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**"Strengthening the Gatekeepers: The importance of independence and
accountability to the capital markets"**

Thank you, David, for that kind introduction. And thank you all for welcoming me to Toronto.

It is a pleasure to be back here in Canada. As many of you may know, a few years ago, I was asked to conduct an audit of the NHL's books and operations.

Now, I didn't know a lot about hockey before I started. But after that investigation and report, I came to understand why players now wear helmets on the ice – and why some of the executives may want to wear them to work as well.

Today, I am not here to talk about hockey, but about something I find to be equally exciting and fast-paced: the capital markets.

The advent of global capital markets is one of the greatest advances of the past two decades. Now, companies in Toronto can easily attract investment capital from Thailand...and companies in Bangkok are open to the small investor in Boston.

It's an amazing development – one that technology has made possible.

But no matter how fast capital can move from one nation to the next, at bottom, markets are made up of people – millions of people making millions of individual decisions. And what makes markets work is trust – every market actor having faith that they are being treated fairly...that they will be dealt with honestly...and that they can rely on an objective regulator to enforce the rules of the road.

When this independence and accountability are absent, markets cease to work properly...capital is allocated poorly...and, eventually, someone pays the price.

We saw this during the scandals at the beginning of this decade at Enron, WorldCom, and several other now infamous companies.

Then, auditors – worried about their lucrative consulting contracts -- looked the other way when the numbers didn't add up.

Analysts hyped these companies' stocks on cable TV in order not to lose their lucrative investment banking contracts.

Corporate board members stayed silent in exchange for big paydays or not to offend their friend in the CEO suite.

And the lawyers, the media, elected officials, and individual investors went along for the ride. Everyone was making too much money to let ethics, good governance, and honest accounting get in the way.

You know, I read that in ancient Egypt, where some of the earliest accounting ever occurred, they dealt with inaccurate accounts of what was in their storehouses in a very direct way: through fines, mutilation, or death.

Evidently, there was a lot of auditor rotation...

In the United States, we chose a different response. Listing standards were tightened. Lawsuits were filed. Many of the brightest stars from this period are in jail. And the Congress passed the most far-reaching reform of the markets in the past 60 years: the Sarbanes-Oxley Act.

Unfortunately, too many in the market have a short memory.

In terms of market meltdowns and the degree of pain inflicted on the financial system, the subprime mortgage crisis has the potential to rival just about anything in recent financial history including the post-Enron turndown of a few years ago.

The scope of this crisis is not the only similarity to the Enron-era scandals. They also share root causes that include conflicts of interest, a lack of accountability, and limited transparency leavened with a healthy dose of naive greed.

Indeed, the subprime meltdown -- which is still roiling the markets and the economic health of the world -- is yet another example of what happens when independence and accountability is compromised among key market actors...of what happens when trust breaks down.

Just like we did in the months after the implosion of Enron and Worldcom, we are now learning that a number of critical gatekeepers and market actors did not perform as we had hoped.

First, consider the credit rating agencies.

Until the 1970s, the business model of credit rating agencies was fairly straightforward: Investors bought a subscription to receive ratings which were then used to make investment decisions.

But then the business model changed, and the issuers of securities themselves became the ones who paid to be rated...and as structured finance increased in popularity, it deepened this relationship between issuer and rater.

Now, investors are relying on credit ratings to make informed investment decisions, but the credit rating firms are paid not by investors but by the companies they rate. And as complex, structured debt products have increased in popularity, the relationship between rater and issue became even closer -- and the line between independent rater and paid advisor became blurred.

This very circumstance suggests that a potential conflict of interest – between providing objective ratings and satisfying their corporate clients may be distorting the rating agencies' judgment. That they are both coach and referee.

Of course, the role of credit ratings agencies has been a concern of regulators and market-watchers for some time now. In response, Congress passed legislation last year to bring more competition and accountability to the ratings industry.

Yet the severity of today's credit market meltdown is spurring lawmakers and regulators in the US and Europe to actively examine the credit ratings agencies and how they might be reformed.

While an outright ban on ancillary or consulting services may be the easiest way to eliminate the conflict of interest plaguing this gatekeeper, it is not the most feasible course of action. The rules passed earlier this year by the SEC to implement the Credit Rating Reform Act of 2006 recognize that, and require credit ratings agencies to have policies and procedures in place to manage these conflicts.

To be sure, there are also other smaller measures that can be taken to bring more independence, transparency, and accountability to credit rating agencies.

These include allocating more resources to the SEC so that they can more ably oversee these agencies...giving audit committees the direct responsibility for the selection, monitoring and compensation of credit ratings agencies...and improving the disclosure of ratings triggers and of services that a ratings agency may provide a debt issuer beyond the actual rating.

But before regulatory action is taken, let's recognize a central fact about the rating agency industry: it is essentially an oligopoly with just three main ratings agencies dominating the business. Thus, there are also several, meaningful steps that they can take – on their own – to boost transparency, independence, and accountability.

And I hope they're given the chance to do so.

At the same time, I hope the subprime meltdown serves as a reminder to investors that they need to take more responsibility for evaluating the products they invest in. And this is especially true for complex structured financial instruments.

Investors who are allocating resources into sophisticated credit products need to fully understand the inherent risks they are undertaking – and be critical of anyone who says that the risks are minimal.

None of this takes place in a vacuum. A prospering society gave way to gluttony of debt. New businesses developed, pandering to unsophisticated appetites for the good life. A “starter” home became a “mansion”; a 60% mortgage became a “no money down” borrowing. Incentives created by banks and intermediaries were as obscene and addictive while radio, TV, and newspapers lured by this new source of ad revenues flooded the community with “pie in the sky” inducements to borrow.

Another area that proved weak in the wake of the current crisis concerns the accounting used by the large financial institutions that had significant exposure to sub prime mortgage-backed financial instruments.

For the past two weeks, we have seen bank after bank announce multi-billion dollar write-downs. In some cases, these have cost the CEO's their job. And in every instance, as this information comes to light, millions of investors – of all sizes -- are the ones that have been hurt.

In examining what happened, one has to ask: why didn't investors see what was happening?

The answer is that these risky mortgage-backed products were held in Structured Investment Vehicles that were not reported on the companies' balance sheet. If it sounds familiar, it should because these SIV's are just like the infamous Special Purpose Entities of Enron that also hid the real financial health of that company.

The Financial Accounting Standards Board or FASB, at the time of Enron's implosion, said that they were closing this accounting loophole. But they did not close it all the way, and we are now seeing the effects of that decision.

Of course, these banks claimed that these entities were separate from the bank. If so, then why are billions of dollars being spent bailing out these companies? Evidently, they were not as separate as was claimed in their accounting.

In the months after the passage of Sarbanes-Oxley, the SEC – acting on the explicit wishes of Congress -- conducted a study on the issue of off-balance sheet transactions.

So, the examination of the problem and consideration of how to close the loophole have been done.

Now, it's time for the FASB to act on this issue and write clear, enforceable rules that put these investment vehicles onto the balance sheet so that investors can accurately judge the risks they are taking with their capital.

Unlike Enron, the problem here is not unethical or compromised auditors; it's accounting rules and rule makers that have not kept pace with the sophistication of the markets.

And this should weigh on our minds as we consider the rush to move to International Financial Reporting Standards.

As you know, the SEC is considering a proposal to allow American companies to use International Financial Reporting Standards instead of Generally Accepted Accounting Principles in their financial reports.

In theory, convergence of accounting principles is a goal that all of us in the markets should aspire to; if done right, it can bring efficiencies to the increasing number of multinational companies; and help investors easily compare companies' performance and prospects across the world. For Americans, this, in turn, will probably lead to a host of new investment options as new companies come to list on American exchanges.

It's why I supported a process of reconciliation of standards and a movement toward convergence for many years, including during my time at the SEC.

Yet, now is not the time to stop the process of reconciliation between GAAP and IFRS, accept IFRS, and effectively move to immediate convergence.

In fact, if the United States does take this step, I am afraid that it could bring significant risks for investors and capital market participants; increase the likelihood of future scandals such as what we are experiencing now in the subprime market; and increase the price of and decrease the availability of capital.

Let me explain why.

First, for convergence to work, we need a single set of high quality, financial reporting and disclosure standards that: reflect the true economics of the transactions, provide consistent and comparable reporting, and are comprehensive in their scope – covering all significant industries from mining and oil and gas to financial services and insurance.

Right now, we do not have these conditions.

There still exist significant differences between financial reporting done under GAAP and IFRS.

In fact, a study of 130 reconciliations from foreign filers in the United States using IFRS found a median difference in earnings of 12.9 percent; only two firms showed the same earnings.

There also are divergences in standards between the two systems when it comes to accounting for property, plant and equipment, and intangible assets.

IFRS has not yet established accounting policies for insurance contracts with which companies must comply.

And it has not yet developed requirements for companies in extractive industries.

In addition, because of the International Accounting Standards Board's three-year moratorium on new standards, many new converged standards have yet to be applied. That is to say that IFRS accounting varies across different countries; there is not even one IFRS set of standards.

This is why the process of convergence is almost as important as the goal of convergence itself. It enables standard-setters to continue to work together to identify discrepancies and eliminate them.

Along the way, important information is also made available to investors during reconciliation – such as where “big baths” are possibly being taken and “cookie jars” are being filled.

And over time, deficiencies in both systems of accounting are also identified – such as the accounting for off-balance sheet transactions.

Ultimately, reconciliation will lead to more convergence and a converged set of standards will lead to less -- and eventually no -- need for reconciliation.

Also consider how the process of convergence helps the accounting profession to adapt to a whole new set of standards.

I know of few companies that have sufficient resources to comply with IFRS. And this should come as no surprise. American universities, by and large, are not teaching IFRS in their accounting programs. They lack the personnel and even the texts to teach the topic. With such a thin knowledge base about IFRS in the accounting profession, who will conduct these audits? Who will prepare companies' reports?

We need a convergence process – rather than a convergence declaration – to allow the accounting industry to retool itself and to allow companies, especially small and medium-sized companies, to make the transition to this new standard.

The second reason why I oppose an immediate move toward the acceptance of IFRS concerns who is setting and enforcing these standards. After all, rules are only as good as those writing them and enforcing them.

The independence of the FASB in the United States has contributed directly to the quality of our standards and the strength of our capital markets.

Now with its own funding source independent of any stakeholders, the effectiveness of FASB has been enhanced significantly.

Of course, FASB is far from perfect. But to see what happens when members of a standard-setter are not independent of those they are auditing, one only has to look at the Governmental Accounting Standards Board – the GASB – which still relies on donations from constituent groups in order to operate. I have no doubt that the poor state of public accounting in the United States is directly related to the compromised structure of the GASB.

That is what concerns me with the IASB.

When this body was established in the 1990's, I insisted that it be independent from politicians.

Now, however, there is a proposal to establish a new monitoring body appointed by member governments to review the selection of IASB members and the decisions they make.

I am afraid that such a body would inject politics and lobbying into the standard-setting process – and would further decrease the independence of the IASB.

Already, the IASB has to rely on companies affected by their standards and auditors for between 60 and 70 percent of its funding. This may explain why the IASB's budget and staff is so small. According to one estimate, its manpower is less than half the staffing of the American national office of just one of the Big 4 firms. I don't see how an entity like this could effectively keep up with the financial reporting needs of the capital markets.

Furthermore, the IASB does not have full authority to write and implement standards in Europe until the EU Parliament approves them. During this process, special interest lobbying can affect the shape of standards – and approval for jurisdictional differences can be sought. That is, countries can opt out of the standards that are set.

Without an effective, well-funded, and independent accounting standard-setter empowered and enabled to provide active regulatory oversight, IFRS standards will be sub-standard and convergence impossible.

Indeed, working out differences in enforcement actions is critical to making convergence work. Before the United States ends reconciliation requirements and allows IFRS reporting, we need to ensure that effective auditing and regulatory schemes are in operation.

From the current subprime mess to the move toward international accounting standards, what is clear is that independent, effective gatekeepers are critical -- not just by laying down and enforcing the rules of the road, but by creating the conditions for trust to develop.

To be sure, rulemakers and standard-setters do not create trust itself. They can not mandate ethical behavior – nor can they prevent scandals.

But they can create markets in which all those involved understand that the playing field is level...that no one is able to game the system for his or her private benefit...and that all the information that an investors would need is readily available and usable.

When markets are constructed in such a way, capital is allocated efficiently...economies will grow...and nations will prosper.

And as we continue to reform and improve regulation in our respective countries...and work together to integrate and improve the dynamic global economy...we should never forget that this is why we are undertaking this work.

Thank you.