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SEC, NYSE, NASDAQ, PCAOB Update

2008 NATIONAL DIRECTORS INSTITUTE

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INTRODUCTION

Foley & Lardner LLP presented the "SEC, NYSE, NASDAQ, PCAOB Update" as part of our seventh annual National Directors Institute held March 6, 2008, in Chicago. The roundtable was moderated by Foley Partner Patrick Daugherty and featured Michael Emen, Senior Vice President of NASDAQ; James Duffy, Executive Vice President and General Counsel of NYSE Regulation Inc.; Jarett Decker, Deputy Director and Chief Trial Counsel for the Public Company Accounting Oversight Board (PCAOB); and Merri Jo Gillette, Director of the Chicago Regional Office of the U.S. Securities and Exchange Commission (SEC).

The roundtable addressed recent initiatives of the SEC, including the possibility of adopting International Financial Reporting Standards (IFRS) for both foreign and private issuers. Panelists discussed the globalization of the U.S. economy and the potential impact on the stock exchanges and auditing standards, including the consolidation of stock exchanges internationally and the possibility of the international centralization of accounting rule-making standards. The roundtable also highlighted recent efficiency initiatives at the SEC's Division of Enforcement, which include focusing on high-risk areas and centralizing the agency's internal databases used to track enforcement cases.

SEC AND COMMISSIONER KATHLEEN L. CASEY'S "THREE ELEPHANTS"

The panel began by discussing three of the SEC's most recent and most important initiatives: International Financial Reporting Standards (IFRS), eXtensible Business Reporting Language (XBRL), and the SEC's Advisory Committee on Improvements to Financial Reporting (CIFiR).

IFRS

In recent years, there has been a global movement toward the adoption of IFRS, and many commentators — including the SEC's chief accountant — feel it is inevitable that IFRS will soon replace U.S. Generally Accepted Accounting Principles (GAAP). This change will be one of the most significant events in U.S. accounting.

As more companies across the globe adopt IFRS, the number of companies using GAAP is becoming relatively smaller and smaller. For example, approximately 100 nations, including those in the European Union, already have adopted IFRS, and Canada and Mexico plan to adopt IFRS in the near future. Other reasons IFRS likely will replace GAAP include:

- Foreign companies doing business in the United States want to be able to use the same accounting standards they use in their home countries. Proposed

SEC rules will allow foreign registrants to use IFRS without reconciling with GAAP.

- Global companies based in the United States want to use IFRS so they can apply one set of accounting standards to all domestic and international operations.
- U.S. companies with global competitors want to use IFRS so their financial reports will be comparable to those of their competitors.
- IFRS mandates a principles-based system of accounting that is largely viewed as increasing comparability, reducing costs, and making for more efficient markets.

The switch to IFRS is occurring more quickly than anyone could have predicted. Facilitating the push toward IFRS is the current convergence project between the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), which represents an acknowledgement in the United States that the shift to IFRS is coming. The FASB — the U.S. regulator of GAAP — is attempting to have a hand in developing IFRS to ease adoption and transition. GAAP likely will remain for private companies. The NYSE has advocated the use of international accounting standards since the early 1990s. The NYSE believes that since companies are operating in increasingly global markets, it is increasingly the case that investors are analyzing companies that operate in various jurisdictions, and that one common set of accounting standards will make it easier for investors to compare and analyze these global companies. A question that remains is how auditing standards and standards setting will need to be changed to address the change to IFRS.

XBRL

XBRL is a standard data format for companies' financial information reported to the SEC. The SEC put this initiative out for comment, and companies with more than $2 trillion in market capitalization have voluntarily begun reporting using XBRL. XBRL allows users of financial information to run searches and compare specific financial information across companies.

Implementing XBRL will require that the SEC's EDGAR system be revised to accept the XBRL format. The SEC plans to roll out this process in stages, eventually requiring all companies to file in XBRL. This initiative, like the change to IFRS, also is viewed by the SEC as a tool to enhance the comparability of reporting companies' financial information.

CIFiR

This committee is headed by former SEC Chairman Arthur Levitt. The highlights of the committee's recommendations to date include:

- The committee recommended that more information be made available to investors via issuers' Web sites. Microsoft was cited as the "poster child" for good Web site disclosure. A corporate Web site release is expected later in 2008.

- The committee recommended that the number of restatements should be reduced and that restatements should only be required when there are material errors in an issuer's financial statements that are still being relied upon by investors. The committee felt that immaterial and "stale" errors should not require restatements.

- CIFiR also has suggested that the SEC and FASB clarify their roles and responsibilities in the financial reporting standard-setting and interpretative processes. The subcommittee felt that there are too many sources of GAAP and that FASB should reduce the number of types of authoritative guidance as well as clarify which guidance is authoritative and which is not.

SECURITIES MARKETS — NYSE AND NASDAQ

The NYSE is currently in the process of acquiring the American Stock Exchange (AMEX). After a string of acquisitions, including the merger with Euronext in April 2007 and the 2006 acquisition of Archipelago, the NYSE now operates six equity exchanges in five different countries, and six derivative exchanges in six different countries. The consolidation will not affect prices or services provided by the NYSE or otherwise materially change the operations, since the financial markets are so heavily regulated. In fact, the NYSE cannot make any operational changes, including rule or price changes, without approval from the SEC.

NASDAQ recently closed the acquisition of the OMX, a technology platform operated on a global basis. NASDAQ now has a presence in more than 50 countries and is competing directly with the NYSE. All of NASDAQ's markets are electronic.

SPACs

Special-purpose acquisition companies (SPACs) are "blank-check" companies that are formed with the intention of acquiring existing companies. SPACs accounted for nearly a quarter of all U.S. initial public offerings (IPOs) in 2007. During 2007, the AMEX listed 50 SPACs, capturing a majority of that market. The NYSE is currently in discussions with the SEC about a rule change that would allow it to list SPACs. Currently, NYSE listing requirements require a business history. During the course of the roundtable, Mr. Duffy announced that the SEC gave clearance for the rule change and the NYSE would be putting out a press release later in the day formally making the announcement. The NYSE will require that SPACs have a market capitalization of at least $250 million before they can be listed on the exchange.

NASDAQ also recently proposed a new rule that would allow it to enter the SPAC listing market. Although NASDAQ's current rules do not prohibit the listing of SPACs, NASDAQ's previous practice has been not to allow the listing of SPACs. The rule change was prompted by the facts that the firms listing SPACs are more reputable, such as large investment banks, and the number of listings has grown to account for 25 percent of all IPOs. Realizing the inherent risks in such companies, NASDAQ will put into place specific requirements relating to SPAC listing (rules that are not required by the AMEX), including:

- A requirement that the proceeds from the sale be escrowed until an acquisition is approved
- A large percentage of the proceeds must be devoted to an acquisition within a specified period of time (NASDAQ is currently proposing three years)
- A requirement that SPAC shareholders and independent directors approve acquisitions

PORTAL

Last year, more equity capital was raised on NASDAQ's PORTAL exchange than on NASDAQ, the NYSE, and the AMEX combined. Opened in 1990, PORTAL is an exchange for restricted securities. The exchange is restricted to qualified institutional buyers (QIBs) and is seen as a way for companies to raise money without incurring public company costs and exposure to class-action lawsuits.

SEC ENFORCEMENT DIVISION INITIATIVES

The SEC recognizes that globalization is occurring at a faster-than-predicted rate. As this occurs, the securities markets grow increasingly complex. As the complexity grows, the cost of regulation continues to rise. At the same time, the SEC's resources are shrinking, causing the SEC to focus on efficiency and leveraging its current human resources through the use of technological initiatives. Several of the SEC's largest current initiatives are listed below.

OFFICE OF RISK ASSESSMENT

Founded in 2004, this office is tasked with identifying market risks to determine where resources should be allocated. This office is headed by an economist and is intended to direct scarce enforcement resources to cases where the greatest impact will be made.

PHOENIX

The Government Accountability Office (GAO) cited the SEC for weaknesses in its financial systems. Phoenix is a new system developed by the SEC that allows and requires the SEC to electronically track certain information and be in a position to certify its financial statements.

HUB

HUB is a tracking system in which all open enforcement investigations are stored. The system is not fully implemented yet but eventually will allow policymakers such as congressmen to search open investigations and cases to see what areas are most in need of legislation and regulation.

WORKING GROUPS

The SEC has formed working groups to track specific issues nationwide. This is the SEC's version of having "specialists," even though all of the SEC's enforcement agents are technically generalists. One of the working groups is the subprime working group, which is investigating whether any fraud or breaches of fiduciary duties occurred with regard to the recent meltdown in the collateralized debt obligations (CDO) market.

> **SUBPRIME WORKING GROUP**
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> The subprime working group is currently pursuing enforcement in certain cases involving the subprime mortgage meltdown. The SEC utilizes prosecutorial discretion in deciding which cases to pursue and also is mindful that reactionary regulation is often overreaching (e.g., the Sarbanes-Oxley Act). The SEC intends to focus its enforcement on those cases where directors had actual knowledge of wrongdoing or ignored red flags that were so severe it appears that the board member(s) was/were reckless in allowing certain subprime transactions to occur.

MONITORING INSIDER TRADING

The SEC has seen a resurgence of insider trading cases recently. This is common in "down markets," and many of the insider trading cases are against people who "should have known better," including lawyers, accountants, and other advisers. The SEC realizes that when the economy is tighter, people take greater risks with respect to violating the insider trading laws.

FOR MORE INFORMATION

For more information on this session or the seventh annual National Directors Institute, visit Foley.com/ndi or contact the moderators and panelists directly.

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