and of course, the implementation of

1 the ICFR audits, even though in terms of timing we are still
2 sensitive to the fact that it is AS-2 that is being operated,
3 that is operational here, but still, there is guidance out
4 there in terms of what AS-2 means that does get reflected in
5 the way audits are performed, and it is important to
6 recognize that inspection does include how the process works
7 that will be the process going forward to inspect under the
8 new guidance.

9 We will want to make sure that we think about and
10 weigh in on that, obviously, too. One element of that is of
11 course the standard setting group at the PCAOB, training
12 their inspection team in terms of what the standard means and
13 that is part of our inspection process, too.

14 Those are the top ones on the list in terms of
15 going forward.

16 MS. STACEY: I will just add to it. We do meet
17 with various groups. The FEI study was brought up earlier
18 that was released last week. My understanding is they intend
19 to continue to do that, at least for next year. I think that
20 will help, too, to have the outside groups weigh in as
21 implementation goes forward. People have not been shy about
22 coming and talking to us. We expect that will probably
23 continue.

24 There is a good deal of research going on and we do
25 actually monitor the academic literature for findings in

1 those areas.

2 COMMISSIONER CASEY: How quickly will we be able to
3 gauge our success and draw any conclusions about whether any
4 additional delay may be necessary for smaller companies'
5 compliance with the audit requirements of 404?

6 MS. STACEY: I think there is a short term and a
7 long term. I think in the short term, we do get feedback
8 from a number of sources and forums that gives us a quick
9 read of the temperature of it. There will be some short term
10 feedback here.

11 Then in the longer term, these mechanisms that we
12 are talking about will provide us some insight into sort of
13 more quantitative or measurable aspects of it.

14 MR. WHITE: As you know, when 404 was implemented
15 for the larger companies, there were a series of meetings
16 with the auditing firms and some adjustments in terms of
17 phasing it in, limited extensions and so on, that we were
18 able to do as we got input from the auditing firms and their
19 ability to get it all done on time.

20 I think we have a lot of flexibility.

21 MS. STACEY: I think that will be helpful, to hear
22 from both the audit community and the corporate community for
23 the smaller companies, the audit requirement obviously, as
24 John talked about earlier, does not kick in until 2008, but
25 they are obviously out there on the ground doing the

1 financial statement audits. They are also attuned to what is
2 going on with 404. I do think it is important for us to hear
3 from both communities in the first year of adoption for
4 management and I would like to encourage auditors to pay
5 attention to that, too.

6 COMMISSIONER CASEY: Again, I commend all of you
7 for your work. Thank you.

8 CHAIRMAN COX: Thank you. As we move to our vote,
9 I just want to conclude by recognizing again Carol Stacey for
10 your extraordinary work on this project but just as
11 importantly, your work over such a long period of many years.
12 What you have done here with the Section 404 guidance is of
13 course of enormous importance to American investors, to
14 America's capital markets and participants in the capital
15 markets around the world. It has been extraordinary service
16 to American investors over more than a decade.

17 Thank you very much for your work here.

18 To conclude our work here on this particular topic,
19 I will now ask the Commission a complicated question with
20 five pieces to it, and we are going to vote on all these five
21 at once.

22 VOTE

23 CHAIRMAN COX: First, does the Commission vote to
24 issue interpretative guidance for management regarding its
25 evaluation and assessment of internal control over financial

1 reporting?

2 Second, to adopt amendments to Exchange Act Rule
3 13a-15 and 15d-15, making it clear that an evaluation that
4 complies with the Commission's interpretative guidance would
5 satisfy the annual management evaluation required by those
6 rules.

7 Third, to adopt amendments to Rules 1-02(a)(2) and
8 2-02(f) of Regulation S-X, to require the expression of a
9 single opinion directly on the effectiveness of internal
10 control over financial reporting by the auditors in its
11 attestation reports.

12 Four, to adopt amendments to Exchange Act Rule
13 12b-2 and Rule 1-02 of Regulation S-X to define "material
14 weakness."

15 Fifth, propose amendments to Exchange Act Rule
16 12b-2 and Rule 1-02 of Regulation S-X to define "significant
17 deficiencies."

18 Commissioner Atkins asked if I could repeat that,
19 backwards.

20 How do the Commissioners vote?

21 COMMISSIONER ATKINS: Yes.

22 COMMISSIONER CAMPOS: Yes.

23 COMMISSIONER NAZARETH: Yes.

24 COMMISSIONER CASEY: Yes.

25 CHAIRMAN COX: Yes. The matters are each approved.

1 Thank you very much.

2 (A brief recess was taken.)

3 CHAIRMAN COX: -- consider as part of this
4 rulemaking package are directly responsive to those advisory
5 committee recommendations. The focus on capital formation
6 and the removal of obstacles that impede the growth of small
7 companies go hand in hand with our responsibility to protect
8 investors because these investors who are injured and money
9 is lost when the small businesses in which they invest can't
10 get affordable access to capital.

11 One of the things that we do on a recurring basis
12 to advance our capital formation mission is to sponsor an
13 annual forum on small business capital formation.

14 For more than a quarter of a century now, we have
15 conducted this forum to help promote capital formation, and
16 given the historic importance of small business in the United
17 States as the driver of economic activity, innovation and job
18 creation, the Commission has always supported means to make
19 regulations less burdensome for small business by constantly
20 concentrating on what is truly important for investor
21 protection.

22 The proposals that we are about to discuss this
23 morning further those objectives. These initiatives begin
24 with simplifying our reporting requirements. For example, in
25 response to one of the advisory committee's recommendations,

1 we will consider today whether to increase significantly the
2 number of companies that can qualify to use our scaled
3 disclosure requirements for smaller companies. We will also
4 consider simplifying those rules.

5 Currently, they appear in Regulation S-B. By
6 integrating them into Regulation S-K, we can eliminate five
7 forms and the 36 separate items that currently reside in
8 Regulation S-B.

9 To further streamline our requirements, we will
10 consider whether to completely eliminate the 144 filing
11 requirement for non-affiliates of issuers who rely the Rule
12 144 safe harbor to re-sell their securities. That would cut
13 the number of Form 144s that are filed with the Commission by
14 nearly 60 percent.

15 Finally, given the Commission's strong interest in
16 using technology to help investors, I am pleased that the
17 rulemaking package includes a proposal to move to electronic
18 filing for Form Ds. A Form D, of course, is the simple
19 notice to Federal and state regulators about certain
20 securities offerings that are exempt from registration.

21 Ironically, while it is used frequently by small
22 businesses that are especially sensitive to paperwork
23 burdens, it is one of the few forms that still is filed with
24 the Commission on paper.

25 Now that we are coming to the end of the first

1 decade of the 21st century, it seems an appropriate time to
2 establish an on line filing system.

3 That on line filing system is just not going to be
4 an on line filing cabinet, it is going to make the form and
5 data interactive and easily searchable, something that is
6 vitally important both to the Securities and Exchange
7 Commission and to state securities regulators.

8 These proposals required significant effort by the
9 staff of the Division of Corporation Finance, and I want to
10 thank John White, Marty Dunn, Paula Dubberly, Mauri Osheroff,
11 Betsy Murphy, Amy Starr, Gerry Laporte, Mark Green, Corey
12 Jennings, Ray Be, Katherine Hsu, Dan Greenspan, Anthony
13 Barone, Steven Hearne, Kevin O'Neill and Johanna Losert for
14 your outstanding work.

15 We have a lot of ground to cover in a brief time,
16 so I will turn it over to John White.

17 ITEMS 2 THROUGH 7
18 SMALLER REPORTING COMPANY REGULATORY RELIEF AND
19 SIMPLIFICATION, REVISIONS TO THE ELIGIBILITY REQUIREMENTS FOR
20 PRIMARY SECURITIES OFFERINGS ON FORMS S-3 AND F-3, EXEMPTION
21 OF COMPENSATORY EMPLOYEE STOCK OPTIONS FROM REGISTRATION
22 UNDER SECTION 12(g) OF THE SECURITIES EXCHANGE ACT OF 1934,
23 REVISIONS TO LIMITED OFFERING EXEMPTIONS IN REGULATION D,
24 ELECTRONIC FILING AND SIMPLICATION OF FORM D, AND REVISIONS
25 TO SECURITIES ACT RULES 144 AND 145 TO SHORTEN HOLDING PERIOD

1 FOR AFFILIATES AND NON-AFFILIATES

2 MR. WHITE: Thank you, Chairman Cox. We are
3 pleased to recommend to the Commission that you issue a
4 series of six proposing releases designed to modernize and
5 improve the Commission's registration and disclosure
6 requirements that apply for smaller companies.

7 As you noted, these proposals are responsive to
8 several key recommendations contained in the final report of
9 the Advisory Committee on Smaller Public Companies to the SEC
10 that was issued April a year ago.

11 They also address a number of changes suggested by
12 the American Bar Association's Committee on Federal
13 Regulation of Securities in a March 2007 letter to the
14 Commission requesting that we bring the requirements
15 applicable to private securities offerings into line with
16 modern market practices and communications and technology.

17 In a moment, three of my colleagues on the Corp Fin
18 staff will deliver an overview of these six releases, but I
19 thought maybe I would at least weigh in briefly on a couple
20 of the highlights.

21 One of the releases includes a proposal to expand
22 eligibility for the Commission's disclosure and reporting
23 requirements that are scaled for smaller public companies by
24 actually defining a new term called "smaller reporting
25 companies," and that new term will now apply to all companies

1 with a common equity public float below \$75 million.

2 Currently, there are about 3,500 reporting
3 companies with a public float and revenue below \$25 million
4 that qualify to use our scaled disclosure requirements.

5 We estimate that slightly more than 5,000 companies
6 will be eligible under the proposal, an increase of over 40
7 percent, in terms of companies that need this definition of
8 "smaller reporting companies."

9 I guess we are talking about a fairly substantial
10 increase of the number of companies that will have the
11 benefit of a scaled report, scaled disclosure.

12 One of the reasons in terms of how we chose this
13 threshold is this moving to the \$75 million standard will
14 have the benefit of aligning the public float threshold that
15 we are using for defining smaller public companies with the
16 rules that we are using currently for drawing the line
17 between accelerated filers and non-accelerated filers, that
18 we are really getting rules that apply to smaller public
19 companies in line with what we are doing elsewhere.

20 A second of the proposals will modify the public
21 float eligibility requirements in order to do primary
22 offerings on Form S-3 for the first time in actually about 15
23 years, so that companies that have a public float below \$75
24 million will actually be able to use S-3 for primary
25 offerings for the first time.

1 We think this will assist and facilitate efforts by
2 companies, smaller companies, that tend to have fewer
3 financing options open to them today, fewer than larger
4 companies.

5 The releases also include proposals to establish
6 three new exemptions. Two of them from the Exchange Act
7 registration requirements for compensatory stock options and
8 the third is a new exemption that would be added to
9 Regulation D for sales of securities to a new category of
10 so-called Rule 507 qualified purchasers.

11 Companies relying on this new exemption would be
12 able to actually engage in a limited amount of advertising
13 targeted to these new Rule 507 qualified purchasers.

14 Finally, we are recommending that you issue a
15 release proposing revisions to existing Rule 144 in a manner
16 that is likely to be of particular benefit to smaller
17 companies by shortening the holding period for restricted
18 securities.

19 I guess that is the highlights of these proposals.
20 We will turn to the details in a moment.

21 As usual, I feel like I have to read the list as
22 well, all of us here in Corp Fin. It is a long list, because
23 there are six releases and there are a lot of pages here.

24 First to my left, Marty Dunn, who has led this
25 effort. Marty has been just invaluable in putting this

1 altogether.

2 The rest of the team, Paula Dubberly, Mauri
3 Osheroff, Gerry Laporte, Betsy Murphy, Kevin O'Neill, Johanna
4 Losert, Anthony Barone, Steven Hearne, Mark Green, Dan
5 Greenspan, Amy Starr, Ray Be, Kathy Hsu, and it goes on
6 beyond that. It has really been tremendous work on this.

7 The Office of Chief Counsel in Corp Fin, the Office
8 of Liaison. Also we have gotten a lot of very useful help
9 from the Office of Economic Analysis, and of course, as
10 always, General Counsel's office, and I also obviously want
11 to recognize that we hit them with over 500 pages in a very
12 short period of time, and they have been incredibly helpful
13 and responsive to us, plus the Divisions of Market Regulation
14 and Investment Management have been working hand in hand with
15 us on a number of these releases.

16 There has been really a tremendous effort going on
17 by the staff.

18 With that, I will turn the microphone over to Kevin
19 O'Neill, Tony Barone and Kathy Hsu, who will actually give
20 you the details.

21 MR. O'NEILL: Good morning. In March 2005, the
22 Advisory Committee on Smaller Public Companies was chartered
23 by the Commission to assess the current regulatory scheme for
24 smaller public companies under the Federal securities laws
25 and make recommendations for change.

1 The charter directed the Advisory Committee to
2 conduct its work in connection with the Commission's investor
3 protection mandate and to consider whether the costs imposed
4 by the current regulatory system are proportionate to the
5 benefits, to identify methods of minimizing costs and
6 maximizing benefits, and to facilitate capital formation by
7 smaller companies.

8 I will describe a group of three separate
9 rulemakings that stem from the final report of the Advisory
10 Committee, the three proposals which are similar but not
11 identical to recommendations in the Advisory Committee's
12 final report.

13 First, the Division of Corporation Finance
14 recommends that the Commission propose amendments to its
15 disclosure and reporting requirements under the Securities
16 Act and the Exchange Act that would increase the number of
17 companies eligible for the Commission's disclosure and
18 reporting requirements for smaller reporting companies.

19 The Commission's current regulatory scheme for
20 small businesses adopted in 1992 modifies some of the
21 disclosure requirements for these companies. This should not
22 be thought of as lesser disclosure but as scaling our
23 requirements to the characteristics of the smaller companies,
24 to assure that the burdens of regulations are commensurate
25 with the benefits.

1 The proposals would expand the system by allowing
2 most companies with a common equity public float of less than
3 \$75 million to qualify for these smaller reporting company
4 requirements, up from \$25 million for most companies today.

5 The proposals would combine the small business
6 issuer and the non-accelerated filer categories for smaller
7 companies in our current rules into a new category of smaller
8 reporting companies.

9 In addition, the proposals would simplify the
10 regulations by integrating the disclosure requirements for
11 smaller reporting companies which currently are contained in
12 Regulation S-B into Regulation S-K.

13 The smaller reporting companies which file
14 registration statements and Exchange Act reports on the
15 Commission's regular forms would be able to choose on an item
16 by item basis whether to take advantage of the disclosure
17 requirements or provide the same disclosures as larger
18 companies.

19 We believe this proposal would benefit smaller
20 companies while maintaining appropriate disclosure standards
21 for investor protections.

22 The Division next recommends that the Commission
23 propose amendments to Form S-3 and Form F-3 that would revise
24 the eligibility requirements for those forms for companies
25 with a public float below \$75 million and take advantage of

1 the benefits, subject to a restriction on the amount of
2 securities those companies may sell in an one year period.

3 The amendments are intended to allow smaller public
4 companies that have been timely in filing their reports for
5 at least one year to benefit from the greater flexibility in
6 assessing the public securities markets qualified for Forms
7 S-3 and F-3.

8 Specifically, the Division recommends that the
9 Commission amend the instructions to Form S-3 and Form F-3 to
10 allow companies with less than \$75 million in public float to
11 register primary offerings of their securities on those
12 forms, provided such companies meet the other eligibility
13 conditions for use of the Form S-3 or Form F-3, and are not
14 shell companies and have not been shell companies for at
15 least one year before filing the registration statement, and
16 do not sell more than the equivalent of 20 percent of their
17 public float in primary offerings registered on Form S-3 or
18 Form F-3, as applicable, over any one year period.

19 If the amendments are adopted as proposed, this
20 will be the first time in 15 years that the Commission has
21 modified the eligibility requirements for primary offerings
22 on Form S-3s and with respect to Form F-3s.

23 We are recommending that the Commission propose two
24 new exceptions to the registration provisions of the Exchange
25 Act, Section 12(g), for compensatory employee stock options.

1 Under Section 12(g) of the Exchange Act, an issuer
2 with 500 or more holders of record of a class of equity
3 securities and assets in excess of \$10 million at the end of
4 its most recently ended fiscal year must register that class
5 of equity securities unless an exemption is available.

6 Stock options are a separate class of equity
7 securities under the Exchange Act. An issuer with 500 or
8 more option holders with more than \$10 million in assets is
9 required to register that class of options.

10 Given differences in the nature of the
11 trading -- the first exemption was applied to compensatory
12 employee stock options issued under written compensatory
13 stock option plans from a non-reporting issuer. Eligible
14 option holders are limited to employees, directors,
15 consultants and advisors. Transferability of shares received
16 on exercise of the options and shares of the same class
17 underlying the options is restricted, and risk and financial
18 information is provided to option holders and holders of
19 shares received on exercise of the options.

20 We also recommend that you propose a separate
21 exemption for compensatory employee stock options of issuers
22 that are subject to the Exchange Act reporting. In this
23 case, option holders would have access to publicly filed
24 Exchange Act reports.

25 In addition, Exchange Act Sections 14 and 16 would

1 apply to options in securities issuable.

2 Thank you. You will now hear from Tony Barone to
3 discuss the additional proposing releases.

4 MR. BARONE: Good morning. The Division further
5 recommends that the Commission publish proposals to amend
6 Regulation D, Form D, to conform better to modern market
7 practices and technology without compromising investor
8 protection.

9 Regulation D is heavily relied upon by smaller
10 companies to reach capital. The immediate focus of our
11 recommendation is the reduction of unnecessary regulatory
12 burdens on companies that rely on Regulation D.

13 Specifically, we recommend that you propose to
14 establish a new exemption of the regulation provisions of the
15 Securities Act in Rule 507 of Regulation D. The new
16 exemption would allow most issuers to sell their securities
17 without registration and engage in limited advertising, so
18 long as they sell only to a new category of investors, called
19 Rule 407 qualified purchasers.

20 A proposed definition of Rule 507 "qualified
21 purchasers" would include individuals with \$2.5 million in
22 investments or have annual individual income of \$400,000 or
23 aggregate income of \$600,000 with their spouse.

24 The \$2.5 million in investment threshold is based
25 upon the Commission's December 2006 proposal for accredited

1 investors.

2 Institutional investors generally would qualify if
3 they owned \$10 million in investments. Institutional
4 investors not subject to a monetary threshold would qualify
5 as accredited investors and similarly could qualify as Rule
6 507 qualified purchasers without regard to a monetary
7 threshold.

8 Likewise, any director, executive officer or
9 general partner of the issuer could qualify as a Rule 507
10 qualified purchaser without regard to a monetary threshold.

11 We also recommend proposing revisions to the
12 existing accredited investor definition in Regulation D. We
13 recommend adding an alternative way to qualify for accredited
14 investor status. In addition to the total current assets,
15 net worth and income statements, there would be a new
16 investments owned standard of \$750,000 for individuals and \$5
17 million for institutions.

18 In addition, we recommend adding several new
19 categories of entities to the list of approved accredited
20 investors. These proposals would increase the number of
21 investors qualified as accredited investors and increase the
22 pool of capital available to companies that engage in private
23 placement relying on Regulation D.

24 We also recommend proposing to adjust for inflation
25 the thresholds for accredited investors and Rule 507

1 qualified purchasers in Regulation D on a going forward basis
2 starting on September 1, 2012.

3 Our last recommended change to Regulation D is to
4 decrease the time frame for the innovation of safe harbor in
5 Regulation D from six months to 90 days, and to provide
6 uniform updated bad actor disqualification for all offerings
7 under Regulation D. Currently, disqualification provisions
8 are only in Rule 505 of Regulation D.

9 We also recommend that the Commission in a separate
10 release propose rules to mandate electronic filing of Form D
11 and to refine and simplify the form. Form D is a notice
12 required to be filed by companies that have sold securities
13 without registration under the Securities Act based on a
14 claim of exemption under Regulation D or Section 4-6 of the
15 Act.

16 The current version of Form D was developed jointly
17 by the Commission and state securities regulators in the
18 mid-1980s as an uniform Federal and state form. It continues
19 to be accepted by many states to satisfy their filing
20 requirements and it has played a significant role in
21 eliminating duplicative and unnecessary burdens of dual
22 Federal and state securities regulations.

23 The vast majority of Form D filings are made by
24 private companies. Form D filings were intended to serve
25 important data collection objectives. They contain basic

1 information about the issuer, the offering, and the exemption
2 claim. The data is used by regulators in enforcement
3 activities. It also enables the Commission to evaluate the
4 effectiveness of Regulation D as a capital raising device,
5 and to tailor its rules to provide appropriate support for
6 both capital formation and investor protection.

7 Currently, Form D filings may be made only on
8 paper. They are one of the Commission's few remaining paper
9 filings. The Commission received approximately 25,000 Form D
10 filings last year. The interactive on line filing system
11 that the staff intends to develop for electronic Form D
12 filings will be accessible from any computer with Internet
13 access.

14 Filers could input data which would be tagged
15 automatically and easily searchable by regulators and members
16 of the public who may choose to view it.

17 Improvements to the Commission's rules resulting in
18 better information availability of Form D information could
19 result in significant benefits to companies that rely on
20 Regulation D exemptions, especially smaller companies, as
21 well as to investors.

22 Thank you. Kathy Hsu will now summarize the final
23 release.

24 MS. HSU: Good morning. The final release that we
25 are presenting for your consideration this morning proposes

1 amendments to Rules 144 and 145 of the Securities Act. We
2 recommend that the Commission propose to shorten the Rule 144
3 holding period applicable to restricted securities from one
4 year to six months for the issuer of the securities is
5 subject to Exchange Act reporting obligations and has been
6 for at least 90 days before the sale of the securities.

7 Securities holders with restricted securities of
8 non-reporting companies continue to be required to hold their
9 securities for one year before any public re-sell, pursuant
10 to the existing requirements.

11 We believe that shortening the holding period in
12 this manner would increase the liquidity of privately held
13 securities, reduce the liquidity discount for the securities,
14 and thus decrease the cost of capital for issuers.

15 We further recommend that the Commission propose to
16 re-introduce a tolling provision that suspends the holding
17 period while the security holder has a short position or has
18 entered into a put equivalent position with respect to the
19 securities in connection with the proposed six month holding
20 period for restricted securities of reporting companies.

21 This is due to the recognition that the shorter
22 holding period could make it significantly easier and less
23 costly to enter into hedging arrangements.

24 However, the proposed tolling provision would not
25 apply if the securities holder has held the securities for

1 one year or more, regardless of any hedging activity, so that
2 the effect of the proposed tolling provision would be no more
3 restrictive than the existing provision.

4 Accordingly, the proposed tolling provision would
5 in no event require a security holder relying on Rule 144 to
6 hold their securities for more than one year prior to
7 publicly selling the securities.

8 We also recommend that the Commission propose to
9 substantially simplify compliance with Rule 144 by a person
10 who is not an affiliate of the issuer and has not been an
11 affiliate for three months prior to the sale of the
12 securities.

13 Currently, a non-affiliate is required to comply
14 with all the conditions of Rule 144 for an additional year
15 after the holding period is met. Only then is a
16 non-affiliate able to re-sell securities freely and without
17 any restrictions.

18 Under the proposed amendments, a non-affiliate with
19 restricted securities of a non-reporting company could
20 re-sell freely after the requisite one year holding period is
21 met. A non-affiliate with restricted securities of an
22 Exchange Act reporting company could re-sell freely after the
23 six months holding period, subject to the tolling provision,
24 as long as current information regarding the issuance of
25 securities is publicly available as required by Rule 124c.

1 The current public information requirement would be
2 applicable for up to one year after the acquisition of the
3 securities. We believe that the proposals reduce the
4 complexity of Rule 144 for non-affiliates as well as further
5 increases liquidity of restricted securities.

6 In addition, with respects to sales by affiliates,
7 we recommend that the Commission propose to eliminate the
8 manner of sell limitations with respect to debt securities,
9 raise the thresholds triggering a Form 144 filing
10 requirement, and codify staff interpretations relating to
11 Rule 144.

12 We believe that the combined effect of our
13 proposals, to eliminate the Form 144 notice requirements for
14 non-affiliates and raise the Form 144 filing thresholds,
15 would significantly decrease the number of Form 144 filings
16 that are required to be filed annually.

17 We also recommend that the Commission solicit
18 comments on whether to coordinate Form 144 filing
19 requirements with Form 4 filing requirements.

20 Under the proposed amendments to Rule 144, only
21 affiliates are required to file the notice of a proposed sale
22 of securities on Form 144, and many of these affiliates are
23 also required to file a Form 4 under Section 16 of the
24 Exchange Act, to report changes in beneficial ownership of
25 their securities.

1 In order to reduce duplicative paperwork
2 requirements on individuals who are required to file both
3 Form 144 and Form 4, we recommend that the Commission solicit
4 comment on whether to revise the Form 144 filing deadline to
5 coincide with the Form 4 filing deadline to permit affiliates
6 subject to Section 16 requirements to have the option to
7 satisfy their Form 144 filing requirements by timely filing a
8 Form 4 reporting the sale of securities.

9 The proposing release also solicits comment on
10 whether the Commission should revise Item 701 of Regulation
11 S-K to require additional disclosure about the re-sell status
12 of securities issued in unregistered transactions at the time
13 the company first issues the securities.

14 Finally, we recommend that the Commission propose
15 to eliminate the presumptive underwriter provision in Rule
16 145, except with regard to transactions involving shell
17 companies.

18 Under the proposed amendment, only a party to a
19 Rule 145(a) transaction involving shell companies, other
20 business combination related shell companies, or an affiliate
21 of the parties be deemed a presumed underwriter of the
22 transaction. Those deemed presumed underwriters are
23 permitted to re-sell their securities under the provisions in
24 Rule 145(d.)

25 We recommend that the Commission propose to

1 harmonize the re-sell restrictions in Rule 145(d) to the
2 re-sell restrictions for securities of shell companies as
3 opposed in Rule 144.

4 I will now turn it back to John White. Thank you.

5 MR. WHITE: Thank you. You probably have gotten
6 the idea that this is a big package of releases. We would be
7 pleased to take your questions in any order.

8 CHAIRMAN COX: Thank you. Any time we get an
9 opportunity to streamline regulations at the same time as we
10 can increase investor protection, we want to seize that
11 opportunity, and that is clearly what we are doing today.

12 All of us and the staff have a great interest in
13 furthering transparency and promoting clarity, including
14 plain English, and regulatory simplification in all our
15 rulemaking.

16 Let me ask to begin with with respect to the
17 elimination of paperwork in connection with Form D, since
18 this is a benefit not just to us in a regulatory way, but
19 also in an enforcement way, since it reduces paperwork --

20 (Inaudible due to background activities.)

21 MR. BARONE: That is John's fault.

22 This is actually something that has been
23 percolating around for years and years. It is one of those
24 things that kind of waits for its time to come. We have been
25 building on it. I think the key inertia to getting it done

1 is when the 3s, 4s and 5s went on line. That gave us a
2 framework to build off of. Since then --

3 CHAIRMAN COX: Our experience in that area, because
4 it was so positive, gave us confidence this was the way to
5 go.

6 MR. BARONE: It also gave us the format that is
7 easily used.

8 CHAIRMAN COX: I mentioned earlier the data is
9 going to be interactive. I think it was Kathy Hsu who was
10 explaining that the tagging is automatic.

11 MR. BARONE: These guys can help me more with that.
12 They know 3, 4 and 5 better than I do. The notion is it goes
13 in there. The tagging is XML. It works better than XBRL and
14 it gives you the full searchability of everything, and you
15 just fill out the form and it is searchable.

16 From the small businesses' standpoint, they never
17 need to know about data tagging, it just happens. Our goal
18 is to make it easy.

19 I want to make it really clear why we decided to
20 make this proposal. About two weeks ago, the job of opening
21 those 25,000 envelopes a year and entering these Form Ds into
22 our EDGAR system was assigned to Corp Fin.

23 CHAIRMAN COX: That's good. While we are at it,
24 the number, for record purposes here, the number of pieces of
25 paper that don't have to be filed any more, the number of

1 forms that do not have to be filed any more is each year
2 25,000, except they are now electronically filed. No more
3 paper.

4 MR. BARONE: In terms of this whole package, there
5 are lots of more things. There is reducing the number of
6 Form 144s by 60 or 70 percent.

7 CHAIRMAN COX: If we cut the number of Form 144s by
8 60 percent, roughly, how many forms a year would that be?

9 MR. BARONE: She says about 30,000. We are looking
10 at probably 50,000 forms.

11 CHAIRMAN COX: That is remarkable. Let me ask a
12 question just to flush out what I think I understand. From
13 an enforcement standpoint, from a regulatory standpoint, why
14 is being able to access these things in electronic form,
15 especially after it is tagged and interactive and so forth,
16 important?

17 STAFF SPEAKER: It is important because we have
18 statistical data now that we can find more easily, and we
19 hope that Enforcement will find this useful. Now, you have
20 trouble even tracking down who files the Form D let alone the
21 data that is in them. We will be able to identify specific
22 industries and look at those industries. We will be able to
23 look at companies that generate particular amounts of revenue
24 and in general, we will be able to do searches across a wide
25 database as well as finding specific companies.

1 CHAIRMAN COX: Excellent. Because so many of these
2 recommendations come to us courtesy of the Advisory Committee
3 on Smaller Public Companies, have we communicated with the
4 leadership of the Advisory Committee in furthering their
5 recommendations?

6 MR. WHITE: Yes, we have. I spoke to Herb Wander
7 earlier this week actually to explain to him we would be
8 getting the final results of what we were planning on doing
9 today. Unfortunately, he could not be here today, but I
10 certainly want to extend our thanks to both Herb and Jim
11 Thyen for their tremendous work, both leading the committee
12 and helping us with this whole process.

13 CHAIRMAN COX: Indeed, we need to thank all the
14 members of that Advisory Committee for their exceptional
15 public spirited work. It is nice to be able to have quality
16 recommendations that we can act upon. I am very pleased.

17 I don't have any other questions. Commissioner
18 Atkins?

19 COMMISSIONER ATKINS: Thank you very much, Mr.
20 Chairman. So many individuals have devoted significant time
21 and energy to thinking about how our private offering rules
22 could be improved. You mentioned 500 pages. This is why so
23 many people have been involved.

24 Although private offerings are utilized by issuers
25 of all sizes, they most significantly affect smaller

1 companies who do not have the variety of options available
2 that larger companies have at their disposal to raise
3 capital.

4 For many years, the Commission has held an annual
5 forum on small business capital formation to discuss these
6 issues. Gerry Laporte and others have been very much
7 involved in that.

8 The Advisory Committee on Smaller Public Companies
9 also, of course, focused, as we heard a portion of their
10 report, on capital formation for smaller companies, and
11 various committees and a task force of the American Bar
12 Association have focused on smaller companies as have our
13 regulatory counterparts in states through the North American
14 Securities Administrators Association.

15 I very much appreciate the staff effort in quickly
16 turning around these proposals. It was a big task. I do not
17 think anyone here has felt greater frustration about private
18 offering reform than the Division of Corporation Finance, but
19 for the past five years, of course, the Commission has been
20 preoccupied with implementing and then of course now today
21 taking a step towards fixing Sarbanes-Oxley and public
22 companies' securities offering reform, and of course,
23 executive compensation.

24 I am pleased that we can now turn our attention to
25 private offering reform as well. I support the efforts being

1 proposed today by the Division. If adopted, I think they
2 will provide more flexibility for raising capital, especially
3 for smaller public companies.

4 More importantly, today's proposals go far towards
5 promoting efficiency, competition and capital without
6 compromising investor protection.

7 Today's proposals also address many of the concerns
8 facing smaller public companies. Having been at the SEC back
9 in 1991 and 1992 when we adopted Form S-B, I feel as if I
10 have now come full circle. Our regulatory relief proposal
11 will allow more companies to take advantage of the scaled
12 disclosure and financial reporting requirements.

13 Our proposals on Form S-3 and Rule 144 will provide
14 additional alternatives to raise capital for smaller public
15 companies seeking it and hopefully on more favorable terms.

16 Issuers seeking to raise capital not only from
17 persons who have significant existing investments or
18 financial wherewithal will have an easier ability to solicit
19 financial customers.

20 Finally, I think we cannot under state the
21 importance of changes to Form D. Electronic Form D will
22 provide the Commission and other interested persons data
23 about the private offering market in a format that is easier
24 to compile and easier to analyze.

25 I am a strong component of using cost/benefit

1 analysis to guide regulatory actions, and I believe that an
2 electronic Form D will provide much more concise information
3 about what is going on in the marketplace.

4 The proposals today are an excellent start for
5 updating our rules governing private offerings. Many
6 provisions are substantially the same as when they were first
7 adopted back in 1982, but as the capital markets have changed
8 over the years, so should our rules.

9 I mentioned that these proposals make an excellent
10 start because I do not believe that the Commission's work in
11 this area is going to be finished after today or even after
12 we adopt these particular sets of proposals.

13 Our proposals do not address other issues brought
14 up by the Advisory Committee, the forum, or the ABA, such as
15 finders and private placement broker/dealers, expanding and
16 testing the waters provision that we first put in back in the
17 early 1990s, clarifying the definition of "control" for
18 certain purposes, or revising Rules 504 and 505.

19 I think more work needs to be done by the
20 Commission to achieve an optimal level of investor protection
21 and capital formation for smaller companies.

22 The staff has only been significantly engaged on
23 these rulemakings since the beginning of this year. I would
24 encourage you all to continue your fine work in this area and
25 present some additional ideas. I look forward to seeing this

1 during the year.

2 I just have a couple of questions about the
3 proposals. First, I wanted to look at the proposal to
4 separate the S-B forms from the regular S forms. Right now,
5 a small business issuer can choose to file a form on S-B or
6 on a regular form. The regular forms have a higher standard
7 of disclosure.

8 If we have a single form, will that cause
9 confusion?

10 MR. DUNN: That is one of the things to think
11 about. As Kevin was saying and others have said, we don't
12 think there is a higher level of disclosure. We like to
13 think it is better and can actually be more useful there.

14 One of the things we are saying is on the front of
15 the form, you have to mark whether you are relying on the
16 smaller reporting companies, so hopefully there will not be
17 confusion as to what is there.

18 Within the form, what we are saying in the release
19 is the companies have this lower level base line. They are
20 allowed always to do more, but what they are held to is that
21 lower level. I really think that on the front, indicating
22 they are a smaller reporting company, and therefore, at that
23 lower level, I do not think folks will be confused, and I
24 think it will have the added benefit of -- for some reason,
25 some firms and underwriters will not use S-B forms, they

1 won't go near them, and I think that has lessened the
2 effectiveness of it.

3 I think we have dealt with the possibility of
4 confusion and hopefully eliminated whatever stigma might be
5 there.

6 COMMISSIONER ATKINS: That is the ala carte nature
7 of this and that destination on the cover will then tip
8 people off as to whether it's an S-1 with the highest amount
9 of disclosure or an S-1 somewhere in between.

10 MR. DUNN: Correct.

11 COMMISSIONER ATKINS: We propose to allow all
12 issuers to use Form S-3 in a primary offering so long as they
13 are current with their Exchange filings. Why should we
14 extend this privilege to companies that are trading on the
15 Bulletin Board and pink sheets, and not limit it solely to
16 issuers on national securities exchanges?

17 STAFF SPEAKER: The recommendation we made today
18 would require that companies meet all the non-float
19 requirements of Form S-3, so that would include the basic
20 timely reporting of all their Exchange Act reports during the
21 last year so all their filings would have been made with us
22 electronically on EDGAR in a timely fashion. Investors would
23 have had all that information available to them.

24 We think that combined with the limitations on 20
25 percent of their float being offered per year and excluding

1 shell companies or ceased to be a shell company for a year,
2 should take care of any other concerns.

3 COMMISSIONER ATKINS: I think the comments will be
4 very instructive. I look forward to that.

5 For smaller business issuers registering securities
6 on Form S-3, how are we going to monitor whether they are
7 staying within their 20 percent limitation?

8 MR. DUNN: The way we are looking at that is the
9 same way we look at people doing 424s off the shells all the
10 time now, they have come in with unallocated shells,
11 universal shells, or if they just come in with the regular
12 shell, and 424s reflect each take down, and that is how we
13 can tell. It is a similar notion to what we are going to see
14 here.

15 The question is are they taking down more than they
16 are allowed and they have to reflect it.

17 COMMISSIONER ATKINS: I would like to pose a
18 question to our economists. The new electronic Form D, I was
19 curious if you think there might be some additional data that
20 can be collected and analyzed from these electronic filings
21 that might prove useful.

22 STAFF SPEAKER: We actually have been looking at
23 the possibility of getting other data tagged through the Form
24 D filings. Certainly, there are private offerings
25 that -- Form D is part of that offering process. Having

1 information like that tagged or possibly the asset value of
2 the offerer, not just of that filer, not just a check box of
3 whether it was less than \$5 million, I think, would be
4 useful, but at the same time, we are cognizant of the
5 possible burden on costs, and have been suggesting that there
6 could be questions put in the release, if there are not some
7 already, about how useful those additional requirements would
8 be and what the costs are.

9 I would like to comment relatedly, all of these
10 releases that our group has been working on, from an OEA
11 perspective, they are very difficult to analyze because there
12 is not a lot of good data out there on smaller issuers.

13 When the work with the Advisory Committee first
14 started getting into improving the quality of data, the work
15 our group has done has reflected that, and I would like, if
16 you don't mind, take the opportunity to thank Alan Herrell,
17 Jeannie Frensky, Katherine Handley and Jennifer Westberg for
18 the outstanding job they have done in putting together some
19 background information for the proposals on very short
20 notice.

21 COMMISSIONER ATKINS: Great. Thank you.

22 With respect to Form D, have we talked to the
23 states? Originally, this was a joint form.

24 MR. DUNN: We have been speaking to them on and off
25 for a good while about it, about what they would like to see

1 in it. We have talked to them about it. We have not
2 coordinated the development of it. They have definitely seen
3 it and talked to us about it. We are looking forward to
4 comments on it.

5 I think you always run into the natural intention
6 of from our side, we want to view it more as a notice, and on
7 the state side, they want more information. So, we try to
8 find the right balance. That is why it is so important that
9 we talk to them. I think we have probably had at least a
10 half a dozen or dozen conversations with them as we have gone
11 along.

12 You are never going to reach the perfect balance
13 because people have different views. The notion of this
14 being electronic and the means it gives them to better dig
15 into the database to see what is at the state level, they are
16 very encouraged by that. They have let us know they are
17 going to comment on this and we are definitely going to work
18 with them.

19 COMMISSIONER ATKINS: Okay. I look forward to
20 their comments. I wanted to also give the General Counsel
21 people time here. We are basing the super accredited
22 investor standard on Section 28 and not Section 4-2, and the
23 Commission and its staff have a long history of equating
24 general solicitation is not compatible with a private
25 offering, all the way back to the 1930s.

1 I think one can argue as the Advisory Committee and
2 others have that this approach might not be correct. I think
3 the Advisory Committee said that we focused on purchasers and
4 not offerees.

5 I was curious what our General Counsel's Office
6 thinks in order to address these interpretations.

7 MR. DUNN: Let me say at the outset that we are
8 entirely comfortable with the approach that the Division is
9 taking here which I think achieves the objectives that the
10 Division of Corporation Finance has in its recommendations.

11 For at least present purposes, the approach taken
12 here enables the Commission not to confront the very
13 long-standing and very large body of law that you referred
14 to.

15 We think the Division has taken the proper course.
16 I don't think we want to preclude or pre-judge what might be
17 determined to be appropriate in other circumstances.

18 COMMISSIONER ATKINS: We got a nice supplemental
19 memo yesterday. I guess this will be a work in progress over
20 the next few days to finalize it.

21 With respect to the various standards for natural
22 persons and legal entities and considering what we did back
23 in December regarding the accredited investor changes, we
24 have very inconsistent approaches here across the board in
25 506 and the proposed 507 and then this proposed 509.

1 The fact that we have now a higher level for
2 institutions under 507 and under 506 for the hedge funds, and
3 after seeing all the comments that have come in on that and
4 proposed 509, I am not really sure I would support what we
5 came out with.

6 My hope is that we are going to get this consistent
7 here, and if we have to re-propose the hedge fund rule, then
8 that is probably what we have to do to get it in sync. I just
9 have a concern with where we are going. I don't know if you
10 have any comments on that.

11 STAFF SPEAKER: I am not completely sure what your
12 question is. The rules as proposed today are not to be
13 reviewed with the rules that the Commission proposed back in
14 December.

15 COMMISSIONER ATKINS: For example, under proposed
16 509, there is a \$5 million total net asset test, the same as
17 under 506, but you now have proposed 507, we have a \$10
18 million net investment test. Basically, we have a higher
19 standard under 507 than we do under 509 or 506.

20 I just think these need to be harmonized in some
21 way and especially with the net asset test. We have a choice
22 now under 507 to account for the net investment test.

23 STAFF SPEAKER: One thing I can comment on is I was
24 looking at exactly the same issues you are raising right now
25 and trying to figure out whether there is any inconsistency.

1 I appreciate all the work we have done with Corporation
2 Finance and with the Office of General Counsel in harmonizing
3 the two rules.

4 If I could go back to the rules proposed in
5 December, all those rules are -- what those rules do is
6 re-define accredited investors who are natural persons who
7 seek to invest in a special type of hedge fund, the hedge
8 fund that relies on 3(c)(1). Those are hedge funds that have
9 less than 100 investors and are not presently making and do
10 not propose to make a public offering.

11 All that we did or all the Commission has proposed
12 to do in the December proposals is to re-define natural
13 persons for those types of hedge funds to be persons who have
14 \$2.5 million in investments.

15 The rules that Corporation Finance -- Rule 507
16 that Corporation Finance is proposing today is not a safe
17 harbor under Reg D. It is not a new type of private
18 offering. It is an exemption -- jump in, please -- it is
19 where we overlap and I am sure I will say it a little bit
20 different than Mauri's group would -- it is an exemption from
21 the registration requirements.

22 It is in no way saying that an issuer that relies
23 on 507 is not making a public offering. It is simply saying
24 you are exempt from registration if you meet the requirements
25 of 507 and you do a tombstone ad.

1 Hedge funds would not be allowed to use that
2 provision. They are by definition restrained, prohibited
3 from making a public offering, so that because the exemption
4 doesn't address that question, 507 simply doesn't apply to
5 them.

6 COMMISSIONER ATKINS: I agree with that. I guess
7 my point is not necessarily a technical one, but how we are
8 adding a third one. It doesn't seem to be harmonized. I
9 think that is one thing that I think we have to work out, we
10 have to listen to the comments coming in, and we are probably
11 going to have to, in my opinion, re-address that hedge fund
12 proposal.

13 MR. DUNN: What we are trying to accomplish in it
14 is work in alternative definitions so whatever the Commission
15 decides to do on the hedge fund piece, we can adopt to match.
16 That is our goal, because we realized a key thing here is
17 there has to be one best answer.

18 COMMISSIONER ATKINS: I think you have done an
19 exemplary job. I just think as our thinking changes with
20 time and as we have the benefit of substantial comments, I
21 think a lot of this will be very well put. We need to
22 incorporate that.

23 With that, thanks.

24 CHAIRMAN COX: Thank you. Commissioner Campos?

25 COMMISSIONER CAMPOS: Thank you. I also would like

1 to congratulate the staff of our Division of Corporation
2 Finance for all of its hard work and all the other staffs
3 that have contributed to these six proposals.

4 While I am told this is not a record, it is not
5 often that you see six proposed rulemakings from one division
6 in one calendar. I guess the number actually is eight or
7 nine perhaps if we include the three releases from management
8 guidance. That must be some sort of record.

9 I know the Corp Fin staff has put in tremendous
10 amounts of hours, and as we said, that has also caused our
11 staffs to put in a tremendous number of hours. All that
12 together has produced the good work here today.

13 I just have a short statement.

14 One of the Commission's missions is, as we all
15 know, to promote capital formation. It is especially
16 important to both smaller public companies and also private
17 companies.

18 As a former owner of a privately held company, I
19 understand how important this is. If our rules are out of
20 date, unnecessarily vague, or overly restrictive, smaller
21 public and private issuers will face certain obstacles.

22 There has been much discussion recently about the
23 allegedly evidence of the decline of competitiveness in the
24 U.S. markets. What is missing from this discussion in my
25 view is talk of capital raising that occurs in the United

1 States. In particular, private capital raising by foreign
2 companies.

3 I would think that trends in this regard are as
4 important as IPO trends if not more so. For example, it
5 seems to me the trends with respect to unregistered offerings
6 by private companies correspond much more closely than IPOs
7 with respect to critical measures of our economy, such as
8 where jobs are created and where technology is developed, the
9 sort of companies with unregistered offerings formed the
10 backbone of our system.

11 If the private offering process is streamlined,
12 these companies, it seems, would have greater capacity to
13 innovate and grow. and to bring us back to IPOs, statistics
14 that show that the vast majority of companies go public in
15 their home market. It stands to reason that if private
16 companies in the U.S. thrive, so, too, will ultimately the
17 U.S. IPO market.

18 With that said, let me turn to a few specific
19 points. First, I am glad to see that the staff is proposing
20 to revise the content of Form D and mandate electronic filing
21 of the form. There is no reason that we should be stuck in
22 the paper when virtually all of the other required Commission
23 filings are electronic.

24 In addition, our staff has heard that Form D is
25 confusing, complicated, and apparently many issuers are

1 choosing simply not to file the form.

2 By simplifying Form D and making it easier to file,
3 we can hopefully reduce the burden on issuers. Moreover, this
4 should make Form D a better tool to collect empirical
5 information, so we can measure private offering trends and
6 report on capital raising.

7 These are important trends, as I have said, that we
8 should be measuring.

9 Second, I think the proposal to allow limited
10 advertising to occur in an offering solely to Rule 507
11 qualified purchasers via Rule 507 is very promising. On the
12 one hand, it would relax one of the primary restrictions
13 currently imposed on private offerings. On the other hand,
14 by limiting the offering to an even narrower class of
15 investors, the rule would seek to minimize the potential for
16 fraud by unscrupulous issuers.

17 It will be interesting to see the comments that we
18 receive on this. I am also curious to see what the
19 commentators have to say about our revisions to the definition
20 of "accredited investor."

21 I know our proposal last December to amend this
22 definition generated significant commentary and we should be
23 mindful of the comments that we received in that regard.

24 I also should not overlook the fact that we are
25 also proposing to remove some limitations on the ability of

1 smaller public companies to conduct offerings on Form S-3s.
2 This seems appropriate given the more comprehensive real time
3 disclosure regime put in place over the last few years.

4 Again, however, we are trying to balance investor
5 protection interest here as well by limiting the amount of
6 securities that can be sold by smaller public companies and
7 by not allowing shell companies to take advantage of this
8 proposed rule.

9 I hope this is an appropriate balance. Again, I
10 look forward to the comments.

11 Again, let me congratulate the staff for this very
12 fine and very comprehensive work, and I know it is at least a
13 record in terms of the weight I had to carry to this
14 particular open meeting for me. Thank you again.

15 CHAIRMAN COX: Thank you. Commissioner Nazareth?

16 COMMISSIONER NAZARETH: Thank you, Mr. Chairman.

17 I'd also like to congratulate the staff on the good job with
18 respect to this package of small business proposals.

19 (Inaudible due to background noise/activities.)

20 COMMISSIONER NAZARETH: Commissioner Atkins had
21 some concerns about the intersection between this proposal
22 and the December 2006 proposal from the Division of
23 Investment Management with respect to Rule 509. I also share
24 an interest in to the full extent possible aligning at least
25 definitions. I can understand there may be some policy

1 reasons to employ different standards for safe harbor versus
2 the exemption, although I don't think we have fully had that
3 discussion prior to this meeting.

4 There are opportunities, it seems to me, in some of
5 the definitions to ultimately align these. I think what
6 happened in the drafting process is we have now tried to
7 align them because we have an existing proposal out there,
8 when in fact it may be based on some of the comments that we
9 received, that some of the things that are now raised as
10 questions for today's proposal -- (inaudible) -- what was
11 done in the December proposals before we adopt or take those
12 improvements into account. If what that means is that we
13 have to in some way re-propose parts of the December
14 proposal, that is fine with me. If it is possible to do that
15 by raising the questions in this document. I do not know
16 what the procedural rules will be on that.

17 Ultimately, we want to end up with the best result,
18 and something that is easy to apply and not with multiple
19 definitions simply because these things were done at
20 different times.

21 Again, I agree with what Commissioner Atkins
22 expressed there.

23 I had one or two other sort of quick comments. One
24 I think relates to Form D. Obviously, this is something that
25 NASA has a great interest. Have you received input from NASA

1 on this?

2 MS. OSHEROFF: We received some informal input from
3 a project group working on Form D. We also spoke to them
4 about it a few weeks ago. We understand their concern. They
5 understand ours. I think they will be very happy with it.
6 In fact, when I answered the question a few minutes ago on
7 why this electronic form would be helpful to Enforcement, I
8 should have also mentioned state enforcement efforts.

9 The states similarly will be in a better position
10 once they have an easy way to search for and identify data,
11 and the states will be able to receive forms that are
12 targeted at their own state. This will be helpful with their
13 enforcement efforts as well as ours.

14 We expect they will give us more input after the
15 proposal. I am sure we will get comments from them. We do
16 not want to represent that they have signed off on the form.
17 I think they will be pleased with it.

18 As I think Marty mentioned a few minutes ago, there
19 is a certain balance in terms of the information that we ask
20 for. We want information that will be useful to us for
21 statistical and enforcement purposes and we want the states
22 to feel that they also have useful information. We do not
23 want the form to be a many, many page form, although since
24 it's electronic, I am not sure pages have any meaning, but we
25 do not want it to be burdensome.

1 We would like to achieve the right core of
2 information, and we are looking forward to hearing from them
3 and working with them on that.

4 COMMISSIONER NAZARETH: Thank you. I also have a
5 question on Form 144, on the tolling periods. Do we think
6 that security holders and brokers will have difficulty
7 calculating tolling periods?

8 STAFF SPEAKER: No, we are not anticipating they
9 will. They already have to make reasonable inquiry about a
10 number of things.

11 COMMISSIONER NAZARETH: Thank you.

12 MR. WHITE: I might just make one procedural
13 comment here. There have been a couple of comments about a
14 lot of documents floating around here.

15 In terms of what you are voting on today, you have
16 a draft release which is in the stack you have, and then
17 there is an action memo that went around, or supplemental
18 action memo's that went around yesterday that outlines a
19 number of changes in the draft release we had sent you, but
20 it outlines the material terms of those changes, and that
21 will also reflect a number of questions.

22 It is laid out so that we have complete flexibility
23 when it comes to adopting the final release.

24 CHAIRMAN COX: Thank you. Commissioner Casey?

25 COMMISSIONER CASEY: In the spirit of the time

1 limits that we have with the meeting and the next agenda
2 item, I will also limit my comments.

3 As a general matter, I would like to say that I am
4 very supportive of the proposals that are being put forward
5 today. As has been noted, they are intended to facilitate
6 capital formation by liberalizing and modernizing certain of
7 our registration reporting requirements, and they should
8 benefit companies of all sizes, but particularly aimed at
9 smaller companies. I think that is extremely important, as
10 they are the engines in our economy and responsible for a
11 great deal of job growth and creation in our economy.

12 I think as a general matter I would say I am really
13 pleased that given the fact that we have modernized many of
14 our other rules and forms, which you related to, Marty, that
15 we are focusing our attention now on certain rules for
16 private or limited offerings in Reg D.

17 I would love us to continue to look across our
18 rules and regulations in other areas to ensure that we are
19 continuing to achieve the goals and our mission, and that we
20 should give consideration to whether they need to be updated
21 or revised.

22 I would also note that I also share the views of
23 both Commissioners Atkins and Nazareth as it relates to 507
24 and the December release. While I appreciate the fact that
25 what we have before us today allows us the flexibility to

1 give consideration to the appropriate approach, I think it is
2 going to be extremely important that we take the value of the
3 comments that we get on the proposal today, that we are
4 adopting today.

5 If that requires any additional reconsideration of
6 the December proposal, I think we should do so. I think the
7 end result, the policy, should definitely take advantage of
8 the comments. I thought the comments we received on the
9 December proposal were extremely informative.

10 Again, I commend all of you. I know it was a
11 tremendous amount of effort. We are realizing the benefits
12 today. Thank you.

13 VOTES

14 CHAIRMAN COX: Thank you. If there is no further
15 questions or discussion, we will move to four separate
16 questions on adopting each of these changes.

17 The first question is does the Commission vote to
18 propose amendments to its disclosure and reporting
19 requirements under the Securities Act and the Exchange Act
20 that would allow most companies with a common equity public
21 float of less than \$75 million to qualify for the
22 Commission's scaled disclosure and reporting requirements for
23 smaller reporting companies?

24 COMMISSIONER ATKINS: Yes.

25 COMMISSIONER CAMPOS: Aye.

1 COMMISSIONER NAZARETH: Yes.

2 COMMISSIONER CASEY: Yes.

3 CHAIRMAN COX: That matter is approved.

4 Second, does the Commission vote to propose
5 amendments to its disclosure and reporting requirements under
6 the Securities Act and Exchange Act that would integrate the
7 disclosure requirements for smaller reporting companies which
8 currently are contained in Regulation S-B into Regulation
9 S-K?

10 COMMISSIONER ATKINS: Yes.

11 COMMISSIONER CAMPOS: Yes.

12 COMMISSIONER NAZARETH: Yes.

13 COMMISSIONER CASEY: Yes.

14 CHAIRMAN COX: Yes. That matter stands approved.

15 Third, does the Commission vote to propose
16 amendments to the disclosure and reporting requirements under
17 the Securities Act and Exchange Act that would combine for
18 most purposes the current two categories of smaller companies
19 into one category called "smaller reporting companies?"

20 COMMISSIONER ATKINS: Yes.

21 COMMISSIONER CAMPOS: Yes.

22 COMMISSIONER NAZARETH: Yes.

23 COMMISSIONER CASEY: Yes.

24 CHAIRMAN COX: Yes. That matter stands approved.

25 Fourth, do the Commissioners vote to propose

1 amendments to the disclosure and reporting requirements under
2 the Securities Act and Exchange Act to rescind the
3 Commission's S-B form for smaller companies?"

4 COMMISSIONER ATKINS: Yes.

5 COMMISSIONER CAMPOS: Yes.

6 COMMISSIONER NAZARETH: Yes.

7 COMMISSIONER CASEY: Yes.

8 CHAIRMAN COX: Yes. That matter stands approved.

9 Thank you very much once again for excellent work.

10 I'm sorry. Does the Commission vote to propose
11 amendments to the eligibility requirements of Form S-3 and
12 Form F-3 under the Securities Act to permit registration of
13 primary offerings by companies with a public float of less
14 than \$75 million, subject to a restriction on the amount of
15 securities those companies may sell pursuant to the expanded
16 eligibility standard in any 12 month period?

17 COMMISSIONER ATKINS: Yes.

18 COMMISSIONER CAMPOS: Yes.

19 COMMISSIONER NAZARETH: Yes.

20 COMMISSIONER CASEY: Yes.

21 CHAIRMAN COX: Yes. That matter stands approved.

22 Does the Commission vote to propose two exemptions
23 from the registration requirements of the Exchange Act for
24 compensatory employee stock options, the first exemption for
25 issuers that are not required to file periodic reports under

1 the Exchange Act, and the second exemption for issuers that
2 are required to file those reports because they have
3 registered under the Exchange Act, Section 12, the class of
4 the equity security underlying the compensatory employee
5 stock options.

6 COMMISSIONER ATKINS: Yes.

7 COMMISSIONER CAMPOS: Yes.

8 COMMISSIONER NAZARETH: Yes.

9 COMMISSIONER CASEY: Yes.

10 CHAIRMAN COX: Yes. That matter stands approved.

11 Does the Commission vote to propose a new
12 Regulation D exemption from the registration provisions of
13 the Securities Act for sales of securities to a newly defined
14 category of qualified purchasers that will permit limited
15 advertising and propose other revisions to Regulation D,
16 including changing the definition of "accredited investor,"
17 adding revised disqualification conditions to all exemptions
18 under Regulation D and shortening the timing required by the
19 integration of safe harbor in the regulations, and finally,
20 to propose interpretative guidance regarding the integration
21 of current public and private offerings?

22 COMMISSIONER ATKINS: Yes.

23 COMMISSIONER CAMPOS: Yes.

24 COMMISSIONER NAZARETH: Yes.

25 COMMISSIONER CASEY: Yes.

1 CHAIRMAN COX: Yes. The recommendations are
2 approved.

3 Does the Commission vote to propose revisions to
4 Form D to mandate electronic filing of Form D, which is the
5 notices filed by companies that have sold securities without
6 registration under the Securities Act based on a claim of
7 exemption under Regulation D?

8 COMMISSIONER ATKINS: Yes.

9 COMMISSIONER CAMPOS: Yes.

10 COMMISSIONER NAZARETH: Yes.

11 COMMISSIONER CASEY: Yes.

12 CHAIRMAN COX: Yes. That recommendation is
13 approved.

14 Does the Commission vote to propose amendments to
15 Rule 144 that would shorten the holding period for the
16 re-sale of restricted securities where the issuer of the
17 securities is subject to the Exchange Act reporting
18 requirements, to simplify compliance with the rules for
19 non-affiliates to sell restricted securities after satisfying
20 the holding period, raise the Form 144 filing thresholds,
21 eliminate the manner of sale restrictions with respect to
22 debt securities and codify certain staff interpretations
23 relating to Rule 144?

24 COMMISSIONER ATKINS: Yes.

25 COMMISSIONER CAMPOS: Yes.

1 COMMISSIONER NAZARETH: Yes.

2 COMMISSIONER CASEY: Yes.

3 CHAIRMAN COX: Yes. That recommendation is
4 approved.

5 Finally, does the Commission vote to propose
6 amendments to Rule 145 to harmonize the holding period of
7 Rule 145 with the proposed Rule 144?

8 COMMISSIONER ATKINS: Yes.

9 COMMISSIONER CAMPOS: Yes.

10 COMMISSIONER NAZARETH: Yes.

11 COMMISSIONER CASEY: Yes.

12 CHAIRMAN COX: Yes. That recommendation is
13 approved. Are there any other proposals that the
14 Commissioners seek to vote on?

15 (No response.)

16 CHAIRMAN COX: If not, all of those recommendations
17 are approved. Thank you very much.

18 ITEM 8

19 OVERSIGHT OF CREDIT RATING AGENCIES REGISTERED AS
20 NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS

21 CHAIRMAN COX: Our next item is Credit Rating
22 Agency Reform Act of 2006. These are recommendations from
23 the Division of Market Regulation. In giving the Commission
24 statutory authority to oversee the credit rating industry,
25 Congress explicitly found that this kind of oversight would

1 serve the interest of investor protection.

2 The new regulatory framework is intended to ensure
3 we carry out the intent of Congress and to benefit investors.

4 President Bush signed the Credit Rating Agency
5 Reform Act into law on September 29th of last year. By its
6 terms, the Act gave the Commission 270 days to adopt rules to
7 implement the new law. That deadline will arrive on June
8 26th, about a month from now.

9 To meet that deadline, we proposed rules back in
10 February, on February 2, 2007, just four months after the law
11 was signed, by proposing our regulations five months before
12 the deadline, we put ourselves on track to meet the
13 legislative schedule.

14 Today, we are preparing to adopt final rules more
15 than a month before the statutory deadline. I want to
16 generously congratulate the staff for their exceptional good
17 work in that respect.

18 The Act states that the basis for its provisions
19 included the Commission's 2003 report and public comment
20 letters on the Commission's concept released rule proposals.
21 The goal of the new law is to improve credit rating's quality
22 by fostering competition and accountability, and transparency
23 for the industry.

24 The replacement of the transparent voluntary
25 Commission registration system favors no particular business

1 model. For the first time, the Commission has been given
2 statutory responsibility to oversee the NRSROs.

3 The Act prescribes a specific time line within
4 which the Commission must act on an application and requires
5 that our implementing rules are narrowly tailored to achieve
6 their purpose.

7 The rules that the Commission is considering today
8 are intended to faithfully implement the statutory mandate.

9 I particularly would like to thank the following
10 people for all your efforts in getting this new regulatory
11 framework to the Commission well within the time frame
12 specified by Congress.

13 Director and Deputy Director of the Division of
14 Market Regulation, Eric Sirri, Bob Colby, Mike Macchiaroli,
15 Tom McGowan, Randall Roy, Sheila Schwartz, Rose Russo Wells,
16 as well as Janice Mitnick in the Office of the General
17 Counsel. I particularly want to thank the Commissioners and
18 their counsels for their comments and work.

19 I will turn the floor over to Eric Sirri, the
20 Director of the Division of Market Regulation for a more
21 detailed description of the recommended final rules on
22 NRSROs.

23 MR. SIRRI: Thank you, Mr. Chairman. Good
24 afternoon, Commissioners.

25 The Division of Market Regulation recommends that

1 the Commission adopt final rules to implement the Credit
2 Rating Agency Reform Act of 2006. As instructed by Congress,
3 the final rules before you are narrowly tailored and are
4 designed to promote the quality and integrity of the credit
5 ratings by fostering accountability, transparency, and
6 competition in the credit rating industry.

7 The Commission proposed rules for comment on
8 February 2, 2007. We are pleased to have received 62
9 comments during what was a very short comment period.

10 The final rules before you today incorporate
11 changes responsive to those comments. We have prepared six
12 rules and a registration form for consideration.

13 First, we recommend that the Commission adopt Rule
14 17g-1, the registration procedures for the nationally
15 recognized statistical rating organizations or NRSROs, and
16 the Form NRSRO.

17 Rule 17g-1 will require a credit rating agency to
18 apply to the Commission for registration as an NRSRO and if
19 approved, to provide updated information when certain
20 information provided becomes materially inaccurate and an
21 annual certification on Form NRSRO.

22 The credit rating agency will be required to
23 provide the information on Form NRSRO such as the classes of
24 credit ratings for which it is applying to be registered,
25 credit rating's performance measurements statistics, a

1 general description of the procedures and methods for
2 determining credit ratings, organizational structure,
3 procedure to prevent misuse of information, conflicts of
4 interest, procedures to address and manage conflicts of
5 interest generally, a description of the minimum
6 qualifications of its credit analysts and credit analyst
7 supervisors, and information regarding the designated
8 compliance officer.

9 Second, we recommend that the Commission adopt Rule
10 17g-2 concerning the records to be made and retained by
11 NRSROs. Rule 17g-2 will require NRSROs to make and retain
12 certain records related to its business as a credit rating
13 agency. The rule will also prescribe the time periods and
14 manner in which the records must be maintained.

15 Third, we recommend that the Commission adopt Rule
16 17g-3 requiring annual financial reports to be furnished by
17 NRSROs. The rule will require NRSROs to furnish to the
18 Commission on a confidential basis certain financial reports
19 on an annual basis, including audited financial statements.

20 In addition to the audited financial statements,
21 the rule also required NRSROs to furnish separate unaudited
22 financial reports that will assist the Commission in carrying
23 out its statutory responsibilities under the Credit Rating
24 Agency Reform Act.

25 Fourth, we recommend that the Commission adopt Rule

1 17g-4 which seeks to prevent the misuse of material
2 non-public information. Rule 17g-4 will require an NRSRO to
3 have written policies and procedures reasonably designed to
4 prevent (1) the inappropriate dissemination within and
5 outside the NRSRO of material non-public information obtained
6 in connection with the performance of credit rating services.

7 (2) a person within the NRSRO from purchasing,
8 selling, or otherwise benefiting from any transaction in
9 securities or money market instruments when the person is in
10 possession of material non-public information obtained in
11 connection with the performance of credit rating services
12 that affects the securities or money market instruments.

13 (3) the inappropriate dissemination within and
14 outside the NRSRO of a pending credit rating action before
15 issuing the credit rating.

16 Fifth, we recommend that the Commission adopt Rule
17 17g-5 to address conflicts of interest. Rule 17g-5 will
18 require an NRSRO to disclose and manage those conflicts of
19 interest that arise in the normal course of engaging in the
20 business of issuing credit ratings.

21 For example, one conflict of interest for NRSROs
22 would include being paid by issuers or underwriters to
23 determine credit ratings with respect to securities or money
24 market instruments they issue or underwrite.

25 Finally, we recommend that the Commission adopt

1 Rule 17g-6 to address certain prohibitive acts and practices
2 as directed by Congress.

3 Rule 17g-6 will prohibit the NRSRO from engaging in
4 certain unfair, coercive, or abusive practices. For example,
5 an NRSRO could not threaten to issue a credit rating that is
6 not determined in accordance with the NRSRO's established
7 procedures and methodologies for determining credit ratings,
8 based on whether the rated person will purchase or purchases
9 another product of the NRSRO.

10 Rule 17g-6 also would prohibit an NRSRO from
11 issuing or threatening to issue a lower credit rating,
12 lowering or threatening to lower an existing credit rating,
13 refusing to issue a credit rating or withdrawing or
14 threatening to withdraw a credit rating with respect to
15 securities or money market instruments issued by an asset
16 pool or as part of any asset backed or mortgage backed
17 securities transaction, unless all or a portion of the assets
18 within such pool or part of such transaction also are rated
19 by the NRSRO, where such practice is engaged in by the NRSRO
20 for an anti-competitive purpose, a practice that is known as
21 "notching."

22 Proving anti-competitive intent in this regard will
23 be difficult, particularly where an NRSRO has analysis to
24 support the contention that its methodology is not arbitrary
25 and designed to make the credit rating of a structured

1 product more accurate.

2 Nonetheless, we believe this prohibition when
3 combined with the enhanced recordkeeping requirements of Rule
4 17g-2 would serve as an important deterrent against
5 anti-competitive practices.

6 We recommend that the Commission adopt three
7 recordkeeping requirements in this area. These requirements
8 would assist the Commission to better understand how these
9 practices are developed and employed and this information may
10 provide a basis for the Commission to determine whether it
11 should find a specific practice to be unfair, coercive, or
12 abusive.

13 With regard to unsolicited ratings, in the proposal
14 release, the Commission has preliminarily determined that it
15 would be unfair, coercive or abusive for an NRSRO to issue an
16 unsolicited credit rating and then attempt to induce the
17 rated person to pay for the rating or for another product or
18 service of the NRSRO or its affiliates.

19 Consequently, paragraph (a)(5) of proposed Rule
20 17g-6 would prohibit this practice.

21 Commentors have raised a number of concerns with
22 respect to how this prohibition will operate. For the most
23 part, commentors were concerned that it was over broad and
24 consequently would prohibit legitimate business activities
25 that are not coercive.

1 We would like to gain a better understanding
2 through our examination function of how credit rating
3 agencies define "unsolicited credit ratings" and the
4 practices they employ with respect to these ratings.

5 We believe we should gain this understanding before
6 recommending that the Commission prohibit any practice in
7 this area, and therefore, we recommend that the prohibition
8 be eliminated from Rule 17g-6.

9 I would also like to discuss the issue of whether
10 credit rating agencies that register as NRSROs should be
11 required to disclose certain performance statistics, such as
12 standardized inputs, time horizons and metrics to allow for
13 greater comparability among NRSROs.

14 The Commission requested comment on whether other
15 performance measurement statistics would be appropriate as an
16 alternative or an addition to historical default and down
17 grade rates.

18 For example, the Commission requested comment on
19 whether Exhibit 1 should require a measurement of the
20 performance of a given credit rating by comparing or mapping
21 it to the market value of a rated security or to screen the
22 clients on the market value of the security after the rating.

23 Commentors generally questioned whether
24 standardizing performance statistics would be appropriate.
25 For example, the credit rating agencies may have different

1 definitions for their credit ratings, which would make it
2 much more difficult to develop common metrics for evaluating
3 the performance among credit rating agencies.

4 Accordingly, at this time, the staff is not
5 recommending that the Commission take action in this regard.
6 However, we intend to study these issues and consider
7 possible action in the future.

8 Another issue we wish to bring to your attention is
9 the concerns of timing of the release. Under the Rating
10 Agency Act, the Commission must issue final implementing
11 rules no later than 270 days after its enactment, or by June
12 26, 2007.

13 The provisions of the Rating Agency Act that relate
14 directly to the registration and oversight of NRSROs becomes
15 effective on the earlier of June 26, 2007 or the date the
16 Commission issues final rules under the Act.

17 However, once the Rating Agency Act is effective, a
18 credit rating agency that has received an NRSRO no action
19 letter can only represent itself as an NRSRO if it has an
20 application for registration pending before the Commission.

21 Pursuant to the release of the final rules being
22 considered today, credit rating agencies that are currently
23 the subject of a Commission staff no action letter
24 identifying themselves as NRSROs would have a period of time
25 to submit applications for registration as NRSROs before the

1 provisions of the Rating Agency Act and the recordkeeping
2 reporting and conduct rules issued under the Act become
3 effective.

4 This will avoid a gap of time when no NRSRO exists
5 which would disrupt the regulatory use of the terms and
6 applicable statutes and regulations that would be consistent
7 with Congressional intent.

8 Our recommendations today represents the
9 culmination of efforts by staff from several divisions and
10 offices. I would like to thank Janice Mitnick, Michael Plasi
11 from the Office of General Counsel, Tony Tri and Chuck Dale
12 and Lauri Walsh from the Office of Economic Analysis.
13 Melanie Jacobson and Nancy Salisbury from the Office of the
14 Chief Accountant, and the following members from my staff,
15 Bob Colby, Mike Macchiaroli, Tom McGowan, Randall Roy, Rose
16 Russo Wells, and Sheila Schwartz.

17 I would be happy to answer any questions.

18 CHAIRMAN COX: Thank you. I just have two
19 questions, and I want to compliment you for a very thorough
20 presentation, but also preparation. A lot of work has gone
21 into doing this in a very timely way and we are very
22 appreciative.

23 The Act requires the Commission to prohibit
24 practices that it determines are unfair, abusive or coercive.
25 In our proposing release, the Commission preliminarily

1 determined to prohibit a practice that is frequently referred
2 to as "notching."

3 The vast majority of comments that we received
4 address this issue. I wondered if you could more fully
5 explain what the staff's plans are for addressing that issue
6 going forward and how these rules before us today address
7 that issue.

8 MR. MACCHIAROLI: Yes, Mr. Chairman. First, we
9 recommend that the abusive practices actually be one where
10 the one rating the pool -- intends the notching practice to
11 be anti-competitive. In effect, tracks what we think is the
12 legislative intent.

13 This will give us the burden of determining whether
14 or not somebody intentionally is doing something for
15 anti-competitive purposes.

16 We have asked the Commission to adopt a series of
17 rules which will give us information about the practices.
18 That is we will ask the firm as to each security it rates,
19 each pool it rates, where it does not rate all the
20 securities, to identify those and to identify how it rated
21 those particular instruments, that is how it incorporated
22 those instruments into its pool rating, and to also give us
23 information about its notching practices, how it determines
24 how to notch a particular NRSRO.

25 We will in effect use this information to try to

1 build a bridge for determining whether or not they did this
2 for rational purposes, that is for non-competitive purposes,
3 for solely for anti-competitive purposes.

4 The Office of Economic Analysis has in effect
5 agreed to work with us in formulating some sort of approach
6 to this problem. We are going to determine whether or not we
7 are collecting sufficient information through this process
8 and whether we need to go back and get more information from
9 the rating agencies.

10 CHAIRMAN COX: I take it that consistent with the
11 statute, which required the Commission to prohibit practices
12 that are in and of themselves unfair, abusive or coercive,
13 that you will infer anti-competitive intent from the practice
14 itself.

15 MR. MACCHIAROLI: We could not recommend to the
16 Commission that any particular notching itself was
17 anti-competitive. It may be, but we determined it would be
18 better that we make any abusive practice to be one where
19 there is an anti-competitive intent and then determine
20 whether or not in the notching area they are doing that.

21 MR. SIRRI: Just to elaborate, I think
22 anti-competitive behavior is an economic practice. I think
23 in this context, I think ultimately it is going to be an
24 empirical issue.

25 CHAIRMAN COX: That is a very helpful answer.

1 MR. SPRATT: One of the things that is striking in
2 this area is there is a phenomenon called "rating shopping."
3 A lot of times what happens is the issuers approach a number
4 of different rating agencies. They get preliminary
5 indications of what their ratings are going to be, and then
6 make a business judgment as to which ratings they would like
7 on their issue and which ratings they just paid for the
8 preliminary evaluation and say we don't need the final
9 report.

10 What an issuer typically would do in such a
11 situation is they might accept the higher ratings and
12 basically say thank you very much for the lower ratings.

13 There is actually information in the implicit
14 ratings that are provided by the rating agencies themselves,
15 and I think that information may be important to
16 understanding if it is associated with notching.

17 I think this is a very important economic issue,
18 and certainly our office has met with a number of the
19 agencies, and I think what is striking is it is ultimately
20 going to be -- in order to get a handle on this, one really
21 has to study and examine this carefully, which is going to be
22 very important in the implementation of the rules.

23 MR. SIRRI: Let me add a couple of things. I agree
24 with what Chester said. Notching is really one of the most
25 difficult issues that was presented by this release. I would

1 say about three-quarters of the comment letters addressed
2 notching. It was a tough problem.

3 The finding that needed to be made that it was
4 anti-competitive, we felt we could not do with the
5 information that we had. We have considered a number of
6 possible ways to proceed, and the result we have here is one
7 that is based on intent.

8 As we have said, intent is a hard thing to show.
9 You asked the question, Mr. Chairman, how you would make that
10 inference, was it just from the practice. I think that is a
11 very difficult inference to make. The empirical regularities
12 is part of that, but it goes beyond that because if you
13 simply look at a set of outcomes, those could rise either to
14 anti-competitive or non-anti-competitive practices. It is a
15 difficult thing.

16 One thing that I will say is that we will going
17 forward focus our attention empirically on notching. We have
18 agreed as a staff and in talking to OEA that is one of the
19 things we should look at early on. When I say look at
20 this, I mean outside of our normal inspection cycle.

21 I think we need to look at the books and records,
22 information that we are going to have, that have been
23 carefully crafted to give us good information, and I think we
24 intend to look at this issue early on to see what practices
25 we find.

1 CHAIRMAN COX: Thank you. The only other question
2 I have concerns criticisms in the Senate report on the Act
3 regarding the process that had been in effect in prior
4 legislation.

5 First, they complained that the process was taking
6 too long, that it was subject to delays. Another legislative
7 concern was that the Commission was not formally involved
8 itself in the decision.

9 To deal with those concerns, the law requires that
10 all applications for registration be approved within 90 days
11 or alternatively, that within that time period there be
12 proceedings to disapprove them, and it requires that this be
13 done by an act of the Commission.

14 I wondered if you would explain how these rules
15 will work to ensure that the 90 day time period or 90 day
16 deadline is met, and second, that the period begins to run
17 when it is supposed to, and third, that the Commission itself
18 will be in a position to act properly on all applications.

19 MR. MACCHIAROLI: We are going to use everyone in
20 our office, we expect at least seven applications initially
21 for the folks with no action letters within the first month,
22 so we expect those to come in.

23 We are not set up yet, but we intend to use all of
24 our resources to look at these as quickly as possible, to
25 make sure they are complete. We are not going to be able to

1 examine all the applications. We intend to get it to the
2 Commission at least in 30 days of the 90 day period. That
3 gives us 60 days to examine the materials and make sure they
4 are complete and then do whatever analysis is necessary under
5 the Act and forward it to the Commission with our
6 recommendations.

7 CHAIRMAN COX: Excellent. Thank you. Commissioner
8 Atkins?

9 COMMISSIONER ATKINS: Thank you, Mr. Chairman.
10 Thank the staff for all your hard work and for working with
11 me and my staff over the last few weeks in this regard. I am
12 really pleased that we are finally able to promulgate rules
13 that provide transparency, consistency and accountability to
14 the NRSRO designation process.

15 Under the language of the release, and the rules
16 are still not final, we have gotten a few versions here
17 recently, I look forward to taking a hard look at the latest
18 version and talking to the staff before it finally makes its
19 way to be published in the Federal Register.

20 I do have a few questions. First, for Mr. Sirri,
21 Dr. Sirri, are you confident that the NRSRO rules including
22 Form NRSRO are narrowly tailored as is required by the
23 statute?

24 MR. SIRRI: Yes, I am. I think as a staff we
25 worked very hard to craft a set of rules that adhere to the

1 purpose of Congress and Congress' intent. I think what you
2 have here are things that stick as closely as possible to
3 what we were required to do and really go no further.

4 COMMISSIONER ATKINS: I am hoping it will remain
5 narrowly tailored. I see a lot of references to further
6 analysis of issues before we take action. I assume this will
7 be full Commission action.

8 MR. SIRRI: That is our intent. I think what we
9 are saying is both the release and the comments we receive,
10 we want to be responsive to those. They raised some
11 difficult issues. We thought it would be responsible to look
12 at the issues empirically, as Chester alluded to, once we go
13 forward and get some more information, and that would relate
14 to issues like the notching practice, but also it could
15 relate to consideration of perhaps additional performance
16 statistics.

17 We are not saying we are going to do those things
18 or not do those things, but we thought the issues were
19 substantial and we should just take a look at them as a staff
20 and if we came to a conclusion, we would bring that to the
21 Commission.

22 COMMISSIONER ATKINS: What representations, if any,
23 must a credit rating agency make about their clients?

24 MR. MACCHIAROLI: There is not a reference
25 regarding that.

1 COMMISSIONER ATKINS: When will a Form NRSRO be
2 complete? Is it just all the blocks are filled in?

3 MR. MACCHIAROLI: All the exhibits and blocks are
4 filled out.

5 COMMISSIONER ATKINS: Is there a qualitative review
6 of the information as part of that?

7 MR. MACCHIAROLI: No. Our intent is just to make
8 sure the documents are complete as required by the rules.

9 COMMISSIONER ATKINS: If there is any dispute
10 between the staff and applicants regarding completeness of
11 the forms, who would arbitrate that?

12 MR. MACCHIAROLI: I guess initially we would have
13 discussions, but ultimately with the Commission. We have no
14 delegated authority.

15 COMMISSIONER ATKINS: Could you explain exactly
16 what policies and procedures the credit rating agencies will
17 have to disclose and what you all are going to look for to
18 determine accuracy?

19 MR. MACCHIAROLI: We have been discussing that with
20 some of the rating agencies. Some of the larger ones have
21 literally thousands and thousands of pages of rating
22 methodologies, depending on the instrument that is to be
23 rated. I want them to disclose how that is done without
24 getting into proprietary information, for example, how the
25 models are run, or such detail that it would over burden.

1 In some cases we have been told that literally they
2 would have to file thousands of pages. We do not want that.
3 We have agreed to have some much lesser standard on how the
4 ratings are being done. We will not be judging the rating.
5 It will not be a vigorous test.

6 COMMISSIONER ATKINS: We need to be clear and I
7 think Congress made it clear that it should not be subjective
8 determinations. If we are going to be requiring disclosure
9 of their policies and procedures -- beyond that --

10 MR. MACCHIAROLI: We will make sure it is their
11 policies and procedures, that is they are telling us in
12 effect what their policies and procedures are and that they
13 have not made them up. There will be an examination to test
14 whether or not these are in fact the policies and procedures.

15 COMMISSIONER ATKINS: A danger inherent in this is
16 you get into a complete circle back and forth and you haven't
17 disclosed properly about this or that. It could almost be a
18 never ending thing.

19 MR. SIRRI: I think what we are clear about is that
20 the intent of Congress was not for us to evaluate the quality
21 of the processes, and I think the staff is clear about that.
22 It seems like the way this was crafted was to say disclose
23 how you come to these ratings and let the market judge.

24 I think the import of what Mike was saying was if
25 there is a procedure that is laid out there, we will make

1 sure you are adhering to that procedure, whatever it is.

2 COMMISSIONER ATKINS: What representations would
3 QUIBs have to make when they send applications in, and with
4 regard to different languages.

5 (Inaudible due to background noise/activities.)

6 COMMISSIONER ATKINS: I was just curious what they
7 have to do.

8 (Inaudible due to background noise/activities.)

9 MR. MACCHIAROLI: (Inaudible.) That they have
10 seriously considered the credit ratings of the applicant.
11 They are certifying and they have not received any
12 compensation.

13 COMMISSIONER ATKINS: I see that in the
14 recordkeeping rules we have excluded drafts from certain
15 required books and records. Are there any recordkeeping
16 requirements that mandate drafts be kept?

17 MR. MACCHIAROLI: That would be very unusual. We
18 obviously do not require drafts. I was surprised to hear the
19 comment, but we agreed that rather than have an argument
20 about it later, that we take it out so it is clear that is
21 not included. Generally, we would not.

22 (Inaudible due to background noise/activities.)

23 COMMISSIONER ATKINS: Per the statutory requirement
24 for disclosure of organizational information we are requiring
25 it looks like organizational charts.

1 MR. MACCHIAROLI: We will leave it at their
2 discretion and then discuss it. That was our intention.
3 Generally speaking, it has been no serious problem.

4 COMMISSIONER ATKINS: I also see that we are using
5 our ancillary signatory authority to require a chart
6 reflecting reporting lines and the compliance officer. What
7 is the purpose of that?

8 MR. MACCHIAROLI: The statute specifically requires
9 there be a compliance officer. We just thought there should
10 be some information about the compliance officer so the
11 public could judge whether or not the compliance officer will
12 be effective. The statute specifically requires that there
13 be a compliance officer. We thought there should be some
14 further information.

15 COMMISSIONER ATKINS: We are not requiring a
16 particular reporting line?

17 MR. MACCHIAROLI: No.

18 COMMISSIONER ATKINS: That is up to the firm.

19 MR. MACCHIAROLI: Yes.

20 COMMISSIONER ATKINS: What are the requirements for
21 auditors of credit rating agencies' financial statements?

22 MR. MACCHIAROLI: That they do an audit in
23 accordance with general principles. It would depend on the
24 particular jurisdiction. We did not want to pick up all of
25 the rules of every agency even in the United States, so we

1 had to trim it. We want them to be independent, but we do
2 not recommend they be independent in accordance with all the
3 issuer rules, for example. That might be too burdensome for
4 some of the smaller entities.

5 Some of the larger entities are audited by PCAOB
6 qualified auditors. Others may not be when you get further
7 down the chain. We wanted to make sure we had an audit with
8 generally accepted standards.

9 The independence was a key question. Then we will
10 see what we get as we go along.

11 COMMISSIONER ATKINS: I agree with that. I think
12 generally accepted auditing standards incorporate that an
13 auditor has to look at what he is auditing.

14 Thank you very much. I look forward to finalizing
15 this in the next couple of days. Thanks.

16 CHAIRMAN COX: Thank you. Commissioner Campos?

17 COMMISSIONER CAMPOS: Thank you. I would also like
18 to start out by thanking our hard working staff in the
19 Division of Market Regs for their efforts in successfully
20 implementing this particular proposal, the Credit Rating
21 Agency Reform Act of 2006, and responding in small time.

22 I remember frequently predicting that if we did not
23 reach an agreement voluntarily in the industry, that Congress
24 would act, and sometimes I am right. Congress did act.

25 We are here today to implement this. I think

1 sometimes you need a nudge, and this is where we are. I
2 think this particular proposal is actually a very good one.

3 I have a short statement and then I have one item
4 that I want to push a little bit with the staff on.

5 Let me just begin. I want to first commend
6 Congress in its decision to mandate the oversight of the
7 NRSROs by creating this registration and disclosure regime.

8 The Commission now is providing greater
9 transparency in their registration process as well as laying
10 out the objective standards. Indeed, our rulemaking complies
11 with Congress' mandate to improve ratings' quality for the
12 protection of investors.

13 It seems to me it should apply for accountability,
14 transparency and competition. The rulemaking was fashioned,
15 as we all know, after years of review, public comment, and
16 examination. Further, in Congressional intent, the proposed
17 rules are narrowly tailored.

18 The proposed rules do so without regulating
19 substance of credit ratings or the procedures or
20 methodologies by which an NRSRO determines credit ratings.

21 The implementation of the Act addresses the
22 concerns raised regarding the no action letter process, which
23 many viewed as creating a barrier to entry for credit rating
24 agencies seeking wider recognition.

25 Among other things, the rulemaking also addresses

1 the issue of supervision of credit rating agencies.
2 Conflicts of interest and the use of non-public information.

3 It is not an overstatement to say credit rating
4 agencies play an important and valuable role in the
5 efficiency of our capital markets. The impact credit rating
6 agencies have, as we all know, can be tremendous. Credit
7 ratings are used by investors, issuers, investment banks,
8 broker-dealers, and by governments. Investors make purchases
9 or not, deals are made or not, schools are built or not, all
10 based many times on the existence or the type of a rating.

11 In today's world, there is an increased appetite
12 for credit ratings and a corresponding demand for
13 objectivity, independence and transparency.

14 The globalization of our financial markets has also
15 effectively expanded the impact credit ratings have. In
16 fact, the asymmetry of the global financial marketplace is
17 the very thing that gives credit rating agencies their
18 grounding.

19 By providing a system of relative creditworthiness,
20 the credit rating agencies give market participants a key to
21 unlock a heavy door. Inherent in the system of granting
22 credit ratings is trustworthiness and impartiality on the
23 part of rating agencies. Confidence, therefore, in the
24 credit rating agencies and the ratings they issue is critical
25 to the efficient operation of our nation's and indeed the

1 world capital markets.

2 I have also maintained over the years that having
3 rules in the U.S. through the SEC would also effectively
4 create a boundary and a model that other countries in the
5 world would like to have, and I believe that is a benefit for
6 the credit rating operations.

7 I also believe that this rulemaking will have a
8 positive impact on the industry. The changes made by this
9 rulemaking may very well result in the expansion of the
10 number of NRSROs. Competition may also emerge for developing
11 markets outside the United States over the next number of
12 years as the number of rating agencies grows.

13 On the international front, there have been several
14 developments as well. In 2004, the IOSCO Committee published
15 a Code of Conduct Fundamentals for credit rating agencies,
16 the so-called IOSCO Code. The Commission played an active
17 role in this process through chairing the committee and
18 assisting with the drafting of the final language.

19 I believe that the rulemaking before us today is
20 generally consistent with existing international principles
21 governing the activities of credit rating agencies and the
22 intent underlying the IOSCO Code. This rulemaking today
23 represents a major leap forward.

24 While we received several comments and suggestions
25 for change at the proposing stage, overall, there has been

1 strong support from a number of market participants,
2 investors and other interested parties.

3 I believe the proposed rules reflect the extensive
4 research and thoughtful deliberations of the staff.

5 I just have one question that I want to explore,
6 and it has been brought up, but I'm not sure that I totally
7 understand where we are going.

8 As to notching, a question would be before the
9 agency as to whether it is indeed anti-competitive or some
10 sort of abusive practice. I understand we do not feel we
11 have the data right now to make that determination, but get
12 me to an end. When will we? What will we do? What process
13 is likely to be suggested? We have already complaints about
14 this area.

15 I think it is appropriate for the agency to be able
16 to tell them how we will eventually resolve that issue.

17 MR. SIRRI: I think the reason it is a difficult
18 question is that the practice of notching could rise for
19 anti-competitive reasons or for other reasons, and given that
20 we have a rule that is based on intent, we are going to have
21 to make an inference, and to do that fundamentally we need
22 data.

23 You asked where would we go and how would we do
24 something like this. The records that are going to be
25 required to be kept here are going to help us. For example,

1 for every deal in which a structured project is done in which
2 another NRSRO has rated some of the underlying assets, the
3 record of that will have to be kept. There will also have to
4 be records kept with regard to how notching calculus, if you
5 will, is done, if those records are made at all.

6 In other words, if you go through an analytical
7 process as an NRSRO and come to a basis for saying I need to
8 lower a credit rating, then you will have to make that record
9 and you are going to have to keep it.

10 The reason why I think these are effective is the
11 NRSROs will have an obligation to justify how they came to
12 their down grading, their selective down grading practices,
13 and we will look for support for why that is reasonable, and
14 we will probably be relying on records for that.

15 Once we have those, we will be able to look at them
16 analytically, the data, and their records, do these seem
17 reasonable or not. That is information we do not have today.

18 What I am really saying is there will be some light
19 shed on the process.

20 COMMISSIONER CAMPOS: Let me again push you a
21 little bit. If there were to be a complaint of notching or
22 maybe that is not what triggers it, you are saying there is
23 an examination process, that there will be an examination of
24 the records justifying the lowering of a rating because
25 another agency was also involved in the rating, and then that

1 data is analyzed by whom and how and what standards would be
2 used to decide whether it is abusive or anti-competitive?

3 MR. SIRRI: I think to be frank, we would have to
4 learn as we go. This is a new business. This is not
5 something we have looked at. We have the ability to request
6 those records and that is something that I think we would do.
7 It would be an analytical process that would happen within
8 the staff. I think people who might participate in that
9 would include people from the Office of Economic Analysis,
10 people from the staff of Market Regulation, and probably
11 people from the Office of Compliance.

12 Finding anti-competitive practices is very
13 difficult, a difficult task. You have to look for the
14 indicia of that. I can't tell you right now exactly what
15 they would be, it is a facts and circumstances sort of thing.
16 We just have to look very carefully for a collection, a set,
17 a pattern, a set of findings that would lead us to become
18 concerned.

19 Frankly, I must say the mere fact that some light
20 is being shed upon this may have some positive benefit. I do
21 not know. I can't tell you today whether anti-competitive
22 practice is going on or not because we were not able to come
23 to a finding. It may be just the knowledge in the industry,
24 the credit rating industry, that we are looking at this
25 actively may help remove any anti-competitive practice, if in

1 fact one was there.

2 COMMISSIONER CAMPOS: I appreciate that. Again,
3 just to push a little bit more. It seems to me that if that
4 were to be done, organize a committee, an inter-divisional
5 committee of some sort, I suppose that would be proposed
6 internally somehow that is the process, then I suppose there
7 is some finding that has to be made, and then if there is a
8 finding that has to be made, I suppose there is some process
9 because that has some legal implications and some issues
10 having to do with the rights of those against potentially,
11 assuming a finding was made.

12 I just see this as a far more detailed and
13 adjudicatory type of system that we are going to have to go
14 down. There may not be any other way. I would think that is
15 something that needs to be vetted and worked with the
16 Commission.

17 MR. SIRRI: I completely agree. We would work with
18 the Commission and let you know what our processes are. Let
19 me point out one other thing. It is rather unusual that we
20 have something quoted in a statute where we are actually
21 looking at anti-competitive behavior. This is somewhat
22 unique for us.

23 I think maybe what you are sensing and quite
24 correctly is this is new ground for us.

25 MR. SPRATT: The Commission has a lot of tools if

1 it does find a violation.

2 COMMISSIONER CAMPOS: I think you get my drift. It
3 smacks of a lot of due process issues, of a hearing, to
4 decide, let their views be known, to defend their position.
5 There is just a lot here. I just would expect this is an
6 area that would be worked with the Commission and I am sure
7 our General Counsel have views about what is appropriate with
8 respect to any type of finding and adjudication aspects of
9 that and whether we have a hearing and what is the form,
10 administrative process, and so forth.

11 MR. SPRATT: If there were a violation, it would be
12 an enforcement action. It would be a normal enforcement
13 process.

14 COMMISSIONER CAMPOS: Ultimately, it would be a
15 referral to Enforcement?

16 MR. SPRATT: Yes.

17 COMMISSIONER CAMPOS: Those are all my questions.

18 CHAIRMAN COX: Thank you. Commissioner Nazareth?

19 COMMISSIONER NAZARETH: Thank you. I am pleased to
20 support the adoption of these rules that implement the Credit
21 Rating Agency Reform Act of 2006.

22 The rules are designed to preserve and foster the
23 integrity of the credit rating process which is critical in
24 light of the ever increasing reliance on ratings over the
25 years, particularly with structured debt and derivative

1 products.

2 Market participants use credit ratings as a proxy
3 for the in depth analysis and their reliance increases for
4 integrity, transparency and accountability of the credit
5 rating process.

6 Through the legislation, Congress established a
7 clear and transparent set of standards. For the first time,
8 the SEC will have a formal regulatory program for registering
9 and supervising credit rating agencies, and they must have
10 their ratings recognized.

11 The legislation also calls for recordkeeping and
12 examination authority over NRSROs, something that it did not
13 have previously, as well as requirements to provide financial
14 reporting to the Commission and to have policies and
15 procedures to prevent the misuse of material non-public
16 information, to manage and address conflicts of interest.

17 This past January, the Commission had proposed
18 rules that were narrowly tailored to satisfy statutory
19 requirements. As Eric said, we received over 60 comments and
20 a significant number of these addressed acts and practices,
21 such as notching. The comment process was productive and I
22 believe the staff presented today the final rules that
23 sensibly respond to the concerns of commentors as well as
24 meeting the Congressional objectives.

25 Commentors were helpful in pointing out some

1 practical considerations such as the requirements that would
2 apply to all associated persons or affiliates. The staff
3 reconsidered its proposals in light of the statute and the
4 comments and where appropriate, narrowed the requirements to
5 persons within the credit rating agency or to affiliates
6 engaged in the rating system.

7 With regard to notching and other activities that
8 may be unfair, coercive or abusive, the Commission has
9 created specific recordkeeping requirements and will endeavor
10 to rigorously examine NRSRO practices with a view to taking
11 action against those who engage in anti-competitive
12 practices.

13 Congress has clearly armed the Commission with the
14 authority to prohibit anti-competitive activities and it will
15 be incumbent on us to more aggressively scrutinize practices
16 that may have an anti-competitive impact.

17 I am also pleased that both the legislation and the
18 proposed rulemaking are largely consistent, as Commissioner
19 Campos said, with international codes of conduct for credit
20 rating agencies. Indeed, the credit rating business crosses
21 national boundaries and consistency with international norms
22 minimizes the costs to regulated entities, which is certainly
23 something that we all favor to the fullest extent possible.

24 I just have one or two sort of thoughts and
25 questions. Again, I know we are all very concerned about the

1 notching. As I noted in my remarks, notching has a very big
2 impact. It seems to me that what we really need to make
3 clear is that these kinds of practices that have such a high
4 impact, we will give heightened scrutiny with respect to our
5 oversight of these practices.

6 We talked about recordkeeping. Is it clear that
7 even in the absence of a record, we can scrutinize these
8 practices and ask for data in order to determine whether
9 these practices are anti-competitive?

10 MR. SIRRI: Yes, it is. I think the mention of
11 recordkeeping was to ensure that the information would be
12 available. When we went to an NRSRO and said we want to
13 investigate whether there is an anti-competitive version of
14 notching going on here, that records would be kept that would
15 aid us in coming to a determination.

16 COMMISSIONER NAZARETH: Can we specifically ask
17 these NRSROs to provide us with data to justify why they are
18 engaging in these practices?

19 MR. SPRATT: The Commission has the same authority
20 under this rule as under broker-dealer to require reports and
21 to examine all the books and records. The Commission has the
22 right to examine all their records and to require reports.

23 COMMISSIONER NAZARETH: There may not be books and
24 records that have been created that justifies this practice.
25 It may be the economic data that would show in fact there is

1 not a justification for the level of notching, for instance,
2 that is occurring.

3 MR. SPRATT: The agency can say they can justify
4 their notching practice based on their prior history. We can
5 test whether or not they are notching. We know their
6 notching schedule is something they will have. We can then
7 compare that and see what their rationale is, to see whether
8 or not their notching is justifiable.

9 COMMISSIONER NAZARETH: I think a point that Eric
10 made earlier is very important. It has not sort of
11 traditionally been so clearly in our mandate as this
12 legislation is, for us to look at anti-competitive practices.
13 It is going to be incumbent on us to embrace that
14 responsibility and to develop whatever internal expertise is
15 necessary to do this appropriately. We are an agency that
16 has no shortage of securities lawyers, and the economists
17 will help us a bit.

18 MR. SPRATT: In that spirit, we tried to identify
19 the types of data that would be relevant to this sort of
20 analysis, and have requested that data be included in the
21 books and records requirement. I think that is why Eric
22 summarized it in the way that he did.

23 COMMISSIONER NAZARETH: Thank you.

24 I know there was a suggestion earlier and concerns
25 raised about the staff not doing a qualitative analysis with

1 respect to what comes in on these applications. I understand
2 the tension that we have between not having this process held
3 up inordinately.

4 Clearly, if we are going to keep to these time
5 frames and the staff sends these packages to the Commission,
6 somewhere along the line Congress intends for this process to
7 have integrity and they intended this legislation and the
8 rulemaking under it to further the goals of integrity.

9 I assume that when the staff sends these packages
10 to the Commission, they will make a recommendation. I, for
11 one, if I get a package that has all the requisite number of
12 pages and purports to satisfy the requirements of the rules
13 but does not, I will not vote in favor of it.

14 Rest assured, somewhere along the line, a decision
15 will be made based on the qualitative determinations of what
16 is in that package. I just wanted to make that point.

17 Thank you.

18 CHAIRMAN COX: Thank you. Commissioner Casey?

19 COMMISSIONER CASEY: I would like to start as well
20 by commending the staff for the work that they have done with
21 a fairly ambitious time table. I commend you on all that you
22 have put forward in the rules we see today.

23 As I stated when we voted to proposals that were in
24 final form before us, passage of the Credit Rating Agency
25 Reform Act of 2006, it sends a clear and unmistakable message

1 from Congress that it is dissatisfied with the status quo,
2 and expected the Commission to use its new authority under
3 the Act to promote accountability, transparency and
4 competition in the credit rating industry.

5 Keeping this message clearly in mind, it is
6 incumbent on the Commission to adopt rules for NRSROs that
7 mirror the intent of Congress as closely as possible.
8 Congress wished the registration process for NRSROs to become
9 more transparent, and I believe the process under the new
10 rules does more clearly identify the criteria to become an
11 NRSRO, and narrow the time frames for the processing of
12 applications.

13 I am pleased that the staff has eliminated or
14 reduced some of the information requests from Form NRSRO as
15 well as the ongoing books and records requirements.

16 There were commentor views in whether the rules
17 pertained to any vestitures and the anti-competitive effects
18 of the prior regulatory approach to NRSROs.

19 The statute's definition of "credit rating agency"
20 speaks in terms of agencies that make their credit ratings
21 accessible via the Internet or other readily accessible means
22 for free or for a reasonable fee. The adopting release does
23 not define the term "reasonable fee." Instead, citing the
24 need for additional experience to assess the bounds and what
25 is reasonable.

1 The Commission will require the disclosure of fees
2 by credit rating agencies that do not make their ratings
3 available for free.

4 While I support the proposals today, I do question
5 this approach. In addition to the obvious disadvantages of
6 having the Commission involved in deciding the appropriate
7 level of fees, the Commission scrutiny of fees -- agencies
8 that charge fees for ratings that are subsidized by the
9 issuers and make their ratings available for free will not be
10 caught up in the "reasonable fees" determination.

11 Credit rating agencies that operate on a
12 subscription basis, bundling their ratings and their
13 analysis, and charging one fee for both, will run into a real
14 problem.

15 I question a rule that treats business models
16 differently, whether that truly levels the playing field that
17 was anticipated under the law.

18 Going forward under our new process, I hope that
19 the Commission will interpret the statute's reasonable fee
20 language broadly. I am certain that Congress did not intend
21 that the reference to a reasonable fee would provide a basis
22 for making it more difficult for subscription model credit
23 rating agencies to gain NRSRO status.

24 If the consequences of our interpretation is to
25 support the goal of increasing competition, I question

1 whether we are achieving the spirit if not the letter of the
2 law.

3 I found the comments received very helpful in
4 providing an initial assessment of our success in achieving
5 the goals Congress set. The most common area was the
6 notching issue, as many of the Commissioners have noted.

7 Notching is a very difficult issue and there is no
8 easy answer. While we recognize the concerns expressed by
9 the various NRSROs of the effects of this practice, we do not
10 have sufficient capability or experience at this time to make
11 the findings of unfair, abusive and coercive practices
12 required by Congress.

13 Therefore, I believe the modified approach we have
14 taken is a sensible one. Additional recordkeeping by NRSROs
15 and scrutiny by Commission examiners will provide a basis for
16 further Commission actions if that is deemed necessary.

17 All and all, I believe that the rules that we adopt
18 today will go far towards improving our oversight of credit
19 rating agencies to the extent provided under the Act, credit
20 rating agencies play an important role in our securities
21 markets and Congress has placed on us the responsibility to
22 ensure that NRSROs meet certain minimum standards, disclosure
23 of their policies and procedures, including policies for
24 managing conflicts of interest and handling material
25 non-public information is accurate, and that certain unfair

1 and coercive practices are prohibited.

2 As we move forward, we must exercise our oversight
3 authority cautiously and judicially. Having said that, I
4 very much support the oversight system, and to better our
5 understanding of NRSROs practices including notching
6 practices, the more effective our oversight will be.

7 I have one question and one comment. I very much
8 appreciate the response to the questions put forward
9 regarding when an application is considered complete and
10 properly executed. I think there was a concern that the
11 application process takes an inordinate amount of time in
12 order to be considered complete and executed.

13 I appreciate the response in that regard.

14 I also have one question. In the proposing, again,
15 in the adopting releases, the information required on Form
16 NRSRO and the exhibits is necessary to assess the adequacy of
17 an applicant's financial or managerial resources, yet we do
18 not have an indication of what the standards for accepting
19 financial or managerial resources are.

20 What are our standards?

21 MR. SPRATT: The idea that they have the managerial
22 and financial resources to do the role which they are
23 actually doing, that is they have enough of that to do what
24 they are actually doing, and taking that into the foreseeable
25 future.

1 It is a facts and circumstances thing. In this
2 case, what are they doing with the money and the management
3 they have. I think we have to determine that after
4 examination and based on our experience with these folks.

5 I do not think that will be a difficult thing in
6 most cases.

7 COMMISSIONER CASEY: The only concern I have, as
8 we discussed, that other commentators have raised, whether or
9 not we would be trying to say you have to have a certain
10 amount of personnel.

11 MR. SIRRI: I think the standard here would
12 be -- we would expect there to be a number of models that
13 come to the floor. There might be a very labor intensive
14 model, where you meet with management and you have a lot of
15 analysts who crunch numbers. There could very well be other
16 models that we don't have at least very often today at the
17 NRSRO level that are purely analytical, number crunching on a
18 computer. There, your resources would be the number of
19 people you have, both managerial and financial would be a
20 fraction of that, which is required in the other.

21 I think what Mike was saying is it is a
22 portionality factor. You look at what their technology is,
23 do they have the resources, both financial and managerial,
24 and the other, which makes no sense, to require a lot of
25 financial and managerial resources with a small amount of

1 people and a small amount of technology.

2 COMMISSIONER CASEY: I appreciate that very much.
3 I have no further questions.

4 VOTE

5 CHAIRMAN COX: If there are no further questions,
6 the question now is on approving implementation of the
7 provisions of the Credit Rating Agency Reform Act of 2006.

8 Does the Commission vote to adopt rules to
9 implement provisions of the Credit Rating Agency Reform Act
10 of 2006, define the term "nationally recognized statistically
11 rating organization," provide authority for the Commission to
12 implement registration recordkeeping, financial reporting and
13 oversight rules with respect to registered credit rating
14 agencies, and direct the Commission to issue final
15 implementing rules?

16 COMMISSIONER ATKINS: Yes.

17 COMMISSIONER CAMPOS: Yes.

18 COMMISSIONER NAZARETH: Yes.

19 COMMISSIONER CASEY: Yes.

20 CHAIRMAN COX: Yes. The recommendation is
21 approved. Thank you very much for your presentations and
22 helping us with questions and answers.

23 There is no further business to come before the
24 meeting, so the meeting is adjourned.

25 I will just announce that our annual awards

1 ceremony will be starting in this room in a short while, and
2 then we have several special guests, including five former
3 Commissioners -- I should say five former Chairmen of the
4 Securities and Exchange Commission, so I look forward to
5 seeing you all there.

6 (Whereupon, at 1:40 p.m., the opening meeting was
7 adjourned.)

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