

An accelerated pace of change: what to expect from the presidential candidates

Introduction

The role of corporate board directors, and in particular audit committee chairs, has changed dramatically since the passing of the Sarbanes-Oxley Act of 2002 (SOX). At the time, President Bush hailed SOX as the most significant securities law reform since the establishment of federal securities law in the 1930s.

Beyond the changes required to conform to SOX, directors have experienced a wave of other changes, many of which have come from the private sector, with companies being more proactive or changing in light of investor demands. Examples include the fast pace at which companies adopted majority voting for the election of directors and changes that have been made to the executive compensation structures.

Directors might have expected the pace of change to decline, particularly in light of a loosening of SOX's Section 404 requirements relating to internal controls. However, the credit crisis and subsequent federal market rescue plan¹ have tipped the scale in the other direction; it now seems likely the pace of change will increase as new legislation is enacted and the private sector continues to adopt new practices. The two presidential candidates, Republican Senator John McCain (R-AZ) and Democratic Senator Barack Obama (D-IL), support a range of reforms of importance to audit committees, notably relating to capital markets regulation, shareholder rights, and climate change legislation and disclosure. The next president will also be in office as significant decisions are taken on the future of financial accounting standards in the United States.

In this issue of *InSights*, a range of experts across the political spectrum offer their views on what legislation audit chairs may expect to see. For a complete list of participants, please see the appendix, on page 13.²

Executive summary

Participants in our research believe directors will see the pace of change accelerate in several key areas:

- **Capital markets regulatory reform is likely to top the political agenda as the credit crisis continues** (page 2)

Participants unanimously expect capital markets reform to top the political agenda in 2009. They all support an overhaul of the regulatory structure, as do the presidential candidates. However, participants highlight significant obstacles to reform, notably an unwillingness of political powerbrokers and regulators to relinquish power. Short-term reforms could include regulatory oversight of hedge funds. At a minimum, audit committees – particularly those in financial services – may have to oversee changes to risk management practices, such as more detailed oversight of liquidity and counterparty risk.

¹ Emergency Economic Stabilization Act of 2008. Available at <http://financialservices.house.gov/essa/essabill.pdf>.

² For more information about *InSights*, see “About this document” on page 12. Generally, this document uses a modified version of the Chatham House Rule whereby names of contributors to the research and their companies or organization affiliations are a matter of public record, but the comments made in the conduct of the research are not attributed to individuals.

- **Shareholder rights may improve, to a degree** (*page 5*)

Participants expect changes to shareholders rights over executive compensation and director elections. On compensation, most expect the so-called “say on pay” to become a reality. Some predict other types of political intervention on pay-setting practices, such as tax changes to promote long-term pay structures. On director elections, most participants believe the debate over proxy access will remain deadlocked at the SEC, but several expect changes to shareholder voting processes.

- **Climate change legislation and enhanced disclosures are on their way** (*page 8*)

The credit crisis and high energy prices have taken some of the momentum out of the push for climate change legislation. In the first half of 2008, a comprehensive program of legislation seemed probable. While research participants believe such a program is still “*inevitable*,” they feel it may come in two waves, the first focused on tax incentives and more robust disclosure requirements, and the second on cap-and-trade legislation. Audit committees could face significant changes to their workload as a result.

- **The road to adopting IFRS may be bumpy** (*page 11*)

The August announcement by the Securities and Exchange Commission (SEC) of a Roadmap toward the adoption of International Accounting Standards (IFRS) for all U.S. companies proposed major change ahead. Research participants generally expect, and endorse, a move to one global reporting standard, and they believe companies and audit committees should start to prepare for that change. However, they emphasize that the move to IFRS is “*highly political*” and will not be without bumps along the way, or even potential delays.

Capital markets regulatory reform is likely to top the political agenda as the credit crisis continues

As the financial crisis in the U.S. deepens, the necessity for regulatory reform of capital markets – an issue not typically discussed in presidential campaigns – has been propelled to the forefront of political debate. Senator McCain stated, “We are not going to waste a moment in changing the way Washington does business. And we’re going to start where the need for reform is greatest.”³ Similarly, Senator Obama stated, “For years, I have consistently called for modernizing the rules of the road to suit a 21st century market.”⁴

Growing support for reform, with some common themes

Calls for capital markets regulatory reform are not new. Some 18 months ago, New York City’s Mayor Michael Bloomberg and Senator Charles Schumer published their report *Sustaining New York’s and the US’ Global Financial Service Leadership*, which called for a regulatory system based on a streamlined set of commonly understood regulatory principles, rather than the “*thicket of complicated rules*” currently in

³ John McCain, “Remarks by John McCain on Reforming Our Financial Markets,” press release, September 16, 2008. Available at <http://www.johnmccain.com/Informing/News/PressReleases/7b8e0118-8212-4ab7-bec6-e5677ff31faf.htm>.

⁴ Barack Obama, “Statement from Senator Barack Obama on the Situation in Financial Markets,” press release, September 15, 2008. Available at http://www.barackobama.com/2008/09/15/statement_from_senator_barack_6.php.

place.⁵ More recently, in March 2008, at the request of Treasury Secretary Henry Paulson, the Treasury issued its *Blueprint for a Modernized Financial Regulatory Structure*, which laid out a broad plan to overhaul the regulatory structure.⁶ Now the discussion of wholesale regulatory reform is at the center of political debate.

The presidential candidates have avoided discussion of detailed policy solutions, at least in recent weeks. However, some insight into their viewpoints can be gleaned by looking at their comments following the March bailout of Bear Stearns, the recent failure at Lehman Brothers and the rescue of American International Group (AIG). Both candidates proposed reforms that share some common themes:

- **Streamline regulatory agencies.** Senator McCain stated, “The McCain-Palin Administration will replace the outdated and ineffective patchwork quilt of regulatory oversight in Washington and bring transparency and accountability to Wall Street.”⁷ Senator Obama stated, “We need to streamline a framework of overlapping and competing regulatory agencies.”⁸
- **Regulate institutions based on function.** “We need to enhance regulatory clarity by holding the same financial activity to one regulatory standard,” stated Senator McCain.⁹ Senator Obama stated, “We need to regulate institutions for what they do, not what they are.”¹⁰ While there are some substantive differences, at a broad level, the candidates’ approaches are in line with the Treasury’s *Blueprint*, which recommended “An objectives-based regulatory approach best represents the optimal regulatory structure for the future.”¹¹ With a growing consensus between the candidates and regulators, one research participant foresees that there will be “*a move towards regulation by function rather than by legal entity.*”
- **Increase capital requirements.** Senator Obama stated, “We must reform requirements on all regulated financial institutions. We must strengthen capital requirements, particularly for complex financial instruments like some of the mortgage securities and other derivatives at the center of our current crisis.”¹² Senator McCain declared, “In financial institutions, there is no substitute for adequate capital to serve as a buffer against losses.”¹³

⁵ Michael Bloomberg and Charles Schumer, *Sustaining New York’s and the US’ Global Financial Services Leadership* (New York and Washington, DC: Office of the Mayor of the City of New York and the U.S. Senate, 2007), ii. Available at http://schumer.senate.gov/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf.

⁶ U.S. Department of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure* (Washington, DC: Department of the Treasury, 2008). Available at <http://www.treasury.gov/press/releases/reports/Blueprint.pdf>.

⁷ John McCain, “Statement on the Financial Markets,” press release, September 15, 2008. Available at <http://www.johnmccain.com/Informing/News/PressReleases/1fbfc057-03af-415d-8bea-1a3b355b72b6.htm>.

⁸ Barack Obama, “Renewing the American Economy.” Speech at New York City’s Cooper Union, March 27, 2008. Available at http://www.barackobama.com/2008/03/27/remarks_of_senator_barack_obam_54.php.

⁹ John McCain, “Remarks by John McCain on Our Financial Markets.” Speech in Green Bay, WI, September 19, 2008. Available at <http://monkeycrash.com/2008/09/21/transcript-from-green-bay-john-mccain-on-our-financial-markets/>.

¹⁰ Barack Obama, “Confronting an Economic Crisis.” Speech in Golden, CO, September 16, 2008. Available at <http://my.barackobama.com/page/community/post/amandascott/gG5XWF>.

¹¹ U.S. Department of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure*, 13.

¹² Barack Obama, “Confronting an Economic Crisis.”

¹³ John McCain, quoted in Ben Smith and Avi Zenilman, “Obama, McCain diverge on Wall Street cures,” *Politico*, September 16, 2008. Available at <http://dyn.politico.com/printstory.cfm?uuid=67EC64F1-18FE-70B2-A8884C7B13B5AFDF>.

- **Enhance disclosure.** Senator McCain stated, “Capital markets work best when there is both accountability and transparency.”¹⁴ On a separate occasion, he stated, “I will propose and sign into law reforms to prevent financial firms from concealing their bad practices.”¹⁵ Senator Obama stated, “Transparency requirements must demand full disclosure by financial institutions to shareholders and counterparties.”¹⁶ Several participants believe that the first area of enhanced transparency will be in the structured finance markets. Another felt that enhanced disclosure requirements on credit rating agencies’ methodologies and key assumptions will be forthcoming.
- **Identify risks prior to a crisis.** Senator Obama proposed establishing “a process that identifies systemic risks to the financial system.”¹⁷ He emphasized the need to have “a standing financial market advisory group to meet regularly” and stated, “It’s time to anticipate risks before they erupt into a full-blown crisis.”¹⁸ With systemic risk in mind, Senator McCain proposed creating a mortgage and financial institutions (MFI) trust, an early-intervention program that will help financial institutions avoid bankruptcy and expensive bailouts and put “the Treasury and other financial regulatory authorities in a proactive position instead of reacting in a crisis mode to one situation after another.”¹⁹

While differences in policy exist, both candidates have been forceful in calling for reform, in recent weeks. Many participants believe the pressure to act will continue to build and that 2009 will be dominated by calls for regulatory reform. As one participant put it, the candidates will have to act, even if only because “*that’s what [people] do so [they] can say they have done something.*” Another agreed, noting that although it may be best to wait until after the crisis to write and implement reform, “*the only way the U.S. acts is when there is a crisis.*”

Senator McCain has called for a “9/11 commission to find out what went wrong and to fix what’s going to happen in the future so this never ever happens again.”²⁰ Several participants expect such a commission to be established early in the new president’s term, regardless of who wins the presidency. Participants expect a wave of activity in relevant Senate and House committees.

Reform will prove very difficult to execute

However, the scale of the task may prove its undoing. The U.S. capital markets regulatory landscape is highly complex. There are five regulators of federal depository institutions and additional state-based supervision, one federal securities regulator, one federal futures regulator and additional state-based regulation and self-regulatory organizations with broad regulatory powers, and 50 state insurance regulators.²¹

¹⁴ Ibid.

¹⁵ John McCain, “Remarks by John McCain on Our Financial Markets.”

¹⁶ Barack Obama, “Renewing the American Economy.”

¹⁷ Barack Obama, “Confronting an Economic Crisis.”

¹⁸ Ibid.

¹⁹ John McCain, “Remarks by John McCain on Our Financial Markets.”

²⁰ John McCain, “ICYMI: John McCain on the Financial Markets,” press release, September 16, 2008. Available at <http://www.johnmccain.com/Informing/News/PressReleases/73c9d46e-6674-4d33-a88b-56cf87e0a6ee.htm>.

²¹ U.S. Department of the Treasury, “Treasury Releases Blueprint for a Stronger Regulatory Structure,” press release, March 31, 2008. Available at <http://www.ustreas.gov/press/releases/hp896.htm>.



In addition, state attorneys general have shown that they can play a major role in regulatory reform and consumer protection.

Participants generally agree that this complexity presents a major obstacle to reform, with most acknowledging that, political will notwithstanding, comprehensive reform will prove very difficult. As one participant pointed out, *“In Washington, agencies never disappear.”* Another said, *“The reality is [that] streamlining is much less likely to happen because each institution has its own constituents, in [the House] and the Senate, and would fight against change.”* Another participant commented that politicians are *“always unwilling to give up power over agencies to other committees.”*

Despite these obstacles, a small minority of participants believe that comprehensive reform is possible, as a result of the depth of the financial crisis. One participant predicted, *“[There will be a] move to a more unified regulatory structure.”* Another suggested that *“change may come in two parts. We might have small steps that get done first and then a second, more comprehensive effort [later]. The major difference now is the starting place will be comprehensive, instead of piecemeal, reform.”*

Participants speculated on a couple of potential short-term regulatory reforms:

- **Hedge fund regulation.** Several participants commented that there is an undercurrent of anger focused on what one described as the *“shadow side of banking.”* Until now, hedge funds have avoided detailed regulation. One participant believes that federal regulation may be forthcoming, while another speculated that hedge funds will face, at a minimum, much tougher disclosure requirements. But, another participant believes the industry, which has for the most part performed relatively well throughout the credit crisis, will fight successfully against reform.
- **Federally chartered insurance companies.** Several participants believe concerns relating to regulatory oversight of insurance companies and financial guarantors will spur the establishment of an optional federal charter for insurers and a new federal oversight body. One participant noted, however, that state regulators and small insurers will fight against such a proposal.

Audit committee chairs have often commented that whenever something new is added to the board agenda, it often trickles down to the audit committee. No matter what shape the current reform takes, audit committees will be looking at additional work overseeing changes to risk management, particularly in financial institutions. Recognizing this pattern, one participant expressed concern about overloading the audit committee and suggested that *“[it] may make sense to carve out some work from the audit committee and establish a public policy or regulatory committee.”* Certainly as the reforms come to fruition, the audit committee may serve as a catalyst for discussion at the full board level about who should oversee the company’s response.

Shareholder rights may improve, to a degree

The fallout from the credit crisis and the federal market rescue plan has driven executive compensation and director election matters up the political agenda. This is evident in the fact that that federal market rescue plan includes provisions related to executive compensation for those companies selling assets to the

government, e.g., limits on severance payouts and tax deductions.²² Although executive compensation is mainly a compensation committee or full board issue, audit committees may be pulled into reviewing compensation as investor and regulator pressure continues to grow. In addition, changes in how director elections are carried out may affect audit committees directly: as seen in the credit crisis, when investors target directors after corporate failures, they begin by focusing on audit committee members.

Expect checks on executive compensation

Participants unanimously agreed that executive compensation will accelerate up the political agenda in 2009. The inclusion of executive compensation limits in the federal market rescue plan indicates a heightened appetite for political intervention. Most participants view the passing of legislation mandating an annual advisory vote on executive compensation – say on pay – as highly likely. A small minority of participants believe say on pay “*is not a done deal*,” citing the arguments of critics of these votes. These critics argue that the 2008 proxy season showed that say on pay does not have broad shareholder support: proposals calling for such a vote fell somewhat flat, at least in comparison to the strong support for them in 2007, which was effectively the first year they were submitted to a vote.

Regardless of this argument, most participants believe the political momentum has increased significantly in light of the prolonged credit crisis. “[*Many people are worried about*] the perverse incentives in executive compensation,” stated one participant. Another commented that, it will be difficult to argue against say on pay in the current political environment: “*No one wants to be on the wrong side of this vote.*”

The presidential candidates look set to support such a proposal. Senator Obama sponsored the Shareholder Vote on Executive Compensation Act (1181), which, although it did not move beyond committee, called for say on pay. While Senator McCain did not commit to that bill, he has said publicly that he agrees with the idea, and has even gone as far as to suggest shareholders should have more say over severance packages.²³

In fact, several participants expect that Congress may get involved in executive pay beyond passing say on pay. Several participants pointed to the Corporate Executive Compensation Accountability and Transparency Act (S.2866), which was introduced by Senator Hillary Clinton earlier this year. The bill, which stalled in the Senate, included a range of proposals, such as changes to taxes on executive pay and so-called “clawback provisions,” which would make it possible for companies to take back past payouts to executives if accounting irregularities or fraud are subsequently unearthed.

There was no consensus among participants about the likelihood or desirability of having Congress more involved in executive pay. One participant described the options available to policymakers as follows: “*Congress could get involved in the governance of pay ... how it’s set, how much is long-term versus short-term, and so on ... but I see little real appetite for getting mired in that sort of debate. A more politically honest approach would be to tax executives more, because [politicians] need revenues to achieve other objectives. That I could see happening.*”

²² Emergency Economic Stabilization Act of 2008, sections 111 and 302.

²³ John McCain, “Remarks at NFIB and eBay 2008 National Small Business Summit.” Speech in Washington, DC, June 10, 2008. Available at <http://www.johnmccain.com/Informing/News/Speeches/641cbd73-6945-4103-ad70-306862fdecf3.htm>.



On the tax side, several participants speculated that there may be moves to change the taxes on deferred pay or to promote long-term pay components, the rationale being that such moves encourage long-term decision making. One went as far as to suggest that such an approach might be wrapped into a broader political theme of *“revitalizing the economy.”* Several participants, who ranged across the political spectrum, felt such an approach would be *“disastrous;”* one pointed to the negative unintended consequences that followed Congress’ intervention in executive compensation in the early 1990s as evidence, when tax laws that were implemented to put downward pressure on compensation led to it ratcheting upwards.

Directors elections could open up

Activist shareholders will likely use congressional outrage over the failures in the financial sector to press for more power over director elections. Top of their wish list will be the most politically charged issue of proxy access, which would provide shareholders with more power to nominate their own candidates to the board. Activist shareholders have been pushing for more access to the proxy through the courts and with the SEC. So far, the SEC has been deadlocked. The fact that proxy access was discussed (though not included) in the context of the federal market rescue plan suggests pressure could increase on the SEC to resolve this issue.

Participants remained skeptical that a compromise can be found that is acceptable to all major constituents. One participant pointed out, *“This has been an issue for decades. Yet no one, not even the biggest advocates, can find a mechanism that does not favor one set of shareholders over another.”* The most cited mechanism, similar to the one discussed in the early market rescue plan discussions, would provide holders of shares above a certain threshold – say, 1–3% – who have held the shares for more than a minimum period – say, one or two years – with greater access to the proxy. Advocates of such a mechanism argue this provides only long-term, relatively significant, minority shareholders with the enhanced access. One participant believed such a compromise could be palatable to union activist funds and companies. Whether proxy access is resolved or not, as one participant noted, *“To date, this issue has been on a dual track: in the courts and at the SEC. While I don’t think it will be resolved, we can expect a third track as of next year – in Congress.”*

In discussing proxy access, several participants suggested that the mechanics of voting should, and in their view likely would, be changed. *“The mechanisms for voting are archaic,”* said one participant, *“and in need of reform.”* Chief among the reforms that some participants believe will be adopted is the removal of broker votes (sometimes called broker non-votes) for director elections. At present, brokers can vote on behalf of their clients on routine matters, including director elections, when their clients do not return their proxies. Typically, brokers vote with management, which, critics argue, unfairly favors management to the detriment of the shareholders who do vote. The New York Stock Exchange proposed in 2006 changing its Rule 452, which controls such votes, so that director elections would be considered non-routine matters, which would mean that brokers could not vote in them on their client’s behalf without specific instruction to do so.²⁴ As yet, the SEC has not approved the proposed rule change. Several participants said that the removal of broker votes could provide a significant boost to investors’ efforts to unseat directors, particularly at companies that have adopted a version of majority voting (whereby a director not receiving a majority of votes would, at a minimum, have to tender their resignation to the board).

²⁴ Proxy Working Group, *Report and Recommendations of the Proxy Working Group to the New York Stock Exchange* (New York: New York Stock Exchange, 2006), 6. Available at http://www.nyse.com/pdfs/PWG_REPORT.pdf.

Climate change legislation and enhanced disclosures are on their way

Both presidential candidates have stated their intention to make energy policy one of their top priorities. When voters asked Senator Obama what his highest priorities would be in his first 1,000 days in office, energy reform topped his list.²⁵ Senator McCain has criticized the current administration and reinforced his commitment to energy reform, stating, “I will not permit eight long years to pass without serious action on serious challenges.”²⁶

Participants agree, therefore, across the political spectrum, that companies should expect climate change legislation. The fact that renewable energy tax breaks and deductions for the purchase of solar panels were included in the federal market rescue plan indicates that climate change is top of mind. Participants agree with one participant’s prediction that, “*We will see more legislative and regulatory initiatives on [environment-related] disclosures.*” As reported in the August 2008 issue of *InSights*, these anticipated developments may draw in the audit committee to review the company’s climate change strategy from a risk management perspective and to oversee related disclosures on greenhouse gas (GHG) emissions.²⁷

Several participants expect to see a staggered approach to climate change legislation, despite the strong momentum for such legislation during the first half of 2008 (when, for the first time, GHG cap-and-trade legislation came to a vote on the Senate floor). In their view, the pace of change in the capital markets and concerns about high energy costs has affected the likely timing of climate change legislation. One participant stated, “*I think it is inevitable, but it is a matter of timing. Events that I can’t predict will affect the timing to a large extent: the weather, academic reports, and the campaigns.*” Several participants expect legislation to come in two waves: a first wave to lay the groundwork with incentives and disclosure requirements, and a second wave to include comprehensive cap-and-trade legislation.

Wave one: the groundwork for a comprehensive approach

There may be a number of legislative initiatives in the first wave. First, there may be more legislating of incentives for the use and production of renewable energy. Recent examples include the measures in the market rescue plan and the House’s passage of \$17.6 billion of renewable energy tax breaks.²⁸ Renewable portfolio standards (RPSs) are another example. Currently, 27 states have RPS policies in place. The standard recently passed by the state of Michigan, for example, mandates that 10% of the electricity provided to consumers be generated from renewable or advanced cleaner-energy sources by the end of 2015.²⁹

²⁵ Edward Luce, “US candidates resist diluting climate plans,” *Financial Times*, August 14, 2008. Available at <http://www.ft.com/cms/s/0/c1ddea7a-69a3-11dd-91bd-0000779fd18c.html>.

²⁶ John McCain, “Remarks by John McCain on Climate Change Policy.” Speech at the Vestas training facility, Portland, OR, May 12, 2008. Available at <http://www.johnmccain.com/Informing/News/Speeches/0B381ABD-E573-459D-8716-FBD83AB62D8D.htm>.

²⁷ Ernst & Young and Tapestry Network, “Climate change: a hotter topic for audit committees,” *InSights*, August 18, 2008. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_InSights_Aug08.pdf.

²⁸ Tom Ichniowski, “House Clears \$17.6 Billion in Renewable Energy Tax Breaks,” *ENR.com*, February 28, 2008. Available at <http://enr.construction.com/news/powerIndus/archives/080228.asp>.

²⁹ Lynn Stevens, “Renewable Portfolio Standard passes, not everybody’s happy,” *Western Michigan Business Review*, September 18, 2008. Available at http://www.mlive.com/businessreview/western/index.ssf/2008/09/renewable_portfolio_standard_p.html.



Disclosure requirements impact audit committees

More significantly for audit committees, participants believe this wave will likely include more robust disclosure requirements. Legislation passed last year requires the Environmental Protection Agency (EPA) to develop and publish a rule establishing a GHG emissions registry, which would come into effect by June 2009. In reference to this rule, one participant stated, *“An inevitable consequence is more disclosure on environment impact.”* It is possible that companies submitting data to the EPA will have to have it assured by a third party. This would be in line with requirements adopted in the Canadian province of Alberta, under its GHG reduction program.³⁰ Third-party assurance may force companies to significantly increase the quality of their reporting processes.

The candidates' previous record on GHG disclosures suggests implicit support for such legislation. The Climate Stewardship and Innovation Act of 2007, if passed, would have required the EPA to establish and maintain a national GHG database similar to the EPA GHG rulemaking requirement. Senator McCain sponsored that bill and Senator Obama co-sponsored it.³¹

Environmental risk reporting

Aside from new requirements related to GHG emissions, companies may face broader environmental risk-reporting requirements from the SEC. One participant pointed out the benefit of standardizing disclosure requirements: *“Once industry or [certain] industrial sectors begin on piecemeal disclosure ... industry will want [standardization] to come in place. I hope that [standardization] comes through the Commission.”* As noted in *InSights*, the SEC has been receiving pressure from mainstream investors such as the Investor Network on Climate Risk to improve climate change disclosures.³²

Reform in the private sector may also put pressure on regulators to act, particularly as leading U.S. companies continue to step up their voluntary disclosures on climate change. For example, in 2007, 56% of S&P 500 companies voluntarily participated in the Carbon Disclosure Project (CDP), up from 47% in 2006, and more participated in 2008, according to CDP.³³

Voluntary disclosures may accelerate in the wake of the major agreement in August between Xcel Energy, one of the nation's largest utilities, and Attorney General Andrew Cuomo of New York. The agreement requires Xcel to disclose more information to investors on financial risks associated with climate change, including current carbon emissions. Attorney General Cuomo hopes that this agreement will have a ripple effect: *“This landmark agreement sets a new industry-wide precedent that will force companies to disclose the true financial risks that climate change poses to their investors,”* he stated.³⁴ Investors and attorneys also expect the agreement to have a wider effect beyond the utility industry. As Doug Cogan, head of the

³⁰ See Shawn Denstedt, Ryan Rodier, and Matthew Keen, “Major Commitments to Alberta's Climate Change Regime Announced,” *Osler*, March 12, 2007. Available at <http://www.osler.com/resources.aspx?id=11718>.

³¹ A summary of the bill, list of sponsors, and recent actions on the bill is available at <http://www.opencongress.org/bill/110-s280/show>.

³² Ernst & Young and Tapestry Network, “Climate change: a hotter topic for audit committees,” 7.

³³ *Ibid.*, 6.

³⁴ Office of the Attorney General, “Cuomo Reaches Landmark Agreement with Major Energy Company, Xcel Energy, to Require Disclosure of Financial Risks of Climate Change to Investors,” press release, August 27, 2008. Available at http://www.oag.state.ny.us/media_center/2008/aug/aug27a_08.html.



climate risk management group, at RiskMetrics Group, stated, “This agreement provides a blueprint for disclosure of regulatory, legal, and physical risks associated with climate change.”³⁵

Wave two: cap-and-trade

Ultimately, participants expect a comprehensive response to climate change, including a cap-and-trade regime, which would set a maximum limit on GHG emissions and allow companies to buy and sell carbon credits, depending on their own GHG emissions. Such a regime appears inevitable, given that both presidential candidates support cap-and-trade legislation.

There are already a number of regional cap-and-trade initiatives that can act as models for federal legislation. These include the Regional Greenhouse Gas Initiative, which comprises ten northeastern and mid-Atlantic states and which will implement a mandatory cap-and-trade program to reduce emissions from power plants starting January 1, 2009;³⁶ the Western Climate Initiative, which includes the governors from Arizona, California, Montana, New Mexico, Oregon, Utah, Washington, and several Canadian provinces and which will establish a regional GHG reduction goal and develop market-based strategies leading to emissions reductions;³⁷ and the Midwestern Greenhouse Gas Reduction Accord, which was signed in November 2007 by the governors of Wisconsin, Minnesota, Illinois, Indiana, Iowa, Michigan, Kansas, Ohio, South Dakota, along with the Premier of Manitoba.³⁸

There are a number of cap-and-trade bills currently under consideration in Congress. The first to make it to a vote, the Lieberman-Warner Climate Security Act (S.2191), was killed on June 6, 2008. According to several participants, the failure to pass the Act suggests that comprehensive legislation on cap-and-trade could take time. Concerns about high energy prices and the potential harm to domestic steel companies and manufacturers, to name but a few, have entered the political debate. Moreover, differences between the presidential candidates’ proposals, some of which are substantive, highlight that “*the devil is in the detail*,” as one participant put it.

However, companies can expect a cap-and-trade system over the next few years, according to participants. The effect of such a system would be significant for U.S. companies: “The potential size and scope of a structured carbon emissions market in the US is unequivocally vast,” stated Bart Chilton, commissioner of the Commodity Future Trading Commission.³⁹ As companies prepare for such a regime, they could face a broad set of issues, including financial, litigation, and reputational risks. Audit committees may be drawn into overseeing some of these risks, pursuant to their risk management responsibilities.

³⁵ RiskMetrics, “Xcel Reaches Disclosure Pact,” *Risk & Governance Weekly*, September 2008. Available at http://www.issproxy.com/governance_weekly/2008/170.html.

³⁶ More information on the Regional Greenhouse Gas Initiative is available at its website, <http://www.rggi.org/home>.

³⁷ More information on the Western Climate Initiative is available at its website, <http://www.westernclimateinitiative.org/>.

³⁸ Move information on the Midwestern Greenhouse Gas Reduction Accord is available on the website of the Midwestern Governors Association, <http://www.midwesterngovernors.org/govenergynov.htm>.

³⁹ FT.com June 26, 2008, “Carbon trading set to dominate commodities.” Available at: <http://www.ft.com/cms/s/0/9e3e43be-4318-11dd-81d0-0000779fd2ac.html>.



The road to adopting IFRS may be bumpy

The most significant decision related to financial reporting to be made under the next administration's watch will be the SEC's decision whether or not to mandate that U.S. companies adopt International Financial Reporting Standards (IFRS). While most of the participants in this research view a move to IFRS as *"inevitable"* – and most endorse the benefits of moving to one global standard – they expect the road to adopting IFRS to be *"highly political."*

The SEC announced in August that the Commissioners had unanimously voted to publish for public comment a Roadmap that could result in all U.S. issuers reporting under IFRS by 2016.⁴⁰ SEC Chairman Christopher Cox stated, "The world's capital markets have long searched for a single set of high-quality accounting standards that could be used anywhere on Earth ... An international language of disclosure and transparency would significantly improve investor confidence in global capital markets."⁴¹ The Roadmap includes a provision that would permit approximately 110 companies in about 34 industries in which IFRS is already the dominant standard to begin filing their statements in IFRS after December 15, 2009.⁴² The Roadmap also contains several milestones that must be achieved by 2011 in order for the SEC to require mandatory reporting in IFRS, beginning in 2014 for large accelerated filers.

Participants believe that it is unlikely that Congress will take a stand against adopting IFRS or that a new chairman of the SEC will reverse course. However, several participants suggested that delays in announcing the Roadmap and subsequent delays in publishing it for comment are clear signs that the move to IFRS will remain politically sensitive. One participant remarked, *"It always has been a political decision."*

Some participants pointed out that some members of Congress believe that IFRS is a *"weaker standard"* than the U.S. Generally Accepted Accounting Principles. Even if these individuals become convinced that this is a misconception, participants expect these politicians to push the SEC to use the years between now and 2011 to properly scrutinize the appropriateness of IFRS for U.S. companies. To the extent shortcomings are identified, as one participant put it: *"We should expect to see a change in posture,"* as Congress pushes the SEC to take a *"more proactive role"* in shaping IFRS.

Several participants expect Congress to press the SEC to use the 2011 date as a *"real bargaining chip."* They feel the 2011 date allows time to press for significant progress in making the International Accounting Standards Board (IASB) sufficiently independent, financially and politically, which is one of the key milestones in the SEC's Roadmap. One participant expects the SEC to feel compelled to press other countries to establish robust oversight bodies to regulate the accounting profession in those nations, in line with the Public Company Accounting Oversight Board.

⁴⁰ Securities and Exchange Commission, "SEC Proposes Roadmap Toward Global Accounting Standards to Help Investors Compare Financial Information More Easily," press release, August 27, 2008. Available at <http://www.sec.gov/news/press/2008/2008-184.htm>.

⁴¹ Christopher Cox, "International Financial Reporting Standards: The Promise of Transparency and Comparability for the Benefit of Investors Around the Globe." Speech to the Annual Conference of the International Organization of Securities Commissions, Paris, May 28, 2008. Available at <http://www.sec.gov/news/speech/2008/spch052808cc.htm>.

⁴² Ernst & Young, "SEC proposes roadmap for IFRS adoption in the US," *Hot Topic 20*, August 27, 2008, 2. Available at http://www.securitization.net/pdf/EY/RoadmapIFRS_27Aug08.pdf.

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Many participants believe that, in practice, the timetable for adopting IFRS may be “*somewhat longer than expected.*” Nevertheless, many recommended that companies and audit committees continue to prepare, given that the move to IFRS is probably inevitable.

Several participants speculated that the SEC may have to modify the Roadmap so that companies do not have to maintain dual reporting processes. Companies may find such an approach to be unpalatable due to the increased costs, while investors may reject it given the potential that companies will opt for the accounting approach that provides the most flexibility to management and presents their performance in the most favorable way. Whether or not the SEC does make modifications depends in part on the number of comments it receives that argue against a dual reporting approach.

Conclusion

Audit chairs have experienced many changes since 2002. According to a range of experts across the political spectrum, they should expect continued change over the next four to eight years with the 44th U.S. president in office, regardless of which candidates wins. Participants agree these changes will come from both legislative actions and continued private-sector innovation in governance practices.

Audit committee chairs should stay particularly attuned to potentially significant legislative changes in four key areas: capital markets regulation, shareholder rights, climate change-related matters and disclosures, and financial reporting. Without doubt, the timing of any such changes has shifted significantly in recent months as a result of the financial crisis and federal market rescue plan, with political attention shifting dramatically toward reforming capital markets regulation and shareholder rights. One participant, reflecting on the rapidly changing nature of the crisis and the new sense of urgency regarding reform of capital markets, said, “*I don’t think you could have said [we’d see such reform] even four weeks ago.*” But regardless of particulars, in the current turbulent situation, audit committee chairs should continue to expect change.

About this document

InSights is produced by Tapestry Networks to provide assessments of key issues of interest to audit committees. Initially, *InSights* will be distributed to network members who, in turn, will share it with colleagues on audit committees and boards, and their advisers. It will be distributed by Ernst & Young to its partners. Anyone who receives *InSights* may share it with those in their own network. The ultimate value of *InSights* lies in its power to help all constituencies develop their own informed points of view.

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Appendix: list of interviewees

Tapestry Networks interviewed a range of experts to gain a wide and balanced perspective. Below is a list of the participants:

- Les Brorsen, Americas Director, Office of Public Policy, Ernst & Young
- Richard Ferlauto, Director of Corporate Governance and Pension Investment, American Federation of State, County & Municipal Employees (ASFCME)
- David Hirschmann, President and CEO, Center for Capital Markets Competitiveness (CCMC); President and CEO, Global Intellectual Property Center (GIPC); Senior Vice President, U.S. Chamber of Commerce
- Keith Johnson, Head of Institutional Investor Services practice group, Reinhart Boerner Van Deuren s.c.
- Thomas Lehner, Director of Public Policy, Business Roundtable
- Robert Litan, Senior Fellow in economic studies, Brookings Institution
- Jon Lukomnik, Program Director, Investor Responsibility Research Center Institute, and Managing Partner, Sinclair Capital
- Nell Minow, Editor and Co-founder, The Corporate Library
- Jeff Petrich, Executive Director, Washington Council Ernst & Young
- Damon Silvers, Associate General Counsel, American Federation of Labor and Congress of Industrial Organizations (AFL-CIO)
- Peter Wallison, Arthur F. Burns Chair in Financial Policy Studies and Co-director of the financial markets deregulation program, American Enterprise Institute (AEI) for Public Policy Research