AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

H.R. 3763—THE CORPORATE AND AUDITING ACCOUNTABILITY, RESPONSIBILITY AND TRANSPARENCY ACT OF 2002

HEARINGS

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

MARCH 13, 20; APRIL 9, 2002

Printed for the use of the Committee on Financial Services

Serial No. 107–60

U.S. GOVERNMENT PRINTING OFFICE

78–501 PDF WASHINGTON : 2002

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

MICHAEL G. OXLEY, Ohio, *Chairman*

JAMES A. LEACH, Iowa
MARGE ROUKEMA, New Jersey, *Vice Chair*
DOUG BEREUTER, Nebraska
RICHARD H. BAKER, Louisiana
SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
ROBERT W. NEY, Ohio
BOB BARR, Georgia
SUE W. KELLY, New York
RON PAUL, Texas
PAUL E. GILLMOR, Ohio
CHRISTOPHER COX, California
DAVE WELDON, Florida
JIM RYUN, Kansas
BOB RILEY, Alabama
STEVEN C. LATOURETTE, Ohio
DONALD A. MANZULLO, Illinois
WALTER B. JONES, North Carolina
DOUG OSE, California
JUDY BIGGERT, Illinois
MARK GREEN, Wisconsin
PATRICK J. TOOMEY, Pennsylvania
CHRISTOPHER SHAYS, Connecticut
JOHN B. SHADEGG, Arizona
VITO FOSSELLA, New York
GARY G. MILLER, California
ERIC CANTOR, Virginia
FELIX J. GRUCCI, JR., New York
MELISSA A. HART, Pennsylvania
SHELLEY MOORE CAPITO, West Virginia
MIKE FERGUSON, New Jersey
MIKE ROGERS, Michigan
PATRICK J. TIBERI, Ohio

JOHN J. LAFALCE, New York
BARNEY FRANK, Massachusetts
PAUL E. KANJORSKI, Pennsylvania
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
KEN BENTSEN, Texas
JAMES H. MALONEY, Connecticut
DARLENE HOOLEY, Oregon
JULIA CARSON, Indiana
BRAD SHERMAN, California
MAX SANDLIN, Texas
GREGORY W. MEEKS, New York
BARBARA LEE, California
FRANK MASCARA, Pennsylvania
JAY INSLEE, Washington
JANICE D. SCHAKOWSKY, Illinois
DENNIS MOORE, Kansas
CHARLES A. GONZALEZ, Texas
STEPHANIE TUBBS JONES, Ohio
MICHAEL E. CAPUANO, Massachusetts
HAROLD E. FORD JR., Tennessee
RUBÉN HINOJOSA, Texas
KEN LUCAS, Kentucky
RONNIE SHOWS, Mississippi
JOSEPH CROWLEY, New York
WILLIAM LACY CLAY, Missouri
STEVE ISRAEL, New York
MIKE ROSS, Arizona

BERNARD SANDERS, Vermont

Terry Haines, Chief Counsel and Staff Director

CONTENTS

	Page
Hearing held on:	
March 13, 2002	1
March 20, 2002	66
April 9, 2002	125
Appendix:	
March 13, 2002	175
March 20, 2002	295
April 9, 2002	417

WITNESSES

WEDNESDAY, MARCH 13, 2002

Glassman, James K., Resident Fellow, American Enterprise Institute	12
Hills, Hon. Roderick M., Former Chairman, Securities and Exchange Commission	47
Lackritz, Marc E., President, Securities Industry Association	8
Melancon, Barry, President and CEO, American Institute of Certified Public Accountants	10
Roper, Barbara, Director of Investor Protection, Comsumer Federation of America	49
Turner, Lynn, Director, Center for Quality Financial Reporting	50
White, Ted, Director, Corporate Governance, California Public Employees' Retirement System	14

APPENDIX

Prepared statements:	
Oxley, Hon. Michael G.	176
Gillmor, Hon. Paul E.	182
Carson, Hon. Julia	178
Jones, Hon. Stephanie	180
Royce, Hon. Ed	183
Glassman, James K.	210
Hills, Hon. Roderick M.	254
Lackritz, Marc E.	184
Melancon, Barry	199
Roper, Barbara	266
Turner, Lynn	274
White, Ted (with attachment)	226

WITNESSES

WEDNESDAY, MARCH 20, 2002

Clapman, Peter C., Senior Vice President and Chief Counsel, Corporate Governance, TIAA-CREF	107
DelRaso, Joseph V., Esq., Partner, Pepper Hamilton, LLP	101
Jasinowski, Jerry J., President, National Association of Manufacturers	106
Livingston, Philip B., President and CEO, Financial Executives International	104
McCall, Hon. H. Carl, Comptroller, State of New York, Office of the State Comptroller	96
Pitt, Hon. Harvey L., Chairman, U.S. Securities and Exchange Commission	69
Raines, Franklin D., Chairman and CEO, Fannie Mae; Chairman, Corporate Governance Task Force of the Business Roundtable	98

Page

APPENDIX

Prepared statements:
Oxley, Hon. Michael G. 296
Gillmor, Hon. Paul E. 298
Jones, Hon. Stephanie T. 299
Royce, Hon. Ed 301
Clapman, Peter C. 397
DelRaso, Joseph V. 360
Jasinowski, Jerry J. 388
Livingston, Philip B. (with attachment) 365
McCall, Hon. H. Carl 316
Pitt, Hon. Harvey L. 302
Raines, Franklin D. (with attachments) 320

Additional Material Submitted for the Record

Maloney, Hon. Carolyn:
Hon. Eugene A. Ludwig, former Comptroller of the Currency, speech, February 15, 2002 413
Raines, Franklin D.:
The Business Roundtable statement on the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002 351
Department of the Treasury's Peter R. Fisher, Under Secretary for Domestic Finance, prepared statement 409

WITNESSES

Wednesday, April 9, 2002

Breeden, Hon. Richard C., former Chairman, Securities and Exchange Commission, Richard C. Breeden & Company 137
Langevoort, Prof. Donald C., Georgetown University Law Center 140
Silvers, Damon A., Associate General Counsel, AFL-CIO 141
Walker, Hon. David M., Comptroller General of the United States, U.S. General Accounting Office 135

APPENDIX

Prepared statements:
Gillmor, Hon. Paul E. 418
Jones, Hon. Stephanie T. 419
Breeden, Hon. Richard C. 454
Langevoort, Prof. Donald C. 482
Silvers, Damon A. 492
Walker, Hon. David M. 422

H.R. 3763—THE CORPORATE AND AUDITING ACCOUNTABILITY, RESPONSIBILITY AND TRANSPARENCY ACT OF 2002

WEDNESDAY, MARCH 13, 2002

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The committee met, pursuant to call, at 10:00 a.m. in room 2128, Rayburn House Office Building, Hon. Michael G. Oxley, [chairman of the committee], presiding.

Present: Chairman Oxley; Representatives Roukema, Bereuter, Baker, Lucas, Ney, Kelly, Weldon, Biggert, Shays, Cantor, Grucci, Hart, Capito, Rogers, Tiberi, Royce, Gillmor, Ose, Green, LaFalce, Waters, Sanders, C. Maloney of New York, Watt, Sherman, Lee, Inslee, Jones of Ohio, Kanjorski, Moloney of Connecticut, Lucas of Kentucky, Clay, Israel, and Roso.

Chairman OXLEY. Good morning and welcome to the committee's first legislative hearing on the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002 or CARTA. This legislation makes important changes in the accounting profession, in the way public companies report their financial results, and the manner in which investors access their information. These issues are among the most serious in our jurisdiction. They have percolated for some time. Now, the bankruptcies of Enron, Global Crossing, and others have pushed them to the forefront.

Hearings held in this committee over the past few months have demonstrated yet again the need for modernizing our financial reporting and disclosure system. Also, it is clear that we must have strong oversight of the accounting profession. There should be no question that the Federal securities laws need to be updated to ensure that investors have access to transparent, and meaningful information concerning public companies. Enhancing the public's faith in financial statements is absolutely critical. They serve as the bedrock of our capital markets.

Our legislation, CARTA, addresses these fundamental issues by strengthening our markets in a very careful way. We avoided the temptation some apparently feel to blanket market participants in a sea of red tape. This legislation creates an entirely new oversight regime for public accountants, requiring accountants to be rigorously reviewed to ensure that they meet the highest standards of competence, independence, and ethical conduct.

CARTA also recognizes the need for corporate leaders to act responsibly and holds them accountable if they fail to do so. The leg-

islation makes important improvements in the area of corporate transparency, requiring that company's disclose to investors important company news on a real time basis. It also directs the SEC to require companies to disclose the use of off-balance sheet transactions.

CARTA's provisions are designed to increase public confidence in the U.S. capital markets. It is important that they remain the world's most efficient means of promoting economic growth and providing retirement security.

President Bush recently announced the 10 Point Plan to improve corporate responsibility and protect America's shareholders. I am pleased that the plan's core principles, providing better information to investors, making corporate officers more accountable, and developing a stronger more independent audit system are embodied in our legislation.

I look forward to continuing our close collaboration with the Administration on this vital capital markets issue.

I also would like to mention Fed Chairman Alan Greenspan's recent testimony before this committee. Discussing the implications of the Enron collapse, Chairman Greenspan noted that it has already sparked a very significant shift toward more corporate transparency and more responsible corporate governance practices. While it does not in my view obviate the need for Government action, the market's self-correcting mechanism certainly does underscore the danger of overreacting to the Enron matter.

I am pleased that CARTA reflects Chairman Greenspan's support for more transparent financial reporting and for strengthening the independence of the audit.

I want to thank all the Members of this committee for working so diligently on this important legislation. Let me also thank all of our witnesses in advance for their important participation here this morning.

I turn now to Ranking Member LaFalce for his opening statement.

[The prepared statement of Hon. Michael G. Oxley can be found on page 176 in the appendix.]

Mr. LAFALCE. Thank you very much, Mr. Chairman. I ask unanimous consent that the entirety of my opening statement be included in the record.

Chairman OXLEY. Without objection, all the Members opening statements will be made part of the record.

Mr. LAFALCE. I thank you. Our committee assumed jurisdiction over securities and insurance for the first time in January of 2001. And the Chairman has indicated that he is concerned that we not overreact to the problem. Well, I think that that is a reasonable concern. But I think that it is also true that we under reacted to the problem historically and that was a much greater concern. At the beginning of 2001, I began talking about the problem of earnings manipulation. That is when we assumed jurisdiction. The SEC, as you know, was tripling the number of mandated restatements, which was at least some indication that something might well be wrong.

And there was too much of an incentive it seemed to me within corporate America, particularly because of the compensation mech-

anisms that have evolved over the years, for earnings manipulation, for revenue recognition when it should not be recognized, for channel stuffing, cookie jar reserves, and so forth, and so forth. Very often, unchecked by the board of directors for one reason or another, because of a policy passivity that may have existed at too many boards, because of the same stock options to a lesser extent to be sure that corporate officers, their chief desire is not a better product or a better service, but market capitalization, to drive capitalization.

And then enter the accounting profession that was responsible to the public as a public fiduciary for auditing these companies and making sure that the books by the CFO and the CEO, and so forth, and the audit committees were done right. And there was a difficulty there. They too had evolved over the years so that in a good many respects they would make more money through consulting than through auditing. But also independent of that they just had obviously a vested interest in being retained and then staying retained by the firm because it was an employer/employee relationship and you want to make the client happy so you have this tension.

And then enter Wall Street. Wall Street got into an attitude of stock hype, there is actually no question about it. Certainly the number of recommendations went down precipitously from what it previously had been. And then too we witnesses a number of blatant conflicts that existed.

Now nobody was paying attention in this committee when we were considering the SEC fee reduction bill, I said what we should be considering in the first instance is not a 2 or 3 percent increase in the SEC budget, but a 200 or 300 percent increase in the SEC budget, because of what is going on. And I made the same argument before the Rules Committee, and I made the same argument on the floor of the House. But nobody was paying attention until Enron. And then when Enron happened, people started paying attention.

Now, the Chairman is correct, we ought not to overreact, but we ought to act. And we have to find that balance, what is the right way. We ought to keep that pendulum. But we want good action, strong action.

To restore confidence in the integrity of our markets, I think we have to do at least the following. Enact legislation that will address the serious deficiencies in our current system. Now, I have recently introduced a bill, the Chairman had called a hearing on his bill, but there is at least one other bill. There are many other bills actually. And there are good ideas in all of them. We have to sort through them and try to come to some consensus. I hope we can do that. If we don't, we will just vote them up or vote them down, not bill by bill, but issue by issue.

We should at least consider these particular proposals. The appropriate separate of audit and consulting functions; the concept of auditor rotation; and other proposals that address the relationship of the auditor to its audit client. We must also provide for meaningful oversight of the audit profession. And that means a strong and credible regulator. And you have to have individuals who are on this board, whatever it is going to be, that will instill some con-

fidence in the investing public and restore the concept of integrity to the accounting profession that is so richly deserved over the years. We must reform the functioning of audit committees and the boards of directors of public companies to ensure that independent directors are truly independent and that auditors are working for the shareholders, not for the management. And I think we need to reconsider liability issues. Did we go a bit too far in 1995 and 1998? I think we need to reopen that issue, not in toto, but at least in part.

I said early last year, and Lynn Turner, the Chief Accountant of the SEC at that time, said that what we have witnessed so far was just the tip of the iceberg. I am afraid that what we witnessed so far too is still the tip of the iceberg, that there is a lot more out there. Now I know that corporate officers and board of directors and accountants are much more zealous today than they were in October and November and earlier, but I think that having good legislation will enhance that.

Second, and this is something that I think we can now agree on, and I will finish up, I called for the 200 to 300 percent increase in the SEC budget. I certainly called for pay parity, and the Chairman and I are going to team up I am sure with Mr. Baker and Mr. Kanjorski and push the Administration and the Congress to give the SEC the resources that it so desperately needs to do the job that all America wants it to do.

I thank the Chairman.

Chairman OXLEY. The gentleman's time has expired. The Chair now recognizes the Chairman of the Capital Market Subcommittee, the gentleman from Louisiana, Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman. I want to commend you for the hearing and start by putting what I believe is our mutual perspective about this problem on the record. By and large, day to day, most professionals engaged in the business of running corporations, auditing corporations, analyzing corporations, and reporting on corporations are doing the best job in the most professional capacity they know how to achieve those ends for the benefit of all stockholders, including shareholders.

And the problems we are addressing today, I do not believe are systemic or a condemnation of the business free-enterprise system in the United States. I do believe that the rules now written some 60-70 years ago, are inadequate in light of the technological change and the speed with which business is conducted, but it is apparent to me that most individuals who are here today to testify are coming with helpful suggestions in how they believe we can improve the legislation before us. But generally, everyone agrees we are on track. We have not missed it. It is time to act. Every stakeholder wants these issues resolved. We want to ensure investor and public confidence in the credibility of our markets. And it is in our mutual economic interest to see that occurs as quickly as possible.

To that end, I want to point out, Mr. Chairman, that you took decisive action with regard to suggestions for treatment of analyst conduct, together with the regulators and members of the profession, and announced mandatory, not voluntary, changes that should be implemented which is now subject to public comment. And they were sweeping in their effects. Research departments

may not be subject to supervision or control of the investment banking department. The subject company may not approve prior reports prior to distribution. The firm may not tie compensation to specific investment banking practices. A firm must disclose if the analysts receive compensation based upon the firm's investment banking revenues and establish certain quiet periods. No analyst may purchase or receive an issuer's securities prior to an initial public offering. No analyst may trade securities issued by the company the analyst follows for a period beginning 30 calendar days. And it goes on. A firm must disclose in research reports and an analyst must disclose in public appearances if they have a financial interest in the securities of the company. A firm must disclose in research reports and in public appearances whether or not the firm or its affiliates beneficially own 1 percent of any class of common equity securities of the subject company. And it goes on.

The point being that these are mandatory changes in analyst conduct subject to penalties up to and including disbarment from practice, which will, I believe, significantly alter the method and manner in which analyst reports are issued and the public can view the information contained therein.

The legislation before us here today is similar in its effect. I had suggested that we analyze the consequences of having exchange-based engagement of audits. There has been any number of suggestions to radically alter the relationships between audits and their corporations. And on reflection and consultation with the SEC and many others who have expert opinion, I believe the bill before us, with perhaps slight modification here or there, is an excellent vehicle for appropriate reform in light of the circumstance we face.

Just examine the GAO's own report. I think they make two excellent statements that are worth repeating this morning. One is go carefully. We are engaged in discussions that affect the entire capital markets of this Nation and consequently internationally have some significant potential for repercussions if we get it wrong.

And, second, that we need to make it clear that the financial statement belongs to the shareholder. I was somewhat taken aback when the CEO of Andersen Consulting said in response to a question before our hearing, "To whom does the financial statement belong?" He said, "To management and the shareholder." Management 101, the financial statement should reflect accurate financial condition of the corporation based upon management's performance for the shareholder. Once we return to that, and we ensure that there is independence in the preparation of that audit statement, and that we enable a good auditor to do good work despite what management might choose for them to report, the consequences for our capital markets, the auditor, the shareholder, and everyone will be greatly enhanced.

I think you have got it right, Mr. Chairman. I think this is an excellent start. Perhaps there is a change to be made here or there, but in the overall picture and the risk we would take by going further faster, I think it is not warranted in light of the circumstances we face, and I commend you for calling this hearing.

Chairman OXLEY. The gentleman's time has expired. We now turn to our distinguished panel. And let me introduce them. Mr. Marc E. Lackritz.

Mr. SANDERS. Mr. Chairman, will others be allowed to make opening statements?

Chairman OXLEY. Just the Ranking Member and the subcommittee.

Mr. SANDERS. We were told otherwise.

Mr. SHERMAN. That is not what we were told by staff by the way.

Chairman OXLEY. Staff informs me that you are correct. The gentleman from Vermont, Mr. Sanders.

Mr. SANDERS. Thank you very much, Mr. Chairman. And thank you and Mr. LaFalce for holding this important hearing. I find myself in agreement with the Chairman and Mr. LaFalce and Mr. Baker, but I would go further than they, because I think we have a very, very serious problem, which the United States Congress has got to address.

Let me just for a moment do a Dave Letterman Top 10, if I might, in terms of failed audits. This suggests that while Enron has gotten all of the publicity, the problem is a lot deeper than Enron.

One: Arthur Andersen and Enron. We all know that.

Number two: KPMG failed in its audit of Rite-Aid causing a $800 million loss in stock value after recalculation of profits.

Number three: Arthur Andersen failed in its audit of Sunbeam, causing a $1.2 billion loss in stock value after the recalculation of profits.

Four: PriceWaterhouseCoopers failed in its audit of Micro Strategy, resulting in a $10.4 billion loss in stock value after their recalculation of profits.

Five: Arthur Andersen failed in its audit of Waste Management, resulting in a loss of $900 million in stock value after their recalculation of profits.

Six: Arthur Andersen failed in its audit of McKessen HBOC, resulting in a $7.9 billion loss in stock value.

Seven: Ernst & Young failed in its audit of Cendant, resulting in a loss of $11.3 billion in stock value.

Eight: KPMG failed in its audit of Greentree, resulting in a loss of $1.1 billion in stock value.

Nine: while Global Crossing executives cashed in on some $1.3 billion in Global Crossing stock, Arthur Andersen's failed audit of this company has caused many of their employees to lose their entire life savings.

Ten: Arthur Andersen failed in its audit of the Baptist Foundation of Arizona.

The point is, Mr. Chairman, we have a serious problem. And I think, Mr. Chairman, we need a serious solution. Mr. LaFalce touched on the inherent conflict of interest between those who consult for the company, and that is kind of obvious and I would hope that most of us would want to end that practice immediately. Mr. LaFalce also touched upon the employer-employee relationship. If you are working for a company and you are getting paid well by that company, are you going to go up to that company and say: "By the way, you are cooking the books and you are ripping off the stockowners of your company." Apparently, many of the large auditing firms are not prepared to do that.

So it seems to me that at the very least we need to significantly beef up the SEC, but, in fact, we may want to go a lot further than that. When people invest in the stock market, when people who represent pension funds, who are representing the retirement savings of millions of American workers are investing in a company, they have the right to know that the books are being honestly kept. And, unfortunately, that has not been in many cases the record up to today.

So I think we are going to need some very bold solutions to this very serious problem.

Thank you, Mr. Chairman.

Chairman OXLEY. The gentleman's time has expired. There are other opening statements. The gentleman from California, Mr. Sherman, is recognized for 3 minutes.

Mr. SHERMAN. Thank you, Mr. Chairman. We need not only to be concerned with the culture of the business world, which I don't think we can change, but rather design strong rules and clear rules rather than simply rely on adding more ethics courses to business school curricula.

We ought to look at the scope of service that auditing firms provide. But keep in mind, if Arthur Andersen had just been an auditing firm, they would have collected only $25 million from Enron, not $50 or $52. But they would have been a firm of half the size. And if our concern is the size of the fee having an effect on the auditor and the auditor's judgment, we ought to perhaps limit the total fee for all services provided to 150 percent of the audit fee so that some incidental services could be provided.

We ought to look at the structure of accounting firms to ensure that the technical review department always makes the final decision. That is not what happened with Arthur Andersen, which unlike the other Big Five firms, decided to have the decisions made in Houston in effect by the sales partner.

We need to have minimum capitalization requirements so that if you sue an accounting firm, you don't collect absolutely nothing. You can't drive in most States without liability insurance, but you can practice accounting and be responsible for trillions of dollars in market reliance without adequate malpractice insurance or adequate capitalization.

If we are going to rotate auditors, perhaps we also ought to give them tenure as well. Because if you are in the first year of what is a maximum of 5 or 10 years of auditing a firm, you are subject to pressure from the client, loosen your accounting interpretations or you may lose your last 9 years of a contract. If instead these were 6 or 10-year contracts, auditors would be free without financial pressure to be able to make the judgment decisions.

The SEC should have been here asking us to quadruple their budget or double their budget. Instead the SEC was not even reading Enron's financial statements. If tiny companies, going public for the first time, get a review of their filings by the SEC and have to answer questions and make their documents clear and complete, certainly we should require the same kind of scrutiny of the thousand largest firms in America.

We ought to have the FASB come before us, Mr. Chairman, to talk about how the accounting standards were so loose that people

at Arthur Andersen and Enron could convince themselves that they were even close to compliance. And we ought to hear more from institutional investors, who frankly I think have under investigated in their Washington presence. When it comes to reducing capital gains, we have thousands of lobbyists. When it comes to other things that would help investors, we tend not to hear from them nearly as loudly.

I yield back.

Chairman OXLEY. The gentleman's time has expired. Are there further opening statements?

Now, I turn to our distinguished panel. The gentleman, Mr. Marc Lackritz, president of the Securities Industry Association; Mr. Barry C. Melancon, president and CEO, American Institute of Certified Public Accountants; Mr. James Glassman, resident fellow of the American Enterprise Institute; and Mr. Ted White, director of Corporate Governance, California Public Employees' Retirement System.

Gentlemen, welcome to all of you. And Mr. Lackritz, we will begin with you.

STATEMENT OF MARC E. LACKRITZ, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION;

Mr. LACKRITZ. Thank you, Mr. Chairman.

Mr. Chairman, Congressman LaFalce, and Members of the committee, I am pleased to testify before you today on H.R. 3763. We commend you, Mr. Chairman, and Members of the committee for your ongoing efforts to ensure that investors will continue to be well served and well protected.

SIA is deeply concerned about the implosion of Enron and the corrosive effect this event is having on the public's trust and confidence in our country's corporations and financial markets. Public trust and confidence is the bedrock of our financial system, the core asset underlying why our financial markets are the envy of the world.

Although Enron's collapse appears to be a massive failure in the accuracy of information that flowed into the marketplace, the securities industry's regulatory structure remains fundamentally strong. Although we are still learning the full story behind Enron's collapse, we strongly support responsible reforms that will ensure that financial information, the lifeblood of our markets, is honest, accurate, and easily accessible.

SIA welcomes the reforms in pension laws announced by the Administration in February. We support, for example, prohibiting insiders from selling their securities during a blackout period, requiring prior notice of blackout periods, and the concept of permitting participants to sell company stock in their 401K plan after a reasonable period.

We also encourage the Senate to follow the House's lead in passing legislation to allow retirement plan administrators to provide individual financial advice to employee participants. Giving investors greater access to information will help them make more informed decisions about their retirement accounts.

SIA also supports full funding of pay parity for the Securities and Exchange Commission's professional staff. The SEC has been

a tough, effective cop on the beat. We have been profoundly troubled by the huge turnover in experienced staff that the SEC has suffered in recent years. Congress should fund pay parity and increase the agency's funding to ensure that the SEC has the staff and resources it needs to be an effective regulator.

SIA believes that H.R. 3763 includes a number of important improvements to the current regulatory system. The bill sets up a strong statutory framework for public oversight of the independent audit function. It is a sensible, appropriate reaction to the shadow the Enron debacle has cast on the current performance of outside auditors.

We also support giving the SEC authority to prosecute senior executives of a public company that willfully mislead an independent auditor. Although the SEC already has strong authority in this area, the committee should consider President Bush's proposal to grant the SEC the statutory authority to require senior executives to disgorge bonuses and other incentive-based forms of compensation in cases of accounting restatements resulting from misconduct.

Although SIA generally supports H.R. 3763's provisions for more timely and better disclosure of corporate information, we note that the SEC has already announced its intention to act in this area, we believe that the best action here is to provide the SEC with the flexibility to make the necessary judgments about the timing and content of required disclosures.

Similarly, the bill's provisions to improve transparency in financial statements generally overlap with the recent SEC statement to issuers regarding certain disclosures. Since those disclosures have just been mandated, we believe it is premature to legislate at this time in this area.

Our written statement includes additional recommendations, Mr. Chairman, for improving corporate disclosures. Further, special purpose entities play a critical role in a number of important financial markets, especially in the case of securitization programs. Regulatory or legislative actions should be considered carefully in light of the significant adverse impact upon financial markets that might result from inappropriate restrictions on SPEs.

Finally, SIA supports the provisions directing the SEC to conduct a study of any final SRO rules regarding conflicts of interest by equity analysts. SIA developed a set of best practices for research a year ago that we believe have been very useful and constructive. The NASD and the New York Stock Exchange have recently proposed regulations in this area. And while we have some serious issues with some aspects of these proposals, we support their overall goal.

SIA believes our system of securities regulation and corporate disclosure is second to none. Our financial markets are envied worldwide for their efficiency and integrity, and we now have the opportunity to develop sensible, responsible reforms that will improve the markets for everyone.

Certainly Enron has brought us a new set of challenges to address. We look forward, Mr. Chairman, to working with you, the SEC, and the Administration to develop a reasonable measured response to those challenges.

Thank you very much.

[The prepared statement of Marc E. Lackritz can be found on page 184 in the appendix.]

Chairman OXLEY. Thank you, Mr. Lackritz.

Mr. Melancon.

STATEMENT OF BARRY C. MELANCON, PRESIDENT AND CEO, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. MELANCON. Thank you, Mr. Chairman. Chairman Oxley, Ranking Member LaFalce, and Members of the committee, I am Barry Melancon, a CPA and president and CEO of the American Institute of Certified Public Accountants. I am here today on behalf of the 350,000 members of the AICPA and for the almost 1,000 firms that perform audits for public registrants and 45,000 firms that service small business throughout America.

CPAs across this country and the Members of this committee share a common goal, to restore faith in the financial reporting system and reassure investors that they have access to the most up-to-date, relevant, and accurate financial information.

Our profession has a long history of dedication of maintaining and improving the quality of financial disclosures. We require it, investors demand it, and the strength of our financial markets depends upon it. We take that responsibility very serious, and we have zero tolerance for those who break the rules.

I would like to be clear: We support meaningful change, because thoughtful improvements are needed. But we all should be wary of proposals that can lead to unintended consequences. We ask that this committee and Congress evaluate legislative proposals with an eye to a straightforward public interest test, a test that asks four important questions:

Will it help investors make informed investment decisions?

Will it enhance audit quality and the quality of financial reporting?

Will it increase confidence in the capital markets, our financial reporting system, and the accounting profession?

Will it be good for America's financial markets and economic growth?

We support a robust private-sector regulatory body for auditors of public companies dominated by members who are not accountants, with SEC oversight, and a clear charter to undertake professional discipline and quality review. A highly effective disciplinary and quality review body will alleviate the need for individual prescriptive proposals.

Audit quality is another issue that I would like to discuss today. New and more complicated financial instruments and the speed and complex nature of business transactions has significantly increased the challenges facing auditors. The competency and experience needed to conduct today's audit are vastly broader than they were just even a few years ago. And those requirements will be ever more far-reaching in years to come.

I would like to take a moment here to discuss the very real risk that broad proposals that restrict services provided to audit clients, whether intended or not, could lead to a profession comprised of firms that provide narrowly defined audit services and little else. This will have unfortunate, unintended consequences. The ripple

effect of such action could hurt businesses of all sizes and all communities. Such statutory restrictions will substitute informed and reasoned decisionmaking by companies in their audit committees with Government fiat.

Next, the issue of corporate governance. We should all recognize that the financial reporting process is a complex system of checks and balances that begins with the creation of the financial statement by the company. To enhance this first step in the process, the audit committee should also have the sole authority to approve the company's financial statements and require business disclosures in the annual report and other public documents. And the audit committee should be responsible for the hiring and firing of the company's auditor. Equally important, it should be composed of outside directors with auditing, accounting, or financial experience.

We hope that policymakers recognize that it would be harmful to cast a dark cloud over all services outside the statutory audit by establishing a negative presumption that an auditor cannot be independent if any such services are provided to an audit client even if that presumption could be overridden by an audit committee's affirmative action.

Mandatory rotation of audit firms has been proven to increase the potential for fraud. The COSA study of financial statement fraud shows that client fraud is three times more likely in the first 2 years of a client-auditor relationship. Safeguards are already in place. All firms that conduct audits for publicly traded companies are currently required to take the lead engagement partner off engagements after 7 years for a period of at least 2 years. Finally, I must mention that at one time Canada, Greece, Spain, and Italy all required mandatory audit firm rotation in one form or another. Three of those four countries subsequently dropped the requirement. In short, given the known risk, why follow these failed experiments.

On another note, it is ludicrous to suggest that accountants are off the liability hook. One simply has to read the newspaper today to see that the opposite is true. The past few years have seen record numbers of lawsuits and record settlements from accounting firms.

And now to the reforms that the AICPA has advocated for many years.

Chairman OXLEY. Can you sum up, Mr. Melancon.

Mr. MELANCON. Yes, sir. Reforms in our 70 year old financial system. The current system is no longer adequate in the information age. Efforts to modernize business reporting must be accelerated.

On behalf of the CPAs around the country, I thank you for the opportunity to present our views today and commend the committee for what we trust will be a thoughtful approach to these important and complex issues.

[The prepared statement of Barry C. Melancon can be found on page 199 in the appendix.]

STATEMENT OF JAMES K. GLASSMAN, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. GLASSMAN. you, Mr. Chairman. Mr. Chairman and Members of the committee, thank you for inviting me to testify today. My name is James K. Glassman. I am a Resident Fellow with the American Enterprise Institute and host of techcentralstation.com. Since 1993, I have been writing regularly on investing for a broad audience. I am a financial columnist for *The Washington Post*. My second book, "The Secret Code of the Superior Investor," was published in January.

I believe that my usefulness to this committee lies in my understanding of what makes small investors tick and of the consequences of financial policies on the economy and markets. In the current over-heated atmosphere, H.R. 3763 is admirably level-headed, especially in comparison with the Comprehensive Investor Protection Act. Still, some of the bill's provisions are troubling. Rather than protecting investors, these provisions may harm them.

First, understand that investors do a remarkable job protecting themselves. Investors reward good corporate citizens with higher stock prices and they punish miscreants with lower. Recent academic research confirms this fact, as I show in my written statement. Investors have their own unwritten set of rules and when companies violate them, the retribution is swift. Investors do not tolerate lying. In Enron's case, as soon as it became clear that the firm had deceived them, investors entered a verdict of guilty and applied "capital" punishment. They didn't wait for a trial. They didn't wait for an SEC investigation. Similarly, clients of Arthur Andersen, Enron's accounting firm, did not wait for an indictment or a Government report. Delta Airlines, Merck & Company, Freddie Mac, among others, fired Andersen as their auditor. In addition, of course, Enron and Andersen executives face possible criminal penalties.

In the face of such a ferocious reaction, why is Congress considering at least 30 pieces of legislation in the Enron matter? Congress has played an important role in exposing the details of the scandal to the public and in calling the participants to account publicly. This committee deserves particular praise. But much of the legislation itself is unproductive at best.

Let me comment briefly. Auditor independence: H.R. 3763 would bar accounting firms from providing clients with both external audit services and financial information services or internal audit services. The CIPA goes further. Both approaches are harmful to investors.

First, Zoe Palmrose and Ralph Saul show in an extensive article in the winter issue of *Regulation*, which I would like to enter into the record, the issue of auditor independence has been extensively studied with almost no empirical evidence of abuse. The theory put forth by advocates of independence rules is that companies use the high fees involved in contracts for non-audit services in order to bribe accounting firms to produce deceptive audits that favor the company. But Enron actually paid low non-audit fees relative to its audit fees. And why should forbidding non-audit work solve the problem? After all it is just as easy to bribe accountants, if you believe this theory, directly. Just pump up the fees for audit work.

While evildoers lurk in the corporate world as well as outside it, the main reason that respected companies use the same firms for audit and non-audit is not that this combination provides some kind of nefarious leverage, but that it makes sense economically in an age of high technology. Forcing this highly artificial separation will add expenses, lower profits, and inevitably lower stock prices, and that hurts investors. It does not help them.

Increasing the complexity of accounting rules: You should understand that the complex nature of American corporations means that every loophole cannot be plugged, every possible deception and distortion cannot be remedied with a new rule. The answer is not more numbers and legalese, but more leeway for auditors and corporate executives to explain the truth health of a company, along with strict accountability from companies and auditors.

So what should be done? Well, I strongly agree with Section 4 of H.R. 3763, which requires officers and directors to disclose sales of company stock to the SEC within two days after the transaction. I would go further and say that this information should be contemporaneous. I also concur with blackout provisions and with stricter laws against companies interfering with audits.

Another remedy, which is beyond the scope of this committee, is this: Cash dividends are the clearest, most transparent evidence of corporate profits. An investor who sees dividends increasing every year can properly have confidence in a company. But dividends are taxed twice and mainly as a result fewer public companies now pay dividends ever in history. Ending double taxation of dividends would increase pay-outs and vastly increase investor confidence.

Repealing litigation reform: Congress, in 1995, overrode President Clinton's veto of the Private Securities Litigation Reform Act, a bill that scaled back the excesses involved in often frivolous securities fraud cases brought by a small group of politically generous plaintiffs' lawyers. Now some in Congress have decided that these moderate reforms were responsible for the Enron excesses. In fact, the law does not prevent such lawsuits. Cendant, for example, settled the class action lawsuit after the new law for $2.8 billion. And its former auditor, Ernst & Young, settled another suit for $335 million. Attorneys could have sued Enron earlier and they are certainly suing Enron and its auditor, Arthur Andersen, today.

Repealing this reform would not protect shareholders. It would hurt them by forcing their companies to make payments of tribute and distracting executives who should be focusing on managing their firm. Indeed, in my opinion, the bar should be raised higher to deter more frivolous suits.

After the Enron scandal entered full public consciousness in December, the media carried stories claiming that as a result investors were losing faith in the stock market in general. Instead, while investors have certainly become much more vigilant, to their credit they have not responded by dumping shares across the board. In fact, in January 2002, according to the Investment Company Institute, investors added $20 billion more to equity mutual funds than they took out, the largest such net gain in many months.

Chairman OXLEY. If you could sum up.

Mr. GLASSMAN. Yes, sir. I do have to mention something. I was not aware that CalPERS was going to be testifying today, but let

me say this. For this discipline that I have talked about, the discipline involved with investors enacting retribution against Enron and other firms, for it to work, investors must act responsibly. Unfortunately, that is not always the case. The *New York Times* reported on February 5th that while the large California Public Pension Fund, CalPERS, was alerted to the abuses at Enron, in December 2000, 9 months before the company started to announce to write-offs, was alerted to these abuses, executives "did not confront Enron's board," or "publicize its concerns." Instead it continued to profit from dubious partnerships like Jedi.

Instead of concocting new laws, this committee should use its bully pulpit to exhort accountants, corporations, and pension funds to act responsibly. Finally, in times of scandal, emotions run high. And the urge to rush in with legislative remedies is understandable, but it should be resisted. Parts of H.R. 3763 are admirable, but market discipline and current criminal and civil laws provide powerful remedies and protections against another Enron already.

Thank you, Mr. Chairman and Members of the committee.

[The prepared statement of James K. Glassman can be found on page 183 in the appendix.]

Chairman OXLEY. Thank you, Mr. Glassman.

Mr. White.

STATEMENT OF TED WHITE, DIRECTOR OF CORPORATE GOVERNANCE, CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

Mr. WHITE. Thank you. Chairman Oxley, Ranking Member LaFalce, and distinguished Members of the committee, I am Ted White. I am the Director of Corporate Governance for the California Public Employees' Retirement System or CalPERS. On behalf of the CalPERS' board and myself, I would like to thank you for the opportunity to testify today regarding issues that are of such importance to our capital markets.

CalPERS is the largest public pension system in the world, with approximately $155 billion in assets. We represent over 1.2 million members. Over $67 billion of our assets are invested in the U.S. stock market alone.

CalPERS has long been a vocal, leading advocate for effective corporate governance. We strongly believe that as owners of the companies we invest in, shareholders have a right and a duty to attempt to hold management and boards of directors accountable for their performance. The concepts of accountability and transparency have long been recognized as the cornerstones of a successful corporate governance model. Unfortunately, the events of the last few months have demonstrated all too clearly that basic ethics, something that we may have all taken for granted, must also be a concern for today's investors.

With this background, I would like to focus on two key legislative issues, auditor independence and audit industry oversight and several regulatory matters.

CalPERS was pleased to see both Chairman Oxley's bill and Ranking Member LaFalce's bill include provisions on these important topics. Thank you both for recognizing the need for Congress to address these issues.

On the issue of auditor independence, CalPERS believes there is currently a crisis of confidence with the accounting industry. The independence of the auditor must be beyond reproach. Investors must be able to trust when an auditor says the books are accurate, then they are accurate. The Enron/Andersen situation, as well as many others, have prompted this erosion in investor confidence due in large part to the very obvious conflicts that exist when an auditor is simultaneously receiving fees for non-audit work. How can investors trust the discretion that is inherent in audit work while the auditor may be influenced by the desire to keep a well-paying client happy.

We understand that there is much debate over when to draw the line between audit and non-audit services. As one investor, CalPERS believes that there should be a bright line ban on external auditors providing consulting work or internal audit services to audit clients. A firm should be an auditor or a consultant, but never the same for the same client.

CalPERS is also advocating a system of mandatory auditor rotation of company external auditors. We have suggested a 5 to 7-year limit. Although we recognize there is a cost inherent in this proposal, we believe the cost is far outweighed by the benefits, benefits that can bring a fresh perspective and renewed investor confidence in the industry.

I would note for your reference that CalPERS is mandatorily required to rotate its auditor every 5 years. And while this is not easy for a financial institution of our size and complexity, we do it nonetheless.

Turning to the oversight of the accounting industry, we again applaud the efforts of this committee, SEC Chairman Pitt, and President Bush for identifying the need to strengthen the oversight of auditors and accountants. We believe it is time to update the oversight of this industry.

To achieve a goal of rebuilding the market's confidence, we must create an effective oversight body. To be effective, we believe that the oversight body should be created with the following principles in mind. It must represent the interests of end-users. The governing body should be dominated by independent public members. It should have a stable and independent funding source. It should have the power to effectively oversee the industry, which means conduct investigations and discipline. And it must have standard setting capability. We also believe that while the SEC should oversee this new entity, the creation, its charter, and its scope of authority at a minimum must be established by Congress.

We recognize that the current forms of the Oxley bill, as well as the LaFalce bill, contains several elements that are consistent with CalPERS existing reform package and we appreciate that you are addressing these issues. For example, requirements on auditor independence, mandatory auditor rotation, revolving door provisions, requirements that the auditor be hired by the auditor committee, provisions related to director independence, and the creation of the oversight body with a secure funding service, investigative and disciplinary power, and the ability to set standards.

Finally, CalPERS would like to express our strong desire that pay parity for the SEC staff be fully funded by Congress this year.

In conclusion, CalPERS is pleased that the Members of this committee are taking such a thoughtful and constructive approach to addressing the financial reporting issues stemming from the Enron collapse. We believe Congress must play an important role in helping restore investor confidence by improving auditor independence, enhancing accounting industry oversight, providing regulators with the power and resources to effectively regulate the industries, and encourage interested market participants to assist them when practical.

Thank you. And I would be pleased to answer any questions.

[The prepared statement of Ted White can be found on page 226 in the appendix.]

Chairman OXLEY. Thank you, Mr. White and thanks to all of our panel.

Let me begin by asking Mr. Lackritz, and this was also mentioned by Mr. Glassman, there have been media reports and sources from the trial bar that the Securities Litigation Reform Act of 1995 has reduced the number of shareholders' suits or the average settlement amount. Would you care to comment on the numbers as they are reflected today after passage of that Act?

Mr. LACKRITZ. Yes, I would be happy to, Mr. Chairman. In fact, the number of lawsuits that have been filed in the 4 years since the Act became effective have actually gone up, and gone up proportionately, to the number of suits that were filed actually before the Act was passed. And in addition the average settlement amount has actually gone up, so that indicates that the quality of the lawsuits that have been filed have probably improved significantly. And the purpose of the Act, which is to deter abusive practices by lawyers that didn't have any clients, is being served quite well. And I think that the examples that Jim Glassman cited are further evidence that the law is actually working very much as it was intended to work.

Chairman OXLEY. Thank you. Mr. Glassman, you had indicated even that you would have perhaps gone further in the pursuit of limiting those frivolous lawsuits. Is that correct?

Mr. GLASSMAN. Yes, sir. I think that when you talk to people in Silicon Valley today, these lawsuits, the threat of these lawsuits is hanging over their heads. The notion that just because the stock price has declined, somebody did something wrong, which by the way is the wrong signal always to send to investors, they have to understand that stock prices do decline and they need to protect themselves against that, I think in part has put a chill on that industry and distracted many of its executives. And it is not a good thing. But certainly when companies like Cendant do the things that Cendant has done, they ought to be punished for it in the courts and perhaps in criminal activities.

Chairman OXLEY. I thought your comments were most appropriate. And I am speaking now to Mr. Glassman, particularly in view of Chairman Greenspan's comments that the markets have a remarkable way of making corrections, punishing wrongdoers and the like. One of the biggest fears that I have frankly, and it was expressed by you and Mr. Melancon, at least obliquely, is what would be worst, doing nothing, that is the Congress, or overreacting and passing overly restrictive legislation? I obviously know

your answer, Mr. Glassman. Let me ask Mr. Melancon what his perception of that is?

Mr. MELANCON. Mr. Chairman, I would certainly agree with you that in effect Congress has done something through its bully pulpit, through these hearings, and a whole host of others that have caused changes to occur, due diligence to occur, a greater awareness by everybody involved in the process. And that is a positive thing and that is an indication, as Mr. Glassman has said, of the marketplace's unique capabilities in our economy to be responsive.

With that as a basis, if you are asking me specifically on would it be better to have far-reaching unintended consequences through legislation or no legislation, I think our economy would be better served because it has responded to your activities and others with the more restrained approach because the unintended consequences could be extraordinarily negative.

Chairman OXLEY. One of the things you learn after being around here awhile is that sometimes laws are forever, or at least seemingly so. It took us 70 years to repeal Glass-Steagle and some of us have the wounds to prove it. That is, when the Congress enacts even bad legislation, it tends to take us a long time for it to correct. And clearly the intent of our legislation was to provide a broad framework for corrective action, but essentially to allow the regulators and to allow the market to work this out.

Mr. Greenspan even indicated that he thought, even at this early going, that 50 percent of the problems inherent with the Enron debacle have already been dealt with. And in my discussions with CEOs from various industries, it also leads me to think that that is happening. Clearly, the actions taken by a number of boards recently regarding Andersen, by Andersen hiring Paul Volcker, by Volcker's announcement just recently, all would indicate that there is a heightened awareness of corporate responsibility. There is heightened awareness of auditor independence and their need to provide an accurate and fair audit.

And there is indeed, obviously, the need with the changes taking place in technology for virtually instantaneous information to be placed before the investing public. Mr. Glassman, for example, thought 2 days was perhaps too slow, that it ought to be instantaneous, maybe we ought to look at that. Maybe there are some other issues that can be brought up. But, I have to say the more I discuss these issues with people in the private sector, the more I am convinced that we have to tread very carefully in this arena.

I thank you, and my time is just about up. Let me recognize my good friend from New York, Mr. LaFalce.

Mr. LAFALCE. Thank you, Mr. Chairman. And of course we must always act deliberately and carefully, but we must act. And we must not act with timidity. And we must act in the public interest as opposed to listening primarily to the voices of the private special interests. Discerning the difference between the two is often difficult.

I am struck by a number of comments that have been made. Mr. Lackritz praised the 1995, 1998 legislation, saying that number one, lawsuits have gone up. Number two, settlement dollar amounts have gone up. Number three, the quality of the lawsuit has gone up. And that the intention of the Congress has worked.

I didn't know that the intention of the Congress was to increase the number of lawsuits, increase the settlements. Some people said it was indeed to the contrary. Some people who authored the legislation of 1995, 1998 may actually have wanted to see the number of lawsuits gone down, may have actually wanted to see the settlement figures go down. But that is I supposed historical perspective.

There has also been quite a bit of talk too about the markets will punish the wrongdoers. The markets will make corrections. Well, there is a certain amount of truth in that. But to what extent will the markets, number one, obtain redress for the victims of wrongdoing. And, number two, to what extent will the working of the marketplace in and of itself prevent future difficulties, future earnings manipulations?

That is where I think that you do need—in order to make the market work, you do need a good system of laws and a good system of regulation. That is the whole concept of law and regulation, to make the market work. We have a good public capital market, the public can invest on it. But I don't think we can rely on the concept of buyer beware, which is if I were to summarize Mr. Glassman's testimony in two words, which would be very unfair, Mr. Glassman, because you were thousands of times more nuanced than that, but basically it sounds to me as if you are saying, "Let the buyer beware." And we have to go beyond that. Now how far beyond that, we need to discuss and debate.

Clearly, the accounting industry has come in with its own proposals. Clearly, there have been countless recommendations from corporate America for corporate governance changes. Clearly, the securities industry, the regulator, the NASD, has come in with some changes. They are good as far as they go. Other major securities firms have gone even further, and maybe that is the best practice and maybe we should codify the best practice. This is what we certainly need to debate.

But I don't think it is good to just put our head in the sand and say the marketplace is going to take care of it and to warn us all about overreacting. I have not seen too many individuals so far who have been overreacting. And I don't think when the comptroller for the State of New York, for example, calls for mandatory rotation, when the former controller of the city of New York calls for mandatory rotation, when one of the former chairmen, at least one, of the SEC calls for that concept, that is something that should be considered seriously. When the Chairman of the Capital Markets Subcommittee does not call for mandatory rotation, but calls for at least a consideration of the concept of the exchanges being responsible for the determination of the auditors, that is something that merits very, very serious consideration.

And I look forward to working with the Chairman, maybe his idea is better. It ought to be on the table. When CalPERS can rotate its auditors every 5 years, that shows it can be done. When companies fire one auditor and hire another, as they have been doing the past several weeks, it shows it can be done. And it is done hopefully to improve things. It is done for a whole slew of reasons even though they may have been satisfied with the auditing, they think it is necessary to restore investor confidence, which is a good value in and of itself too that should be weighed along with

whatever learning difficulties there might be. So if we have problems, learning difficulties, whether it is a new Congressman, whether it is a new chief of staff, and so forth, that goes with the territory, but it should not create a paralysis on our part.

I thank the Chair.

Chairman OXLEY. The gentleman's time has expired.

The gentleman from Louisiana, Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman.

Mr. White, in reviewing your testimony, I found it very helpful in this sense, that you obviously manage a system that is financially significant, with a significant responsibility for a large number of people's retirement futures. In your remarks you talk about the adequacy of the audit committee construction and point out that having only one member possess financial literacy skills is not sufficient. I agree with you and think that the provision in the underlying legislation that allows for public members to be part of the regulatory body is an advisable thing, but only if we can assure that the appointment of these individuals to this incredibly important responsibility have financial literacy as an asset. I think it goes beyond the ability just to read the financial statement itself. I think it creates an environment where there is much more likely to be independence in making judgments because you then understand what the facts are saying.

And that really gets to one of the principal concerns I have about whatever system we adopt, to what extent is there assurance that when the auditor is within the structure, doing the work that is required at the direction of the audit committee, the audit team has to engage with management to understand what is going on almost always. Based on Mr. Melancon's comment that fraud is most likely to occur when an auditor is new to the business structure.

At the same time, I don't know on how many occasions that the audit team is asked by the audit committee has management asked you to modify, alter, change, in any way indicate that the financial report you are presenting to us was inaccurate and have a responsibility for that auditor to disclose what relationships may have occurred with management beyond the normal due diligence required to prepare the financials?

Is that a customary practice in your view?

Mr. WHITE. That is a good question. First, your opening comments about the applicability of how we feel about the role of the audit committee and the expertise there and the expertise needed on the oversight body I think are excellent points. What we would stress on the oversight body is that the independence of those members is of extreme importance, along side with their expertise and that they will obviously hire audit staff that would carry out the reviews and you would need a greater level of expertise at that level.

Your question about the role of the audit committee, it would be our strong desire that chairmen of audit committees and audit committee members would hold the audit firm's feet to the fire on exactly those issues. I have no statistics to represent to you how often that happens. In my conversations with audit committees and audit committee chairmen, I think it is a mixed bag of how well they fill that role. One of the things that we have learned out of

this is we are going to put additional pressure on audit committees to do exactly the types of things that you mentioned right there. It is one of the reasons that we want the audit committee to have the absolute responsibility to hire and fire the auditors and to approve any non-audit services, whether there be a ban or come from another angle.

Mr. BAKER. Thank you. Mr. Glassman, I always respect your defense of free enterprise and generally are right there with you on most of these observations. One point that I think needs to be made in the current environment though is that short-term earnings pressures on corporate management are enormous. And if you don't beat the street numbers by a little, something is wrong. And if you invest for the long-term profitability of a corporation's life at the expense of the short-term quarterly report, you enter that category called fired.

I think we need to incentivize in some method a way for management to look to the long term, not to the short-term quarterly report. One of the ideas was to indicate where a no-cost option is exercised by an executive and through manipulations of reports helps to bump the stock price up, either by whisper numbers or whatever is out there that can be done accordingly. And subsequent, in some time period, 3, 4, 5, 6 months, there is a restatement of earnings. Today, the individual profits greatly while the shareholders take the hit for that write-down of value.

Is there any kind of scenario, if it is a no-cost option, give back of profits in that environment, is there anything we can do to lock down and incentivize executives to return to the old fashioned way of making product?

Mr. GLASSMAN. I agree that that is a big problem. And I know that Chairman Greenspan said the same thing. I believe, and I say this in my written testimony, that one step that can be taken is, in fact, to expense options immediately, the majority of options. I know that is a controversial issue. I know that there are especially technology companies that say this would be terrible for them. I don't believe that. I understand their concerns. But I think that would go a long way toward addressing exactly what you are talking about. In other words, there is no reason why there should not be a level playing field between options and cash compensation so that companies are making economic decisions about how compensation should be awarded to executives. And I think that that is a step that I would take.

Chairman OXLEY. The gentleman's time has expired.

The gentleman from Vermont, Mr. Sanders.

Mr. SANDERS. Thank you, Mr. Chairman. The issue that we are discussing is really not very complicated. And the issue is if somebody invests in the stock market or Mr. White helps invest billions and billions of dollars representing workers in the stock market, do they have a right to know that the financial reports that they are reading, talking about the conditions of the company are accurate and who is going to help us determine that. That is the issue.

I think the evidence is pretty clear that we cannot simply trust the industry or the accountants under the present scenario to provide us with that information.

I would like to ask Mr. Melancon a question. Mr. Melancon, while the AICPA has the power to discipline auditing firms and their employees for ethical and legal infractions, my understanding or my observation is that it does not seem to be doing that job. Now I read a little while ago 10 instances of where the top five auditing firms screwed up. Can you tell me the kind of punishment that your organization levied on any of them? You said in your report, as I understand it, we have zero tolerance for those who break the rules. Now tell the American people exactly how you have sanctioned Arthur Andersen and the other companies for repeated violations of the rules, and, in fact, in situations where they were sued for huge sums of money and, in fact, even fined by the SEC. Now tell us what the self-governing regulatory body did in terms of sanctions to those companies?

Mr. MELANCON. Congressman, we discipline hundreds of CPAs each year. In addition to that, I think as you talk about moving to different types of bodies, there are obviously issues of individual due process rights that come into play. And clearly we have supported an enhancement to the disciplinary process that has been talked about because there are some weaknesses in private sector bodies being able to discipline primarily concerns in the liability areas, and so forth.

However——

Mr. SANDERS. Excuse me, Mr. Melancon, may I ask you this. In the last 25 years, has your public oversight board once sanctioned a major accounting firm, one time in the last 25 years?

Mr. MELANCON. The public oversight board oversees peer reviews. There have been firms in the top 20 firms in this country that have gotten modified reports, yes.

Mr. SANDERS. In the top five?

Mr. MELANCON. The firms in the top five have had——

Mr. SANDERS. Who account for a huge amount of the volume.

Mr. MELANCON. There have been individuals that have been sanctioned in the Big Five, yes, sir.

Mr. SANDERS. In the last 25 years?

Mr. MELANCON. Yes, sir.

Mr. SANDERS. Can you tell me who they are?

Mr. MELANCON. I cannot tell you who they are right now. We will be glad to provide you that information.

Mr. SANDERS. My understanding, and I stand to be corrected, is that, in fact, in the last 25 years of existence your supposed regulatory board has never once sanctioned a major accounting firm.

Mr. MELANCON. There has been disciplinary action against members of the Big Five absolutely in that 25-year period. And in addition to that, Congressman, we have a system that——

Mr. SANDERS. Can you describe what—my understanding of that may mean retraining of auditors. Fines? How much have they been fined?

Mr. MELANCON. We do not have the power to fine, Congressman.

Mr. SANDERS. You don't have the power. What do you do, do you re-train? Do you slap them on the wrist? Do you give them a talking to? What do you do?

Mr. MELANCON. We publicly, in an egregious situation, they are publicly dismissed from the AICPA, which would——

Mr. SANDERS. Any of the Big Five publicly dismissed from the AICPA?

Mr. MELANCON. Individual members have been, yes, sir.

Mr. SANDERS. Top members? Mr. Chairman, I would say——

Mr. MELANCON. Partners have, yes.

Mr. SANDERS. Mr. Chairman, I would say that here is a situation, some people talk let the industry regulate itself. You don't need Government to play a role to protect investors or pension funds. I would give an example, I would just simply say that the record is fairly clear that the self-established regulatory group, the AICPA, has not done the job that is necessary. And in fact, whether we like it or not, the Government is going to have to play a much stronger role to protect American investors.

I yield back, Mr. Chairman.

Chairman OXLEY. The gentleman yields back.

The gentlelady from New Jersey, Mrs. Roukema.

Mrs. ROUKEMA. Thank you, Mr. Chairman. I, unfortunately, did not hear all your testimony, but I have reviewed some of it. And I do have a question for Mr. Lackritz. If I understand his testimony, I believe he said, "We believe that as part of the effort to improve disclosure, it would be beneficial to look at the earnings estimates that firms release."

Could you elaborate a little bit more and with more specificity with respect to how this proposed legislation would deal with that issue?

Mr. LACKRITZ. Sure, I would be happy to. The issue here is how to improve the quality of the information in the marketplace. And while the legislation for example would accelerate reporting requirements that are necessary under SEC regulation, the really relevant and important reporting comes with the earnings releases that happen about 21 days after the end of the quarter, not statements to regulators. What we were suggesting was that there might be a means of suggesting a best practices for releasing earnings estimates into the marketplace that would provide a common set of practices for firms to follow in addition to the regulatory requirements.

Mrs. ROUKEMA. Well, does this legislation adequately deal with that subject or how would you suggest that we would refine it and close any potential loophole there?

Mr. LACKRITZ. We were suggesting that it might go further than it did and that is why the suggestion was in there.

Mrs. ROUKEMA. Well, if you have anything more that you would contribute with a specific proposal as to how we would do that, I would be more than happy to accommodate you and work with you.

Mr. LACKRITZ. Great.

Mrs. ROUKEMA. In defining that. And I must say that I do look to the SEC for leadership here.

I thank the Chairman.

Chairman OXLEY. The gentlelady's time has expired.

The gentleman from Washington, Mr. Inslee.

Mr. INSLEE. Thank you, Mr. Chair. From my neck of the woods, the CPAs are people of integrity and the people I know have acted very professional. And yet since the Enron collapse, when I have been thinking about how the accounting industry is structured,

where you essentially have one team paying the referee and the referee being able to go to work for one of the teams afterwards at a good salary, and the referee being sort of working in tandem with just one team like the Harlem Globetrotters for 30 years, it is really amazing to me that we have done as well as we can. So this has been a real eye-opener for me in the Enron situation.

And one thing I think that many of us are considering are how to gain the independence that we need from auditors while not having unnecessary dysfunctions in their services, and that is what I think all of us are looking for.

Mr. Melancon, I was really struck by your testimony. I read your testimony. I don't know if you said this verbally, but you had something that really caught my eye. You said that, "Lower paid, less skilled accountants may staff audit-only firms, harming the ability of lead audit partners to go toe to toe with the modern corporate financial executive."

And the reason it struck me is that what I think you posited there is that we need auditors who can go toe to toe with their clients, if you will, which is a difficult thing to do when the client is paying you to go toe to toe with the client. But we need, because we are unwilling to have the market pay for the auditing services, we are all sort of agreed that we are going to continue the situation where the client pays the service, and that has obvious huge problems for an auditor to go toe to toe with the guy who is paying him. And it seems to me we need to look for ways to reduce the disinclination to go toe to toe like that.

Now in your testimony you told us that some auditing firms now have rules about rotation of lead auditors internally, that that is a rule. And I assume if you rotate a lead auditor, you would have the same difficulty of getting up the knowledge bank as you would if we imposed this rotational requirement. I just wondered should we look at those differently somehow, if internally companies impose the rotational requirement for their lead auditors, it is a much greater problem to have a rotational requirement for the firm itself. And don't exactly the same reasons to impose a rotational requirement for lead auditor, shouldn't those same reasons exist for a firm in itself?

Mr. MELANCON. Congressman, the requirement for rotating a lead auditor is a profession-wide requirement. It is not a company requirement. It is, in fact, a requirement that we have put on the profession.

And on your sort of dilemma issue that you raised, that is why the audit committee is particularly important in the process, because the audit committee is the buffer if you will in that environment that you described in the pay.

When you look at an audit engagement, there is a team of people, these are multi-national companies in large part today, there are literally hundreds and hundreds of people involved in learning curves and understanding the business complexities. To rotate that whole team of people actually creates a greater risk from an audit quality perspective. The fact of the matter is is that by changing the lead partner, which is a requirement again as I said of the firm, of the profession, we are trying to have, and through standard setting in the past, have tried to set up a system that approaches

the appropriate balance. And that is really—and you sort of described it and captured that very well, it is the appropriate balance in all of these issues. And so the system that we have in place is we try to extract the best of knowledge of the enterprise, knowledge of the details, so that the quality of auditing is good, with requirements to take some different look from a lead audit perspective.

We also have a series of requirements if, in fact, someone goes to work for an engagement that requires the audit—for a client that the auditor take certain steps.

So it really is all about balance, Congressman.

Mr. INSLEE. So what do you think of this analogy of the referee situation. I think it would be unhealthy if NBA referees had the possibility of going to work for management of one of the teams they are refereeing in, it seems to me that that is an unhealthy situation. But that is the situation we have now for auditors.

And I understand part of your testimony that that decreases the attraction of the profession a little bit, to think that you now are less able if you do the auditing function to go to work with management. But how can we tell our constituents that we have got this increased level of trust in the profession if we continue to allow the referees to go to work for the people they are refereeing the next Monday morning after they finish the audit? Isn't that a major issue here in trust?

Mr. MELANCON. Congressman, there are series of issues associated with that. There are requirements to discuss that issue with the audit committee. There are requirements where a person would go to work for an audit client, if it is during the audit engagement, that the work that that person did to be re-done by someone else. There is a requirement that if, in fact, a person goes to work in an important position in the client, that someone not associated previously with that audit team review the work of that person and review that work to make sure that there is a completely different look and so that there is no, the concerns that you are articulating or the closeness issues that are taken care of from that perspective.

And in addition to that, if a person is a member of an audit team and is even offered employment from—not even if he takes it, but if he is offered employment from a client, he is required to be removed from that audit team.

Chairman OXLEY. The gentleman's time has expired.

Mr. INSLEE. Just one more comment, if I may. I want to thank a lot of your members for helping us. I have been talking to a lot of your members and they have been very good in helping us understand these issues. I just want to pass that on to you.

Thank you.

Mr. MELANCON. Thank you, Congressman.

Chairman OXLEY. The gentle lady from New York, Ms. Kelly.

Mrs. KELLY. Thank you, Mr. Chairman.

Mr. Melancon, could you please tell me—and give me the correct pronunciation of your name?

Mr. MELANCON. It is Melancon. Congressman Baker had it right because we both have those Louisiana ties.

Mrs. KELLY. Thank you very much, Mr. Melancon. I would like to ask you a question. In your testimony, you talk about your oppo-

sition to a cooling off period. We in Congress have one here as do a lot of the Hill staffers. I am curious about why you don't see any conflict of interest for businesses wrongly influencing audits by offering better jobs with the company. You seem to be opposed to that cooling off period. I wonder if you would talk about that a bit.

Mr. MELANCON. Interestingly, Congressman, in the past we have articulated concerns in that particular area as a profession. The Independent Standards Board, which was made up of people, 50 percent who were not associated with the profession at all, spent a lot of time just in the last couple of years focusing on this particular issue. And the conclusion that was reached was that a series of safeguards was the best way to balance that particular environment, some of the safeguards that I just articulated that require discussions with audit committees, that require work that that person was involved with being reviewed by someone else in the firm that didn't have anything to do with that particular person and the audit team to ensure that the work is being done correctly. And the conclusion was reached through a very deliberative process, with public exposure and a tremendous amount of non-profession involvement in the issue that the right answer was, in fact, a series of safeguards to produce the appropriate balance.

The other thing that I just might mention on this particular issue is that the movement of individuals into corporate America, if we look at that history over the last 40 or 50 years, has had a tremendous positive influence on the quality of financial reporting. If we compare corporate America's internal capabilities today versus decades ago, we have a much better situation in this country because of movement that is supported in that area.

But the safeguards are very, very important. And Congressman Baker's questions about audit committees, I think there is an audit committee role when that particular situation does occur to ensure the protection from the shareholder perspective.

Mrs. KELLY. Thank you. I still find it curious that we are held to such strong restrictions here on Capital Hill and the business community doesn't feel any compunction—well, even though you are talking about your safeguards, you feel that you can get around that. I hope it works better than the Chinese Walls that are written into some areas.

I would like to talk to Mr. Glassman a minute. You talked about the fact that you agreed with parts of H.R. 3763, but you think it is too regulatory and it sends the wrong message to the investors. What do you see as the wrong message here? Do you think it is going to hurt the investment for small investors?

Mr. GLASSMAN. First of all, I think there are two points where small investors are concerned. Number one, as I said earlier, I think it adds unnecessary costs when you essentially tell really some of the best corporations in America—there are 8,000, I think that is the most recent number, listed companies on the three major exchanges, certainly there have been abuses by some of them. But the vast majority of excellent companies, companies like IBM, McDonald's, Exxon-Mobil use the same company for audit work and non-audit work, and there is a reason for that. It is the most efficient way to do it. These companies are very well run. They are looking toward efficiency. So you add in cost.

The second thing, and I think this is maybe more important, the signal that Congress has frequently sent to investors, not just in this area, but in some hearings about analysts is that look, if stock prices go down, somebody is at fault. Somebody, some crook is taking your money away. That is not the way the stock market works. In 22 years out of the last 76, the stock market has declined. It goes up. It goes down. What investors need to be told is the market is extremely risky in the short term. You need to hold diversified portfolios. You need to hold them for the long term. And to have them feel that Congress is going to take care of everything, that there is going to be a law that is going to be passed so that this stock is not going to go down anymore, that is just the wrong signal. While, as you said, I do agree that there are some steps that ought to be taken, and I think there are parts of this bill that I admire.

Chairman OXLEY. The gentlelady's time has expired.

The gentleman from North Carolina, Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman. I appreciate your calling this hearing. It has been enlightening and informative. I just had a couple of comments and maybe one or two questions.

I guess we are all kind of seeking a framework to evaluate what has happened, and we all do that from our individual backgrounds and experiences. In my experience of 22 years of practicing law before I came here and working in the trenches beside accountants, representing small businesses, and seeing them do consulting and/or auditing and accounting more than perhaps auditing for those businesses is that there has been a very strong sense of professionalism among both lawyers and accountants. So I have been kind of wrestling on where I come down on this, whether we should be heavy-handed and overreacting or whether we should be letting the market take some of this into account.

It seemed to me that auditors over the years and accountants over the years have had an even greater responsibility to be independent of the people, the companies for which they are doing work even than lawyers. Yet there has always been a very, very strict conflicts of interest set of standards that apply to lawyers in their relationships with clients and others.

I am wondering, Mr. Melancon, I blow it even worse—I think it is spelled wrong on our sheets is the problem.

[Laughter.]

Mr. MELANCON. It is just pronounced wrong.

Mr. WATT. Well, maybe it is pronounced wrong. Well, I certainly just pronounced it wrong.

Do you think that the existing conflicts of interest and/or other rules in place in your profession are strong enough, the existing set that are out there, strong enough to allow consulting and accounting and auditing to peacefully co-exist without any kind of further regulation or do you think there is something that needs to be done to adjust that?

Mr. MELANCON. First off, Congressman, thank you for the kind comments about the members of our profession that you have worked with over the years, and I would agree with your assessment from that standpoint. There are 350,000 members of our pro-

fession, men and women doing the right thing in small businesses and large businesses every day.

Mr. WATT. Don't take too much of my time to brag about them. I gave them as much of my time to do that——

Mr. MELANCON. Thank you, Congressman.

Mr. WATT. As I wanted to.

Mr. MELANCON. I will move to the answer to your question.

The fact of the matter is that there are significant rules in place to protect that environment. We only need to look at the existing situation to understand that if, in fact, a CPA treads on their reputation, that the horrendous results that can occur. And the thing that they have to protect is their reputation. And so there is a more——

Mr. WATT. You know I kind of expected you to say that. I think the thing that I am having trouble reconciling, and I think Mr. Glassman probably pointed it out more than anything else, it is hard for me to be saying that we should let the market control accounting practices at the same time we seem to be ratcheting up our oversight and rules and laws related to the legal profession. And so this whole—I mean, it seems to me that what Mr. Glassman is saying is—and I mean this in the kindest way, not in a negative way—almost duplicitous. That we should be ratcheting up the standards that are at play in the legal profession, but we should be letting the market kind of control what is happening in the accounting profession.

And so if he could just respond to that.

Mr. GLASSMAN. Well, in the first place, I am not aware of any PRO that governs the legal profession. I do think however that conflict of interest is a serious problem. There is no doubt about that. The set-up with CPAs and corporations presents a conflict of interest. The question is how do you constrain it? I think it is very well constrained by the marketplace where investors say if you guys are fooling around, we are not going to invest in this company.

And let me just give you an analogy, because it is a business that I know about and that is journalism. In 1992, according to a survey by The Freedom Foundation, 89 percent of journalists who were the chiefs of their bureaus in Washington voted for Bill Clinton for president, 9 percent voted for George Bush. But I can tell you that 100 percent of those journalists will tell you that they are unbiased, that they put that particular interest aside in their professional lives. And I would say for the majority of them that is true. And they are constrained by the public. That if their bias shows, people are not going to read their newspapers. People are not going to believe them.

Mr. WATT. In drawing a parallel between voting for some Member of Congress or the President and the responsibilities, the professional responsibilities that accountants have to shareholders and businesses, I think that is——

Mr. GLASSMAN. I am saying that professionals in all walks of life are torn by conflicts, as are you. I am sure you have personal interests, but you have also obligations to your constituents. And you are constrained by what your constituents see of your behavior here. Same thing with investors. I don't think we necessarily need rules on rotation. For example, CalPERS can tell companies, "We

are not going to invest in you unless you rotate your auditors." So those are the kinds of—I think those are much more effective constraints.

Chairman OXLEY. The gentleman's time has expired.

The gentlelady from Illinois, Ms. Biggert.

Ms. BIGGERT. Thank you, Mr. Chairman. I am sorry to have missed the testimony, but I still have a couple of questions that I would like to ask.

One of the issues that came up in one of the hearings recently was the fact—there was a discussion of whether audits now always have to be unqualified or whether an auditing firm can give a qualified opinion. I know that in the past they could. But it was stated, I think on the other side of the aisle. I don't know whoever can answer that, I would appreciate it.

Mr. MELANCON. Certainly there can be qualifications to an audit report today. I think that comment was probably related to where there is a qualified opinion, there is any gradation of a qualified opinion. And so I think that was where it is. But there are qualifications available.

Mr. GLASSMAN. Could I just comment on that briefly?

Ms. BIGGERT. Yes.

Mr. GLASSMAN. This is what I was trying to drive at in part of my testimony. I really think that audit firms should be freer to tell people, tell investors in clear English what is going on with a company. For example, I think Andersen could have said, if it believed that these books were sound, that everything here is on the up and up. However, investors should be aware that there are hundreds of special purpose entities out there, that here are the liabilities. That is the obligation of accountants. And I think frankly that they have failed in that obligation. But part of the reason they fail is the structure, the incredibly complicated structure of the GAAP system. In fact, if it were loosened and more judgment were involved, but also more accountability, the system would work better.

Ms. BIGGERT. And I think that that is what I was driving at in asking that question. And it seems that there is—they want to make it appear the best and even if it is qualified, there still isn't any statements on that. So I would agree with you.

The other question I have is talking about real time disclosures. And it is my understanding that when officers now sell stock or purchase—particularly selling their stock, but purchasing, that the newspapers do carry that. And I guess I would ask this of Mr. Glassman.

Mr. GLASSMAN. Yes, the way that the current system works is that smart CEOs who want to conceal their sales can time it in such a way that it doesn't appear for 40 days. And I think there is no reason on earth for that. I think that sales and purchases of stock by insiders are an important market signal that investors should know about. And they should know about it the instant that it occurs. And I think the technology is there for that happen. And it should happen.

Ms. BIGGERT. In the paper, but certainly there has never been any education to the public or to anyone that this is an important item that maybe as an investor they should be watching for.

Mr. GLASSMAN. Well, there are services that provide this information. It can be overrated as an item. There are hundreds or thousands of little items that go into making decisions about investments. And I think that is one of them. It is not dispositive. It doesn't mean that because someone has sold stock as an insider that there is something terrible going on with the company. But that is a piece of information that people should be able to take into account. Right now, frankly, they can't.

Ms. BIGGERT. So you would agree with the bill then, that it should be immediate disclosure?

Mr. GLASSMAN. Right, what I say in my testimony is actually that the disclosure should be faster. The bill allows essentially 2 days for the information to get to the public, I think it should be 2 minutes.

Ms. BIGGERT. And then as far as the restrictions on selling stock, the selling in the blackout period for officers should be the same as the employees, the restrictions?

Mr. GLASSMAN. I agree with the blackout period in the interest of fairness, even though I understand that there is a difference between assets held in the 401K plan and assets held outside the plan by executives. But I think this is a hardship, if you want to call it that, that executives of corporations should endure in the interest of fairness. So, yes, I think there should be a blackout period for them too.

Ms. BIGGERT. OK, thank you. Thank you, Madam Chairwoman.

Mrs. ROUKEMA. I thank you. Now, Mr. Kanjorski.

Mr. KANJORSKI. We seem to be talking around the issue in terms of what transparency and accountability will do.

First and foremost, I will tell you what I am disturbed about. If you look at the Enron situation, it seems that because of the accounting system that was established, there was not a clear disclosure of all of these risky transactions that were happening. Then, we see that the pension fund was heavily invested in its own stock. 401Ks particularly were heavily invested by the employees. But also, when you look across the country, we have the pension funds, throughout the States, the public pension funds and the private pension funds, that were heavily directed to one stock. So the loss factors, it seemed as a result of the Enron collapse, fell upon people who were not in control of their investments. Their investments were basically being made by investment companies on Wall Street. These companies were deriving profits from the transactions on commission basis as opposed to having anything at risk. They had nothing to lose, and they could only gain by the transactions.

As we move toward democratic capitalism, and that is what we are talking about, we have to recognize, I think, a couple of factors. One, a lot of these people do not directly control their investments. They are controlled by "specialists" who reside on Wall Street. Second, they are not the best informed investors in the world. Now, unless we develop a system that guarantees that we are either going to educate our investors, and that is a large mass of new investors, and we are going to give them some capacity to directly control their investments, they are at risk of these people that did not exercise diligence. These people were the 14 out of 15 analysts

that were calling for purchasing Enron's stock up to a week before the collapse. It is ridiculous. All of us are shocked.

Now, it seems to me that the accounting profession and the accounting firm clearly did not follow principles and rules of accounting to account for all these risky transactions on the book. If they did, they wrote it in such a way, in such language, that not even the best Wall Street analyst could penetrate the language to understand the risk. So clearly, if we do not do something there, this is going to continue in the future.

On the other hand, we run the risk of passing legislation very quickly, and then getting the unintended response. I understand we are hell-bent on getting this legislation passed by Memorial Day, which is shocking to me, because I do not think we know the extent of the problem here.

So maybe any one of the four of you can tell us what you think, or tell me what you think this problem really is at this point and whether or not the Congress of the United States is so able, that it should be able to act in 2 or 3 weeks to solve the problem?

Mr. GLASSMAN. Let me respond quickly. I agree with you that this Congress should not be hellbent on finding a solution, because we really do not even know all the facts in this case. They are just not out yet.

But I just want to comment very quickly on one of the things you said that I completely agree with, and I am glad that you brought it up, Congressman, and that is this issue of investor education, which I have devoted a good deal of my professional life to. The fact is that 50 percent of Americans now own stock. It is going to be 60, 70, 80 percent within a few years. And that is good. That is good. However, many of them really do not understand the basics of investing. And I really think that if there is a role, a major role for Congress here is in making sure that investors do have that base in education. Now in most cases they are going to have to trust professionals to make these decisions, these investing decisions for them. And most of the time professionals do a good job, but they do need that base of education.

And that to me is one of the most important factors that has come out of this Enron case, how little people still understand about the basics, such as diversification. That is the way to protect yourself against an Enron.

Mr. KANJORSKI. Yes?

Mr. Lackritz. Mr. Kanjorski, I would like to respond to your question too. I think that it is very important to get this right rather than necessarily getting it fast. That being said, I think there are a number of provisions in this legislation that obviously are going to help to improve the quality of information in the marketplace, and the real issue here is how to improve that quality of information, because that is what everything else stems from.

And then to go on with the other point that Jim Glassman raised with respect to investor education, I think that is something that both the private sector and our association is engaged in in a big way. We are launching an investor education website next month that will draw together the best of class investment advice, objective investment advice, because there is nothing that is being sold

on this site. It is going to be made available throughout the country.

And so I think that along those lines, I think some of the responses we are making go to that question that you have raised as well.

Mr. WHITE. From our organization, I would be the first to say that we do not want to see overreaction either. We are one of the groups with significant assets at risk in the financial markets. We care more about how they work than any other group. But what I would submit to you is that the issues that are on the table and all the current forms of legislation and SEC Chairman Pitt's proposal and President Bush are not at all overreaction. These issues are not brand new. They have been on the table for years. The issue of auditor oversight and the issue of auditor independence are things that have been fully debated in the public.

We are an end-user of this, and we are completely convinced that the measures that are being debated are absolutely essential to the capital markets and to our protection as an investor.

Mr. KANJORSKI. I am not sure I understand. You think we should adopt immediately, before Memorial Day, the Bush solutions and then go home?

Mr. WHITE. No, I am not saying that that should be a deadline. But what I am saying is that the issue of overreaction is one that we just simply do not agree with. These issues are all real. And, yes, let's take the time to debate them and discuss them, but I think the comments toward overreaction are more geared toward slowing down the process so real reform does not take place.

Mr. KANJORSKI. Do you really think that the Congress——

Mrs. ROUKEMA. Excuse me, excuse me. The 5 minutes are up, but will you let the last panelist respond to your first question. I do not think you have time for another question.

Mr. MELANCON. Thank you, ma'am. Just a couple of quick points. I think, Congressman, the overreaction or the unintended consequences is something you should be concerned about, because it has a dire concern to us in the financial market system. As to the education of people, this Congress enacted a tax-free benefit to educating employees on investment advice, which was a good first step in this education activity. And if you had to focus on one thing that was important to changing this whole environment, that is a financial reporting model that is not rooted in the 1930s, but is commensurate with the world that exists today.

Mrs. ROUKEMA. I thank you.

Congressman Shays.

Mr. SHAYS. Thank you, Madam Chairwoman. I would like to ask Mr. White some questions and preface my statement by the fact that in our previous hearings and going over the Powers Report, Enron clearly is a story of a tremendous amount of greed. And no profession looks good. The accountants do not look good. The lawyers do not look good. The analysts do not look good. The bankers do not look good. And the investors do not look good either, particularly even your organization frankly.

And I want to ask you about the special purpose entities and why you invested in them?

Mr. WHITE. First off, I am not the best person at CalPERS to answer those questions. I will gladly answer what I can and if you want further detail, I will be more than happy to respond in writing at a later date.

The two private equity deals that CalPERS did with Enron were fundamentally different in their nature than the partnerships that got Enron ultimately into trouble. And I would note to you that CalPERS declined to invest in those relationships after the fundamentals of the investment proposal changed. Why there is criticism——

Mr. SHAYS. Well, you invested in Jedi One and you invested in Jedi Two. And Jedi Two was basically determined to be somewhat illegal, wasn't it?

Mr. WHITE. I do not believe that is accurate, no.

Mr. SHAYS. Do you have any expertise to be able to respond to us on these issues? What expertise are you bringing here?

Mr. WHITE. My role is—I am the Director of Corporate Governance. The private equity unit in CalPERS is an asset class that is headed by a senior investment officer. And those questions——

Mr. SHAYS. The reason why I thought you were here was that basically you were a major player with Enron. Isn't that true? Didn't you invest almost $300 million in the first one. And almost $500 million in the second?

Mr. WHITE. Correct.

Mr. SHAYS. And what brought Enron down was the fact that these special purpose entities were basically hiding their liabilities and over-inflating their income. Isn't that true?

Mr. WHITE. Well, the two partnerships that CalPERS invested in, number one, did not have the conflicts of interest that the later partnerships, which CalPERS did not invest in had. There is a fundamental difference in that. Our organization was not interested in participating in those, because we did not like——

Mr. SHAYS. Were you an investor in the company besides having these special purpose entities?

Mr. WHITE. Correct. We hold common stock in Enron as well as——

Mr. SHAYS. So you had common stock and yet you were part of an operation, all these special purpose entities basically enabled the company to get into the fix they were in. And when they had to disclose Jedi Two, they basically were disclosing a tremendous amount of liabilities that nobody knew. That is what basically brought the company down. And that was your investment.

Mr. Glassman, do you have any comment on this?

Mr. GLASSMAN. Yes, because I think actually the worst thing that CalPERS did, which the *New York Times* revealed on February 5th, and I mentioned in my oral statement, is that when it was alerted about the nature of another one of these special purpose entities by its advisors in December 2000, it declined to invest in it. As Mr. White said, it did decline. But then it did not live up to what I think is its moral and public responsibility to bring the matter before the board of Enron. And more important I think what I would have done at CalPERS, I would have brought it to the attention of the American investing public.

Mr. SHAYS. Let me ask why——

Mr. GLASSMAN. And if that had been done, we may have learned about this whole Enron situation at least 9 months before we ended up learning about it.

Mr. SHAYS. Why wasn't that done, Mr. White?

Mr. WHITE. Again, personally I was not even on staff at the time that that happened. But while it is true CalPERS is a leading governance organization, and we pride ourselves on being an active, involved owner, we cannot read the tea leaves. We do not have a crystal ball. While there may have been a conflict at Enron, it was impossible for anybody to forecast that those conflicts would mushroom into the types of relationships and become what is apparently fraud at Enron.

Mr. SHAYS. See, I have a different theory and unfortunately, you are not—you are saying you are not capable of answering. My theory is that basically you were making such a great return on the first 22 percent and then you were making 62 percent on an annualized basis, that you all basically were part of the problem like everyone else. You were part of the whole thing on greed. It would seem to me that anyone who is making 62 percent says, "Hey, why is this happening?" And when they start to ask the questions, they learn. In your case, you learned and then your organization remained silent.

Mr. WHITE. No, sir, our organization did not invest. The types of returns that we made on the partnerships——

Mr. SHAYS. Did you invest in Jedi two?

Mr. WHITE. Correct.

Mr. SHAYS. Isn't it true that you had an annualized gain through June of 2001 of 62 percent?

Mr. WHITE. I believe that is accurate.

Mr. SHAYS. OK. I mean, when you are getting that kind of return, it should tell you a lot of things. And one of the things it tells you is maybe this is not happening in a way that is credible.

Mr. WHITE. Well, if I may respond? If your theory about our decisions were driven only by greed were correct, then those returns would have led us to invest in the next partnerships, yet we did not.

Mr. SHAYS. No, I think by then people were aware of what was going on. I think by then people knew that this was a house of cards that was about to collapse.

Mr. WHITE. I think to the contrary, Enron was only beginning to form all of the partnerships that had the terrible conflicts of interest that led to the problems, at that point in time. You remember this 1996, 1997 era. So at that point in time, Enron was not even forming those partnerships.

Mr. SHAYS. My time is up.

Mrs. ROUKEMA. All right, thank you.

Mr. Sherman.

Mr. SHERMAN. Thank you, Madam Chairwoman. I am glad we are doing something, hopefully not by Easter, but by the Fourth of July. And what we should do is not mere window dressing. We cannot just use the bully pulpit of this committee to urge Wall Street to all join hands and sing Kumbayah or community values are better than greed. Nor can we scream, "Caveat Emptor" at the investing public.

I hope very much that we do not introduce "judgment" into Generally Accepted Accounting Principles to the point where two identical companies will be issuing wildly different financial statements based on the different styles of the auditors that they select, nor can we analogize the conflicts of interest faced by an auditor, by that faced by a journalist who might happen to vote for Al Gore. The difference between the local journalist on the one hand and David Duncan of Arthur Andersen on the other is $52 million. Now if there was any journalist getting $52 million for himself or his publication, then perhaps that would be an equivalent conflict of interest.

I hope that if we rotate, we will also look at providing tenure to auditors. Otherwise if you have a chance of being the auditor for 8 years, but you can get fired after 1, then perhaps Ken Lay will be able to convince you to go a little easy on which special purpose entities you consolidate.

Mr. Melancon.

Mr. MELANCON. Melancon.

Mr. SHERMAN. Melancon. On the wall of my office is the AICPA certificate. I hope our colleagues recognize that you are a voluntary organization like the ABA. Many CPAs choose not to pay you dues. The worst you could do to a CPA is throw him out and then he saves the dues. Really the worst you can do though is publish rules that if we violate, some lawyer can sue us. And it is your rulemaking, not your ability to discipline members who after all do not really want to pay your dues anyway that is key.

I think you are wise to bring up the fact that we need not only untainted judgment, which is the focus of these hearings, but smart investigators. And those two are in conflict. A smart investigator would love to be involved in the internal auditing because he would learn more about the company or the accountants would learn more about the company. But then they would get a fee which might taint their judgment. Likewise, rotation may reduce the tainted judgment, but might prevent the audit from being as effective as it would be because you are in a learning curve the first year of an audit. So I would hope that we would make sure that auditors remain good investigators as well as do everything we can to prevent them from having tainted judgment.

I would like to focus on one area where I think the AICPA——

Mrs. ROUKEMA. Excuse me, Mr. Sherman. I do not know that you realize that a vote has been called. So do you want to continue this or do you want to recess—do the two votes on the floor and then return because your time is almost out?

Mr. SHERMAN. Why don't I continue and then we can go vote.

Mrs. ROUKEMA. Go ahead.

Mr. SHERMAN. The one area where I think the AICPA screwed up is in allowing Arthur Andersen to adopt a structure where the technical review department did not have final authority over whether Arthur Andersen signed the financial statements. And that is like having a situation where the life insurance agent decides whether to insure me for $10 million despite a little heart flutter rather than the underwriter back at the home office. What we I would hope, and I would like to know if you are planning to do this soon, adopt an ethics rule that every member of the AICPA

must vote within their firm to demand that it is the technical review department that makes the decision as to whether to sign the audited financial statement. Otherwise we are going to be in a situation where the guy whose chief job is to go golfing with Ken Lay is the guy that makes all the decisions as to whether Arthur Andersen's name appears at the bottom of the audit report.

I would like you to respond.

Mr. MELANCON. Congressman, first off, I appreciate the fact that you have the AICPA certificate. And I understand your point on that control issue. And I think it is one that is very important for us to take a look at. It would be in the issue of quality control. It would be in the standards in the SEC PS just from a technical standpoint. And I am sure that we will, in fact, take a look at that.

Mr. SHERMAN. Well, I am sure you are going to look at it. I hope that you will call me a month from today and tell me that you have decided to change what is a glaring hole in the ethics rules that you have control over.

Mr. MELANCON. Thank you, Congressman. I would also say, I would agree with you on the issue of discipline and that is why we have supported, as I think you have, the notion of an enhanced capability of discipline that actually is beyond the way you described it from that standpoint.

Mrs. ROUKEMA. I think we are going to have to recess now because the bells have rung. I would just ask the Members to please return promptly so that we can continue and conclude with this panel.

Pardon me?

Mrs. MALONEY. Can you tell me who the next questioner is, please?

Mrs. ROUKEMA. Dr. Weldon on our side and you will follow that.

Mrs. MALONEY. Very good, I will rush.

Mrs. ROUKEMA. You are the second one after the recess. All right, we will be back shortly.

[Recess.]

Chairman OXLEY. [Presiding] Come to order. And the Chair would recognize the gentleman from New York, Mr. Grucci.

Mr. GRUCCI. Thank you, Mr. Chairman. At the risk of destroying your name once more, would it be OK if I called you Barry?

Mr. MELANCON. That would be great, Congressman.

Mr. GRUCCI. Thank you for that. You had in your testimony earlier talked about the ability of industry to self-police itself. And I concur that industry can do a good job of doing that. And you talked about some of the issues that took place, some notices in files and people being expelled, and so forth. If I was a business and I wanted to know about an accounting firm that I was thinking about putting on to give me the types of information and look over my books, and contacted your operation, if indeed there was a sanction against them, would I be able to access that information?

Mr. MELANCON. You would be able to access the results of their peer review report and discipline is typically on an individual basis, however, Congressman.

But it is important to make one point on this that I didn't get to make on the other, and it is along the lines of your questioning. One of the advantages that we have—and we support enhanced

discipline and an enhanced regulatory body for discipline. So we are not opposed to that. But one of the advantages that we have is that if a auditor, a partner, a public company auditor is alleged to have done something wrong, we do not have to—by rule we do not wait until the culmination of the investigation. We can require the firm, and we do today, require the firm to take that person off of audits. They have a choice. They can take the person off audits. They can fire the person. Or they can build an infrastructure around the person to protect the public in effect without going through the whole due process system that would be in a normal Government environment. That is a public protection point. It is an advantage that we have. Now we have some disadvantages as well.

Mr. GRUCCI. But, I guess what I am trying to get to is that I would be able to determine as a business owner that a firm that I was thinking about hiring indeed had some issues that were being addressed by a peer review board of some sort. What kind of an effect do you think that that would have?

Mr. MELANCON. You could get their peer review report and something called their letter of comments, which is sort of like management suggestions and you could have dialogue with the firm as to what are they doing to fix those letter of comments, if they have any, and you could reach a conclusion from that standpoint. All 45,000 firms in the country go through a peer review.

Mr. GRUCCI. And I would suspect that they don't look forward to those types of peer reviews because it could have a chilling effect on their business?

Mr. MELANCON. Congressman, firms, first off, invest millions and millions and millions of dollars in their systems of quality control to avoid failing that process, which is a part of the constant improving process that is in place in our profession, because failing that process is like putting a gun to your head.

Mr. GRUCCI. Thank you. I would like to move to Mr. White if I may. You represented a pension fund that has $150 billion, and I don't know how much of it was invested in any single company. I do not wish to drag up the Enron issue. But what I do wish to ask you is when you are about to invest parts of your pension fund in either a company or in a construction project or whatever you may be investing in for the purposes of getting a return back for the retirees. What process do you go through to make that determination? When I make an investment, basically because it is such a small investment on my part, it is a gut hunch. Do I think that investment is going to do well or not? I would think that you would do more than just a gut hunch when you put millions upon millions of dollars of retirees' pensions at risk. Could you bring me through the process that leads you to your investment decisions?

Mr. WHITE. Certainly. The bulk of our assets, approximately two-thirds, are invested through what we call an index strategy, it is a passive strategy. You will find that many large institutions use that because it is a cost-effective way for us to get equity exposure to the market. We also invest through active strategies through both internal programs and through external programs. We also have private equity partnerships. We also have a real estate program. You will see a huge distinction between how institutional investors put money out on an index strategy versus an active strat-

egy. For the index, if companies are included in the index, by and large we are going to hold them.

Mr. GRUCCI. Let me try asking this another way, because I am not sure I made myself clear to you. When you invest the money, is there a criteria that you go through? Is there a checklist that you go down? Is there some kind of thought process other than, yes, I know that project, it sounds like a good one. I think I will put some money in building a shopping center or building offices or investing into a corporation. What do you do to ensure in your own minds that you have made the right decision in investing in that product?

Mr. WHITE. OK, let me just get to the distinction quicker then. Through our active strategies, we do a high level of due diligence, that includes the real estate program. It includes the private equity program. And it includes the active investments on the public market side. Our external managers that operate on our behalf, as well as our internal managers, do due diligence on company specific. This is fundamental research on the things that you are asking about, whether or not we feel that a company is under valued or overvalued.

On the index strategy, again which is the bulk of our assets, we are buying the market index. It is an efficient way to get exposure to the markets. But what it does is it gives us companies in our portfolios that you may not pick through an active strategy, companies that are weak. It is one of the reasons that CalPERS has such an active corporate governance program, is because our size necessitates that we have broad equity exposure. We simply could not in a cost-effective way make active decisions for a portfolio of our size.

Mr. GRUCCI. Thank you and I assume my time has expired. Thank you, Mr. Chairman.

Chairman OXLEY. Thank you, Mr. Grucci.

Mrs. Jones.

Mrs. JONES. Thank you, Mr. Chairman. When you are doing, Mr. White, your active strategy, what do you use—let me be just real straight. You rely on an audit to make your decision about a company, whether you are going to invest in them, don't you, sir?

Mr. WHITE. Yes, ma'am, we do.

Mrs. JONES. Thank you. Let me turn to Mr. Glassman. Mr. Glassman, tell me what is the American Enterprise Institute, sir?

Mr. GLASSMAN. The American Enterprise Institute is a think-tank started about 50 or 60 years ago. They have 150 people who work there. A think-tank is——

Mrs. JONES. I know what a think-tank is.

Mr. GLASSMAN. OK.

Mrs. JONES. Thanks. Mr. Glassman, what is your area of specialty at the Enterprise Institute?

Mr. GLASSMAN. Economics, finance, markets, although I have wide-ranging interests, including education and health care as well.

Mrs. JONES. OK, but you are here based on your economics and finance background today, is that correct?

Mr. GLASSMAN. I think I am mainly here because I have for many years written a column about investing that is syndicated, it is in *The Washington Post*.

Mrs. JONES. Simple answer, Mr. Glassman, you are here because of your background or experience in this area. I only have 5 minutes. I can't give you a chance to do all you would like to do.

Mr. GLASSMAN. Yes, yes.

Mrs. JONES. OK, now, would you say that as a result of the regulations of the SEC that accountants have a place in the process of investment that few other professionals have?

Mr. GLASSMAN. Yes.

Mrs. JONES. And as result of that, that puts a greater burden upon auditors to be highly ethical in their conduct and forthcoming in the work that they do on behalf of companies. Is that a fair statement?

Mr. GLASSMAN. I think it puts a great burden on them, greater than corporate executives.

Mrs. JONES. Well, let me finish. Greater than any other profession that is not required by the SEC?

Mr. GLASSMAN. Quite frankly, I think corporate executive boards of directors have enormous responsibility.

Mrs. JONES. I was not talking—listen to my question.

Mr. GLASSMAN. Probably greater than accountants.

Mrs. JONES. Mr. Glassman, listen, my question was with regard to accountant——

Mr. GLASSMAN. Right.

Mrs. JONES. Professionals dealing with companies, they have an unusual placement by the SEC, greater than any other professional, I mean a lawyer, I am not talking about the people in the business. I am talking about professionals that are hired by the company. You don't have to have——

Mr. GLASSMAN. I don't necessarily agree with that, but there certainly is a great burden.

Mrs. JONES. Well, let me ask you this question. You don't have to have a lawyer to allow people to invest in your company, do you, sir?

Mr. GLASSMAN. I think it would be a good—I can't imagine——

Mrs. JONES. I didn't say whether it is a good idea, but you are not required by the SEC to have a lawyer?

Mr. GLASSMAN. I guess not.

Mrs. JONES. And you are not required to have a doctor?

Mr. GLASSMAN. No.

Mrs. JONES. And you are not required to have a psychologist?

Mr. GLASSMAN. Right.

Mrs. JONES. But you are required to have an accountant who is to do the audit. Is that a fair statement?

Mr. GLASSMAN. Correct.

Mrs. JONES. I say that to get to the point that you are saying that we ought to allow the industry to regulate—the market regulation to require—to do compliance in this area, is that a fair statement?

Mr. GLASSMAN. No, it is not a fair statement. I think that investors apply—you can call it the market if you want to think about it as——

Mrs. JONES. I got that word from you. I wrote a quote, but if you——

Mr. GLASSMAN. The investors and the market apply a tremendous discipline to corporations to behave correctly.

Mrs. JONES. Who applies the discipline to the auditors?

Mr. GLASSMAN. To the auditors? Well, let's put it this way. Arthur Andersen has just been accused of doing some terrible things regarding Enron. It has been fired by some of the biggest corporations in America.

Mrs. JONES. But what does that do for—since you all are beating up on CalPERS, claiming they made so much money, what does that do for the other smaller public employment retirement systems that lost money as a result of the reports or audits done by Arthur Andersen that were not factual?

Mr. GLASSMAN. There is no doubt that among the 8,000 listed companies in America some of them misbehave. Now actually Mr. White just said something important about indexing. Enron——

Mrs. JONES. My question is, what does that do for the poor people who lost their money as a result of the misrepresentation of Arthur Andersen?

Mr. GLASSMAN. Well, I have to say that the nature of the stock market is that you sometimes lose money. And you sometimes make money. Dell Computer was up by 7,800 percent.

Mrs. JONES. OK, that is enough.

Mr. GLASSMAN. You don't have to turn that money back.

Mrs. JONES. Let me go back to this. That maybe the nature of the stock market that you sometimes lose money and sometimes make money.

Mr. GLASSMAN. Correct.

Mrs. JONES. But when you invest in the stock market, you invest knowing the financial situation of the company, whether you win or lose, and you chose to win or lose based on that knowledge.

And I will be done, Mr. Chairman.

Mr. GLASSMAN. Oh, can I respond? Absolutely.

Mrs. JONES. Oh, I want you to respond, sir.

Mr. GLASSMAN. Absolutely, Congresswoman. I think that that is true. You either make money or lose money. In the case of Enron——

Mrs. JONES. You said you make money or lose money. My statement is you make money or lose money and you invest based on the knowledge you have on the financial condition of the company. Is that fair?

Mr. GLASSMAN. There is no doubt about that and that is why we are here today. Enron misrepresented its financial statements. It is dead as a company. Capital punishment has been inflicted on it before it was ever indicted, before Congress did anything, before anybody did anything. And that is probably true as well——

Mrs. JONES. But what we are trying to do here today——

Mr. GLASSMAN. Because of Arthur Andersen.

Mrs. JONES. Is figure out how we never find ourselves in that situation again.

Mr. GLASSMAN. I realize that.

Mrs. JONES. And the position that I am trying to get is that you have auditors who have a position better than anybody else in the investment world and therefore there has to be a greater obligation on them to represent the truth.

And I yield the balance of my time. Thank you.

Chairman OXLEY. Thank you, Ms. Jones.

Mr. Cantor.

Mr. CANTOR. Thank you, Mr. Chairman. I would like to ask Mr. Glassman, in your testimony I think it is fair to say, and if not, please correct me, that while you agree with parts of the bill, H.R. 3763, you contend it might be too regulatory in its approach and sends the wrong message to investors. Can you respond to that assertion and perhaps offer some suggestions if that is your position?

Mr. GLASSMAN. Well, it is my position. I think there are certain things that should be done that I outlined in my oral testimony and my written testimony. I think there should be a blackout period. I think there should be stricter accountability. I think there should be contemporaneous reporting by executives when they buy or sell stocks. But I worry about for example the notion that Congress should decide the functions that auditors perform within a company. There is a good reason why corporations, the biggest and best corporations in America, corporations completely beyond reproach, and I mentioned some of them earlier, companies like Exxon-Mobil and IBM and McDonald's, and I don't want to leave anybody out, there is a reason that they pay more in proportional sense for non-audit services than audit services because they think they are getting good value. And when you come in and decide that this not the way that they should be doing business, it causes them to incur extra costs, reduces their efficiency, and diminishes their profits and therefore their value to shareholders. So I think that is a big problem.

And the second problem is something I alluded to earlier, which is that we are telling—in hearings like this sometimes people get the wrong message, investors get the wrong message. And the message is that the reason that stock prices go down is there are all these crooks around who are out to make money and do things in nefarious ways and that is why you, the poor shareholder, is losing money. That is not why people lose money in the stock market in most cases. The reason they lose money is because stocks do not go straight up. They never have. About one out of every 3 or 4 years, the market as a whole goes down. And I think it is very important that investors, that Americans understand that and structure their portfolios accordingly. So that is basically my point.

Mr. CANTOR. Can you talk about and address the issue of repealing litigation reform and say that it would not help shareholders. Can you try and address that as well?

Mr. GLASSMAN. Well, I just, you know, despite litigation reform, there have been many, many cases filed, actions taken, I cited in my testimony the Cendant case in which Cendant paid $2.8 billion to settle a shareholder's suit. The accounting firm that was involved paid $330 million. Lots of money has been spent to settle suits since this law was passed. And some in Congress are pointing to this law as a reason for the Enron scandal itself, and I am just saying that it is not and I don't think that law needs to be revised. And I think if anything, the bar ought to be raised, because the law still makes it so easy to sue companies that really are not doing anything wrong in many cases. In some cases they are, and I think it is good that they are sued and they ought to pay for it. However,

it does distract executives and causes money that shareholders—shareholder assets get paid out in these lawsuits. It hurts shareholders.

Mr. CANTOR. Thank you, Mr. Chairman. I yield back.

Chairman OXLEY. Ms. Waters.

Ms. WATERS. Thank you very much.

Mr. White from CalPERS, how much did we lose with our Enron investments in California?

Mr. WHITE. At CalPERS, I can speak for CalPERS, we still have assets at risk. As it stands right now, we have total losses based on the book value of approximately $9 million. But we still have private equity assets that are what I would say at risk. We do not know how much of that we will be able to recover.

Ms. WATERS. Thank you very much. I have a million questions I could ask, but I chose to use this time to distinguish between the thinking of American Enterprise Institute as represented here by Mr. Glassman and the more conservative thought in America politically. I am a Democrat. I am a liberal Democrat. I believe in the body of law that we have developed in this Nation to protect consumers. I do not take the position that they ought to know better. They ought to be smart enough. We have consumer law that is developed in so many ways. For example, maybe people should know the difference between bad meat and good meat. But we do not leave it to them. We have meat inspections. Maybe people should know how to protect themselves against dirty water. But we have laws to ensure that we have clean water. Maybe people should know the difference between big banks and financial institutions that do predatory lending and all of that and insurance companies, but we do not just leave it to them. We believe that Government has a role in helping to protect the least of these or the average consumer. And perhaps we should not have any building and safety laws, because people ought to know when they contract with someone to build a building, that they are just going to do the right thing.

That is where you and I differ. That is the difference between your conservative thought and my more liberal thought. We believe that Government must play an important role in protecting consumers. And when we find that Government is intruding unnecessarily, we should stand up for that also.

To assume that somehow because Enron has been caught and it is going to have to pay a price that the market is working fine and we should not worry about having to come up with new law by which to deal with the problems that have surfaced. However, how many people have to be hurt? You talk about the biggest and the best corporations in America. Enron was considered the biggest and the best. It even got an award for being the best. Enron enjoyed close relationships with the President of the United States and Members of Congress and they gave out lots of money. They were all at the best parties. They said the right things. It was considered one of the biggest and the best.

If you are saying do not get involved in creating new law or getting overly involved in this because it is all right now, they are going to be punished, what do you say to the pensioners who had their life savings in that 401K that was managed by Enron that

helped to make them feel comfortable in putting their funds into the company stock? What do you say to the person who had no more than $300,000 or $400,000 to live with for the rest of their lives once they retired? Don't worry. Don't worry. If another company does something bad, we will catch them. The marketplace will work.

No, the political difference and the philosophy that is so different here is that some of us no matter what you say about the fact that they will have to pay a price, we come at this differently and we say we should not allow people to get harmed time and time again, because eventually the thieves will get caught and the big corporations may come down. Just do not bother with trying to create a body of law that will prevent it.

Well, I want you to know we disagree with you, Mr. Glassman. And we do not think for one minute that the fact that Enron is going to have to pay a price that that is enough. We think that we should use the power that the people have given us to legislate, to prevent this kind of catastrophe from ever happening again.

And so instead of asking you a question, I just want to help people to understand the difference in your thinking and someone like me, my thinking. And probably conservatives versus so-called liberals. We are people who believe that Government must play a role in protecting folks. If you say don't they know they should diversify, don't they know that the stock market is cyclical and that it changes and they should be aware of that, no, we do not take it for granted that they know. And that is why we are going to protect social security from being privatized and leaving retirees out there at the mercy of the suede shoe boys who would take their money and do whatever at the time they can do with it and leave them penniless.

So without having any questions to you, I hope that the students around the country are listening to this so that we can help them to understand the difference between the conservative thought that comes out of the American Enterprise Institute and the thought of us liberals about consumerism and how we use our role in Congress to protect folks who some people think ought to know better, but maybe they don't.

Thank you very much.

Chairman OXLEY. The gentlelady's time has expired. And I would like to start a short second round, and say to a great extent there are elements of Ms. Waters' comments with which I agree. Just because a corporation is large, just because it has been successful, just because it is well regarded does not necessarily mean that it is not subject to failure nor criticism nor that regulatory changes are in order. I would welcome her participation with regard to the GSEs in that regard.

I would also say that——

Ms. WATERS. You got it.

Chairman OXLEY. I would also say that despite the fact we suffered great loss on 9–11 and that we have suffered another great loss with the demise of a Fortune 50 corporation, that the markets have remained extraordinarily responsive and appropriately balanced to these difficult times. Investors, although guardedly, are

still investing their money in the greatest capitalist system in the world and our profiting from it.

Now should we prohibit the blue suede shoe guys from getting involved in the pension funds of social security is another issue. Should we relegate the American taxpayer to a 2.3 percent rate of return simply because we do not want to allow them inside the corporate boardroom? I don't think so. There is balance here to be obtained. I think the balance is appropriate oversight to catch the wrongdoers and create an environment in which there are penalties for inappropriate, unprofessional, irresponsible behavior. And I also agree that the rules of 1930 do not fit 2002 and they need to be revisited, rewritten, and made appropriately responsive for the environment in which we find ourselves.

I do not however think it is advisable to have the Unite States postal system making corporate decisions for the rest of the world. And that the role for Government, from a conservative perspective, is to get out of the way and let free markets make appropriate decisions to provide for a competitive environment where you have the most number of products provided at the cheapest price so that consumers can make the best choice for their families and not be told by the Government they are too stupid to make their own investments.

Somewhere between the chasm that has been created by Ms. Waters and myself there is an appropriate balance that I hope this committee will reach. And for all those students who are listening here today, I hope they take a well-advised approach in looking at both the alternatives presented in the committee today.

Thank you very much.

Mr. LaFalce.

Mr. LAFALCE. Mr. Chairman, may I just point out between the extreme that you pose and the extreme that Ms. Waters pose is my middle ground bill.

[Laughter.]

And I am glad in trying to reach common ground you have now endorsed it. At least that is one spin that I could put at it.

Just a few comments, because I do want to get on to the second panel and when I am Chairman we will only have one panel per day for a hearing so they don't have to stick around forever and lose all the members. I don't know when that day is going to come, but if it does.

Let me just make a few points. Mr. Lackritz, and we go back a long time, and I have the highest regard for you and your profession. But if I were to single out anybody where we need to focus, it is the securities analysts. And I do not mean that in a punitive sense at all. But we have got to improve the quality of analysis. And you have got to work on some mechanisms to compensate analysts based upon the quality of their research. And there has got to be much better peer review and we have got to withstand the pressure to get on a bandwagon and hype stocks. And you and your organization and the NASD are better equipped to do that than the Congress, but that is a heavy, heavy responsibility and you have to be really zealous in going after it. And we will try to watch over your shoulder and assist you in that effort, OK. Sure.

Mr. LACKRITZ. Mr. LaFalce, I think we agree with what you said and I think given the hearings that Congressman Baker initiated last year and the process that he initiated——

Mr. LAFALCE. Yes, his hearings were terrific.

Mr. LACKRITZ. We have made a lot of strides.

Mr. LAFALCE. And you have made strides. You have made strides. We cannot undo the damage, but we can try to prevent future damage.

And speaking of undoing the damage, Mr. Glassman, you point out the settlements. The difficulty is most of those settlements have been for pennies on the dollars that have been lost because of the wrongdoing. And I am not talking about honest—I am talking about the wrongdoing. And so the individuals who have aggrieved have not been made whole even when there has been a successful lawsuit and a so-called settlement. And we want to prevent that, especially given the evolution of people's financial habits and corporate habits. What do I mean? Well, 20 or 30 years or so ago, if you were fortunate enough to have a pension plan, you had two-thirds probability of having a defined benefit plan. Today, a smaller percentage of Americans have pension plans and of those who do, two-thirds are in defined contributions. And a corollary of that and an outgrowth of that in part has been the fact that only a small handful of Americans invested in their publicly traded securities decades ago, today a good preponderance do. So an awful lot more people have an awful lot more of their wealth in the markets, and we need to be more zealous and our laws have to be better, our regulation and our oversight needs to be better.

It is going to be difficult to make the people whole. They have been injured. I don't know that we can, but we have to try to prevent other people from being injured in the future.

And Mr. Melancon.

Mr. MELANCON. Melancon.

Mr. LAFALCE. Melancon. I am very concerned about a number of things. I do not want the accounting profession to take an unfair wrap, but clearly there have been some inappropriate actions, negligence, recklessness, and you have to see this in perspective. There are an awful lot of accounting firms. There is a Big Five right now and then thousands of others that are much smaller and they range from $1 billion dollar to $100,000 accounting firms in revenues. And I know you are responsible for them all. I don't want to see an Arthur Andersen go under. They have got 85,000 employees. I spent money with the chairman of the board of Eastman Kodak, which has so many employees in my district, well, Eastman Kodak is far smaller than Arthur Andersen. That is how big Arthur Andersen is. And I don't want to see a Big Five go to a big four because I don't think the country would be well-served. I like when we had a big eight. I don't think we are going to be able to revisit those days. But I am very worried, if you only have four or five that could do the major corporations in any event, those that are global in nature, and increasingly even small companies are global in nature, you have some real problems in the marketplace because you don't have the type of competition that you do need.

And so we need to do something, with all due deference to the 99 percent of accountants who are always doing the very, very best

they can, that small percentage can wreak havoc with the marketplace. And while the marketplace may correct, the damage done by that 1 percent is not self-corrective and it does not prevent future abuses. So we need to work together. And I just don't think will ever be able to rely on accountants watching accountants again. I just don't think that is going to sell to either Democrats or Republicans. I could be mistaken.

I think we need a stronger oversight board. We can argue about who should be on that oversight board. My preference is to have representatives of investors and institutional investors such as private employees pension funds, public employee pension funds, Council of Institutional Investors because I think they are more likely to be zealous in overseeing it. And that is probably the most, single most important provision within my bill or maybe anybody's bill I think to restore confidence and integrity in the markets.

With respect to each of the other provisions, we will dialogue on them. I thank you.

Chairman OXLEY. Thank you, Mr. LaFalce. I would like to express appreciation to the panelists for their participation and helpful remarks today, particularly you, Mr. Melancon, for the many names that you were called during the course of the day. But as I have explained your good humor to other Members, guys from Louisiana are accustomed to being called a lot of things.

To all of the panelists, our appreciation. I would like to have the second panel.

I am sorry, I did not know you had an interest.

Mrs. Tubbs Jones.

Mrs. JONES. Thank you, Mr. Chairman. I have a couple of questions. Well, I am going to ask a question and then make a quick statement.

Mr. Lackritz, what is your position with regard to the provision that would limit—put a 4-year limitation on the use of an auditor for purposes of preparing an audit?

Mr. LACKRITZ. You mean the term limits?

Mrs. JONES. Yes.

Mr. LACKRITZ. On auditors?

Mrs. JONES. Yes, like the people running for public office, yes.

Mr. LACKRITZ. We have not taken a specific position on that provision. What we are concerned about primarily is improving the quality of the information and so we don't have a specific position on that.

Mrs. JONES. Mr. Glassman, what is your position?

Mr. GLASSMAN. I am against term limits in all their forms, including for Members of Congress.

Mrs. JONES. What do you that think term limits will do in terms of the support or the ability of an auditor to do his or her job?

Mr. GLASSMAN. I think it will add to confusion if there is a term limit. I just do not see the necessity for it. I think companies can do a very good job on their own deciding how long the tenure of their accounting firm ought to be.

Mrs. JONES. Knowing the public's discomfort with auditors right now, let me put this question to Mr. Melancon, even if you do not support the term limits, sir, what do you do to increase the public's confidence in your profession?

Mr. MELANCON. Well, first off, public confidence is critically important and I would agree with your focus in that area. We have supported a board that has greater capabilities in enforcement and in quality control areas so we would support that. We think that that would be a very positive step.

The problem with rotation, ma'am, is that as Mr. LaFalce just pointed out, there are huge capacity issues and there are going to be disruption issues. And if you are looking at 17,000 public companies on an annual basis, 3,400 or so would be changing auditors, there would be a tremendous inefficiency to mandate that.

CalPERS has a situation where they voluntarily do that. They want to do that. That is part of their corporate governance. That is part of the free market system. And we think that audit committees ought to review that relationship. And the other thing that I would say is that we have supported is that the audit committee, representing the shareholders, ought to be the one that hires and fires the auditor.

Mrs. JONES. Let me close with this, Mr. Chairman. I had an opportunity about 2 weeks ago to speak to a class at the Wutherhead School of Management at Case Western Reserve University. These were first year students working on their Master's degrees and they were just full of questioning about what is Congress going to do about Enron and so forth and so on. I went through some of the things that were being presented. But what I tried to weigh upon each and every one of those students, and I call upon each of you when you give testimony, is to help young people in every profession to understand the importance of character and good worth and loyalty and all the things that I don't care how much regulation we do in any of our professions we are not going to take care of.

I feel obligated as Member of Congress sent here by the people of the City of Cleveland and the surrounding communities to put forth some legislation that will deal with some of the issues that Enron brought forward. But I am constantly trying to say, and I come from having been a judge, an elected prosecutor, I serve on the Ethics Committee, I have done a lot of things like that, to say we have got to teach young people what it means to have character and honor. And if you don't do it, I don't know who else will. Those of you sitting in the profession.

I yield the balance of my time, Mr. Chairman. And I thank each of you for coming here this afternoon.

Chairman OXLEY. Again, I thank you gentlemen and appreciate your participation. The record will remain open if other Members have additional questions as a follow-up.

Thank you very much.

And we do appreciate your patience in participating in this important hearing. We have the Honorable Roderick M. Hills, former Chairman of the Securities and Exchange Commission; Ms. Barbara Roper, Director of Investor Protection, Consumer Federation of America; and Mr. Lynn Turner, Director, Center for Quality for Financial Reporting.

Welcome. Please proceed. Your statements will be incorporated as part of the record. Feel free to summarize.

And, Mr. Hills, we are glad to have you with us today, sir.

STATEMENT OF HON. RODERICK M. HILLS, FORMER CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. HILLS. Thank you, Mr. Chairman and Mr. LaFalce.

It should be clear that the accounting embarrassments of Waste Management, Enron, Global Crossing, to name a few, means that we have serious weaknesses in our accounting profession and in our regulatory system. We have had them before. In the middle 1970s, the Securities and Exchange Commission compelled 400-plus companies to disclose that they had bribed foreign officials or made questionable payments to them. At that time, the SEC stimulated the New York Stock Exchange to require outside audit committees as a condition of listing. We strengthened the responsibilities of auditors and we required internal controls for the first time. As we deal with the weaknesses in the system, I would hope that we could build upon the foundation laid back then.

What are the weaknesses?

First, the overall system, as many have said, is very old, it is almost 70 years old. Almost anything 70 years old gets a little creaky. It needs a major overhaul.

Second, it has become increasingly clear that some audit partners are not going to be able to consistently resist the management pressures to allow questionable accounting policies or incomplete financial statements.

And, finally, the audit committees of far too many boards are just not exercising the authority that has been given them.

H.R. 3763 has the prospect of making significant improvements in all three areas.

Criticism of the regulatory system really has two aspects. The audit has become a commodity. The CEO sees no value added. The accountants compete on the basis of price, not on quality. Auditors are not chosen for their judgment. They have become rule checkers and we have too many rules. They have allowed the implication that if something is not prohibited, it is therefore permitted.

The traditional auditor statement says: "In our opinion, the financial statements prepared by management fairly present in all material respects the financial position of the company." That suggests judgment. That is not what they mean. What they mean is we have found no material violation of the laws.

Section 6 of the bill would cause both management and auditors to use considerable judgment in deciding what the key accounting principles are that affect the financial position of the company, whether for good or for bad.

Let me turn briefly to FASB, the Financial Accounting Standards Board.

Paul Brown of the accounting department of NYU summed up the role of FASB pretty well. He said, "It is an old adage of a FASB rule. It takes 4 years to write it. It takes 4 minutes for an astute investment banker to get around it." The proposed bill does not deal specifically with FASB, and I would suggest the committee may wish to put in Section 9 that somebody review it.

Turning to the profession. In addition to its other problems, the accounting profession is not able to get the talent that it needs. Twenty years ago, some 25 percent more people were entering the profession. Twenty years ago the leading business schools, Stan-

ford, Wharton, Michigan, sent a substantial percentage of their graduates to the accounting profession. They do not go there anymore. And yet today, the Big Five are hiring far more people than they hired before.

This difficulty of finding top-notch personnel, the difficulty of finding a precise rule to deal with an ingenious corporate structure designed by Wall Street, and perhaps above all, the pressing financial need to keep a client. Too often, as I said before, it allows a questionable accounting policy to slip by.

Section 3 of the bill will provide some deterrent to zealous management people to try to influence the auditors. But auditors will not have the freedom unless the freedom is given to them, the independence is given to them by the audit committees.

Section 2 of the bill restricts the ability of auditors to provide some services to their audit clients. To the extent that it deals with financial system design, I think it is constructive. I do believe however that an absolute prohibition against the internal audit is both unwise and unpractical. I have set forth in my written statement some reasons for that.

The SEC rules now permit an external auditor to do 40 percent of the internal audit. As long as there is a strong independent audit function, it seems to me that the SEC rule is better than an absolute ban.

The audit committee. The primary responsibility of the audit committee is to protect the auditor. Unfortunately, CEOs too often appoint the members to the board and therefore decide who is going to be on the audit committee and selects the chair of the audit committee. The audit committee members seldom ask the auditors if there is a better way to make the financial presentation that has been designed by the company. In other words, is there a better way to do it?

The audit committee seldom plays any role of significance in the selection either of the auditors or the selection of the audit partner. In short, they seldom establish themselves as the party in charge of the audit, and they do not establish themselves as the party in charge of retaining the auditor.

Section 9 of the bill asked the President's working group to decide whether or not the Commission should establish the duties of the audit committee. I think that is appropriate. But I suggest that the committee may wish to be a bit more specific about what the responsibilities of the audit committee should be.

After 25 years, I think the audit committee deserves a legal status. It has been ambiguous. I suggest first of all that the SEC by a simple speech could say that the failure to have a competent, independent audit committee constitutes a material weakness in the internal controls of the company. That status would be obtained if the SEC would say it.

The SEC could also make clear, as could this committee, that the failure to have an independent nominating committee is absolutely necessary to having an independent audit committee. Who is going to put the members on the committee? Who is going to select the chair? Who is going to evaluate their performance?

And, finally, the SEC can make it clear and this committee can make it clear that the audit committee's single most important

task is to make the auditor believe that its retention depends solely upon the discretion of the audit committee.

In conclusion, Mr. Chairman, the Enron debacle is emblematic of weaknesses in the regulatory system. Andersen is in the headlines, but they all have the same problem. Andersen and the other firms are not blameless, but they are not entirely to blame. The profession has real problems because of a system that they cannot change by themselves.

Thank you very much.

[The prepared statement of Hon. Roderick M. Hills can be found on page 210 in the appendix.]

Mr. BAKER. [Presiding] Thank you, Mr. Hills.

At this time I would like to recognize Ms. Barbara Roper, Director of Investor Protection, Consumer Federation of America. Welcome.

STATEMENT OF BARBARA ROPER, DIRECTOR OF INVESTOR PROTECTION, CONSUMER FEDERATION OF AMERICA

Ms. ROPER. Thank you. I would like to thank the committee for inviting me to testify today. I am testifying on behalf of both Consumer Federation of America and Consumer's Union.

Because of the central importance of the outside audit in keeping company managers honest, our organizations believe the two most important things Congress can and must do to restore investor confidence in the reliability of corporate disclosures is to first and foremost restore real independence to the independent audit and second to provide effective oversight of auditors.

This legislation tackles both of those issues and for that reason we congratulate you. However, because it fails to deal adequately with the central issue of auditor independence and because it does not do enough to guarantee the effectiveness and independence of the regulatory body it creates, H.R. 3763 does not provide the comprehensive strong reforms that we believe the current crisis demands.

Because of time limits I am going to focus exclusively on these two aspects of the bill in my oral testimony. My written testimony discusses the broader provisions of the legislation.

Unless the auditor is independent, unless he or she is free of bias, brings an appropriate level of professional skepticism to the task and feels free to challenge management decisions, the audit has no more value than if the company were allowed to certify its own books. Unfortunately, in recent years auditors have been unwilling to adopt the total independence that this essential watchdog function demands.

To increase auditor independence, this legislation directs the SEC to adopt a rule prohibiting auditors from providing internal audit and financial information system design and implementation to their audit clients. In doing so, it simply codifies steps that the major accounting firms have said they plan to adopt voluntarily. While there is certainly a benefit to having these restrictions written into the rule book to prevent backsliding once attention has turned elsewhere, we believe more is needed. Specifically, we support a broad ban on the provision of non-audit services to audit clients. Certain services could be exempt on a case by case basis, but

only if they benefit investors and only if they are directly and separately approved by the audit committee of the board.

Furthermore, we believe Congress must look beyond the issue of consulting services in dealing with auditor independence. After all the lack of independence starts with the fact that auditors are hired, paid, and fired by the audit client. This gives them considerable potential influence over the audit. We believe one way to limit that influence is to require mandatory periodic rotation of auditors. The basic reasoning behind this approach is that it is far easier for an auditor to challenge management and risk losing an audit client if they know the audit engagement is only temporary.

Another problem that in our view clearly needs to be addressed is the revolving door that all too often exists between auditors and their audit clients. And that is why we also support a cooling off period for auditors before they could seek or accept employment at an audit client.

While Congressman LaFalce's bill, H.R. 3818, does not ban all non-audit services, it contains most of what we believe is necessary to restore a reasonable level of independence to the independent audit.

H.R. 3763 is, in our view, stronger on the issue of auditor oversight than it is on auditor independence. At its heart is a requirement that all accountants who audit publicly traded companies belong to a newly created professional regulatory body with oversight and investigatory powers. We believe that an independent regulator subject to SEC oversight could significantly improve the regulation of the accounting industry. To do so however it must be completely independent of the accounting industry, be adequately funded, have extensive rulemaking and standard setting authority and be endowed with strong investigative and enforcement powers.

The bill takes important steps in this direction. Unfortunately, much of the language in H.R. 3763 is simply too vague to ensure that these essential standards for effective oversight will be met.

The Enron collapse has understandably shaken investor confidence in the safeguards our financial system provides to keep company management honest. Only a comprehensive package of reforms with strong auditor independence and oversight at its heart will restore that confidence. If it were strengthened in these key areas, H.R. 3763 could provide the framework for meaningful reform. Without these changes, many of which can be found in H.R. 3818, fundamental problems will persist and investor distrust of corporate disclosures will remain.

Once again, I want to thank you for inviting me to appear today.

[The prepared statement of Barbara Roper can be found on page 266 in the appendix.]

Mr. BAKER. Thank you.

The Chair now recognizes Mr. Lynn Turner, Director of the Center for Quality Financial Reporting. Welcome.

STATEMENT OF LYNN TURNER, DIRECTOR, CENTER FOR QUALITY FINANCIAL REPORTING

Mr. TURNER. I would like to thank Chairman Oxley and Congressman LaFalce and Members of the committee, including the one remaining Member of the committee, for inviting me here to

speak today. My comments today do draw upon my past experience as an auditor, a business executive, a regulator and an educator.

I commend Chairman Oxley, Ranking Member LaFalce, and Congressmen Baker and Kanjorski for their respective efforts in raising red flags with respect to leaks in our system before Enron struck the iceberg. But now that we have a sunken ship, we need to ensure adequate reforms are made in a timely fashion to protect investors. After tens if not hundreds of billions in losses, we must stop the damage to capital markets and investors.

As described in further detail in my written statement, reforms set forth in the proposed legislation and the following testimony will be even more critical if the Big Five turn into the Final Four. It is in the best interest of both the business community and the profession if Andersen continues as a separate firm. If we end up with just four firms and there is another disaster, our current system of public audits will quite frankly no longer be a viable system. American investors will then rightly ask Congress why was it not fixed after Enron?

The independent and oversight committee of Andersen chaired by former Federal Reserve Chairman Paul Volcker has said the problems facing accountants today are profession wide and not just an Andersen issue. I agree with their conclusion. Those changes made by Andersen and/or the oversight board should receive serious consideration by the committee.

H.R. 3763 does encompass some of the changes that will enhance the current financial disclosure system. But as I will describe later, there are additional reforms required that are addressed in Congressman LaFalce's bill, H.R. 3818, that need to be enacted. While I may quibble with certain sections or have minor quibbles with certain sections, I think it—that bill has my wholehearted support and I think it will move things along a long way.

Key elements of H.R. 3763 include:

The establishment of a public regulatory oversight board for the accounting profession under the oversight of the SEC, making it unlawful for company executives or directors to willfully and improperly influence, coerce, manipulate or mislead the auditor; requiring more timely disclosure of financial information provided all investors receive such information consistent with the current requirements of Regulation FD; and real time electronic disclosure of insider transactions.

Certain improvements to H.R. 3763, many of which are set forth in Congressman LaFalce's bill, would provide greater protection for the investing public. These improvements include:

Providing the PRO with greater authority and powers along the lines of what are outlined in my written testimony, including a public board, as Congressman LaFalce earlier described, made up of members from the public; enhancing auditors' independence by including all the original provisions of the SEC's rule proposal rather than just those the accounting firms have already quite frankly agreed to. There should be both mandatory retention and mandatory rotation of auditors.

Modifying the bill to require the SEC—or modifying the bill to require the SEC to modify its rules in the event that FASB does not complete the task in a timely manner. I strongly oppose con-

gressional influence over and legislation of accounting standards. It has directly contributed to less transparency in accounting for stock options and some of the problems we have today.

Adding a statutory requirement that CEOs and CFOs provide a statement to their shareholders vouching for the full and fair disclosure of a company's public disclosures and consistent with legislation previously enacted by this committee, Section 36 of the Federal Deposit Insurance Corporation Improvement Act of 1991 include a report on management's responsibility for internal controls and laws and regulations and the effectiveness of those controls accompanied by an independent accountant's report provide the necessary appropriations for the SEC, including a provision for adequate staffing and technology resources to undertake the mandated review requirements. In that regard, I strongly support the funding and risk rating system proposed in H.R. 3818, enhancing the independence and oversight of corporate boards.

In general, I believe the PRO proposed in H.R. 3763, while a step in the right direction, does not advance the ball sufficiently down the court to score. As my dad always taught me, if something is worth doing, it is worth doing right the first time.

Let me close by noting that many of the issues being debated today are not new. They were raised again and again during congressional hearings in the 1970s and in the 1980s.

[The prepared statement of Lynn Turner can be found on page 274 in the appendix.]

Mr. BAKER. Thank you, Mr. Turner.

Mr. Hills, I would like to address the first question to you. In view of your extensive experience not only as Chairman of the SEC, but your extensive board experience, can you tell the committee a little bit about what you view the role of the audit committee should be in specificity? What makes a good audit committee and what should they be doing?

Mr. HILLS. They should initially take charge of the audit and that is a simple thing to do. If the auditors know that you are in charge, they will know it. The audit committee should be in charge of the fee negotiations. In my experience of seeing any audit committee for the first time and hearing of other audit committees, they often think their highest role is to reduce the audit fee by 5 percent. They seldom ask what could you do if we gave you $100,000 more?

Let me just speak quickly about the subject of independence. We all talk about objective independence. That is one dimension. But the auditor independence has three dimensions. Objective independence means how many times do you play golf with the CEO? And that is easy to determine. The second dimension is the audit committee has to understand for itself what it needs to know about the company. You cannot just sit there passively and hear what is told you. You need to go out. Whether you call it financial expertise or commonsense, you need to figure out what you need to understand that company. And that takes a second dimension.

And, third, you have got to confer that independence upon the auditor. They have to know that you are in charge of their fee. They have to know that you will be there to mediate the disputes. They need to know that they have to come to you first.

Let me give you an example. At Waste Management we wrote off $3.5 billion in 6 months. The audit committee had not seen a management letter in 5 years, and yet the auditors had given the management a treaty of 12 items, 12 significant items, you have got to change those things. Nobody told the audit committee. Well, who do you blame? I think you cannot understand fully the fragility of the auditor, who is about 55 years of age. If he loses that account, he is out of there. And so the most important thing for the audit committee is to confer that independence upon the auditor.

Mr. BAKER. Ms. Roper, I would like to ask you to turn again to this issue of auditor independence, and I think that we are in agreement that Congress should not politicize and legislate accounting standards. But when you get to talking about standards of independence, I believe that you have suggested that Congress get involved in that area beyond what even the SEC has recommended. And so can you explain to the committee, this difference in your opinion on these two issues?

Ms. ROPER. The only reason to have an audit and to impose that expense on companies is if it is independent. If it is not independent, it does not serve its mandated function to provide outside expertise. And we believe that people respond to financial incentives. And in the area of audits right now we have the worst possible combination. We have financial incentives that at least up to a point favor doing the wrong thing. The money is in consulting. The glamor is in consultant. If you are too tough on the audit, you could lose the consulting contract. If you are too tough on the audit, you could lose the audit fee and not this year's audit fee but, because of the low turnover, an endless stream of future audit fees.

And so we have, as I say, financial incentives that benefit the firm if they do the wrong thing, and we have no real regulatory oversight to punish them in those instances. We think regulation only works effectively when the financial incentives are not stacked too strongly against it. But if you have a system of regulation that is imposed on a system where the financial incentives work the other way, that regulators are always swimming upstream, always cleaning up messes after they have been made.

And our view on auditor independence derives from the Supreme Court's statement that the public watchdog function that auditors perform demands total independence. And so if we are going to have a law that mandates that the audit be conducted, and if its only value is independence, then I think it is absolutely appropriate for the laws to specify what it takes to be independent. And I think it is necessary because the necessary has not accepted that responsibility that goes with performing that function.

In the area of writing accounting rules, we have decided, rightly or wrongly, to delegate that to a provide standard-setting body. And we believe that more needs to be done to enhance the independence of that body as well, because our experience has taught us in following some of the rules that they put forward that if they contemplate a rule that will be opposed by big business and will also be opposed by the accounting firms, they know they have years of opposition in front of them and that those constituents will go to Members of Congress and that they will in turn face threats to their role as a private standard-setting body.

And so we do believe that that process should be politicized, not that Members of Congress don't have an absolutely appropriate way to play in commenting on rules if they have a direct interest in them, but that a group cannot maintain its independence if it feels that its very existence as a standards-setting body will be threatened if it does anything controversial. And I think you have to look at one of the reasons we do not have comprehensive rules on special purpose entities is that FASB knew that if they tackled that issue, that they would be running into even more opposition than they have run into on their rules on hedging practices or stock options disclosures.

So if we are concerned that we do not have adequate rules in this area, I think we have to look at some of the reasons why we don't have those adequate rules. And I think the lack of a guaranteed independence for FASB is one of the reasons.

Mr. BAKER. Thank you, Ms. Roper.

Now, Ranking Member LaFalce.

Mr. LAFALCE. Thank you, Mr. Chairman.

Mr. BAKER. It is nice to be a Chairman after just a year.

Mr. LAFALCE. Again, let me apologize to the three of you. Mr. Turner, you came from Colorado. Ms. Roper, Colorado also?

Ms. ROPER. Also Colorado.

Mr. LAFALCE. And, Mr. Hills, where are you?

Mr. HILLS. Just up the street.

Mr. LAFALCE. Just up the street, OK. You came a long distance and spent a lot of time to testify. It is regrettable that we have almost no Members here, and so they won't hear the benefit of your comments, because each of the three of you, I think, had some really terrific comments to make about the issues. That is why, again, I would exhort at our future hearings we have one panel. What happened here today was not only predictable, but virtually certain, that is you would have an empty House. And we won't correct that. We need some structural changes too in the way we do business and one of them is just one panel per day.

Having said that, I hope the Chair will give me a little latitude since we have so few Members here.

Mr. BAKER. Latitude granted.

Mr. LAFALCE. OK, thanks. Let's try to take the issues one at a time. Let's first go to the corporate officers themselves. And then from the corporate officers, let's go to the board of directors and the audit committee in particular and then let's go to the auditing firm. And if you want to, we can go to the credit rating agencies. But I am just not sure what we should or shouldn't do there. I certainly want to focus on the securities analysts and see what we should do.

How do we get to the corporate officers to make sure that they do not engage in earnings manipulation in order to increase market capitalization in order to make big bucks on their stock options?

Mr. HILLS. I will be a broken record, Mr. LaFalce. The only way you deal with that, first of all, you have to have the capacity to punish them, and I certainly support the notion that the SEC should have an effective way to "disbar" them. I thought the existing law was sufficient, but Chairman Pitt thinks he would like some more help, and I think he should get it.

If you don't have somebody speaking up for the auditors and speaking up for the financial statements, the chairman will run the company, the chairman of the company.

Mr. LAFALCE. My experience, which is extremely limited, has been the chairman or the CEO runs everything. They pick members for the board who are already friendly to them or who will be friendly to them. They pick auditors who are or will be. And then they nurture that relationship so that it almost becomes like a familial relationship where you can't tell on a family member.

Mr. HILLS. Well, it is not quite as bad as it used to be or I wouldn't have been on the last eight boards. It is better. It really is better. But, again, it is to me an oxymoron, you cannot have an independent audit committee unless you have an independent nominating committee. And that happens more and more. Now it happens that Enron did have an independent nominating committee.

Mr. LAFALCE. We don't have to legislate that. That is something that is within the power of the SEC to promulgate by rule, correct?

Mr. HILLS. You bet. You bet.

Mr. LAFALCE. OK, good. Is this something you have discussed with Harvey?

Mr. HILLS. You bet.

Mr. LAFALCE. Please continue.

Mr. HILLS. Well, it is that function, it is that capacity to have—it is the capacity of an independent board. Are there seven to nine people coming to hear the chairman as a panel or have they coalesced into a body that has the capacity to make decisions.

Mr. LAFALCE. They almost need a staff of their own then too, because in my experience on boards, you come and you do not even know what the agenda is before until the night before maybe you get something in the mail and then you probably don't have time to read it by the time you get it. And then the CEO or the chairman, whoever it is, goes over the agenda and sort of tells you. You pretty much rely on the chairman of each of the committees within the board to tell you what is going on within their committee. And then you find out that their committee didn't even meet, that they did everything by phone. And so the members of that particular committee who are supposed to be responsive to the full board usually don't even know what went on within their own committee.

Mr. HILLS. There is a staff available. The chairman of the audit committee, all he has to do is have one lunch a year with the CEO of the audit firm, the audit partner and spend a day or an afternoon. I have been chairman of nine audit committees, and that is how you start out. You sit down and go away to their place, spend the day with them and make sure he understands you are in charge. There is your staff.

Mr. TURNER. Congressman LaFalce, I think it takes a number of things to drive at the question that you are asking about. For starters, I think President Bush's and Secretary O'Neill's notion of dealing with the executives, forcing them to write a statement to their shareholders acknowledging their responsibility for those financial statements and ensuring that they are thoroughly presented I think is an excellent idea. I certainly support that notion along with——

Mr. LAFALCE. But, I don't think that Mr. Lay or Schilling would have had any qualms about writing such a letter or statement. So I don't know whether that is adequate.

Mr. TURNER. In and of itself, no, I think you not only have to deal with the executives, you have to deal with the board and audit committee so I come at it from a number of angles. I think that is a very good thing, and I strongly support what they have done there. I strongly support that some of the things that former Chairman Hills has stated. I would definitely make it a requirement that the audit committee hire, fire, and really oversee directly the audit. Right now in practice the bottom line is the auditors are dealing directly with management. I have been there myself as an audit partner in one of these firms.

Mr. LAFALCE. What about banning auditors from working for the corporate employer for a certain period of time, a year or two, because it seems to me that very frequently an auditor will be encouraged by his firm, maybe take an early retirement, go to work for the company and that will just deepen the relationship between the auditing firm and the company. And of course if an auditor is contemplating future employment as an individual with the firm, the less zealous that auditor is likely to be about the public fiduciary responsibilities. So I have got a 2-year ban on employment if you have audited a firm. What do you think about that?

Mr. TURNER. I will actually speak from personal experience. I was a partner at Coopers, certainly one of the big six at the time and actually went to work for my audit client. Obviously, it was permitted, but it was not a good situation. And I think some of the things that you highlight, if I go back and look at it. First of all, the company had other very fine qualified CFOs that were in the search that they could have picked from. You have always got in the back of you mind the point you just made about would you cut them a deal or not if you had a difficult issue, because you know if you are getting into a fight with them, they are not likely to hire you.

But at the same time when you get across on the other side and you get down to the audit time and here are all these people that you have known for many, many years and now you are in charge, if you will, as the CFO, it just leaves you with a queasy thing. It would be like when I was at the Commission, if I had been involved with an investigation of a situation like Enron and then walked out the door and then right the next day I was back in trying to influence the SEC about the outcome. The Government has put in prohibitions against that. And having gone through that process, and had some of those concerns in the back of my mind, I strongly think the 2-year cooling off period is very good.

And a number of years ago, it was either the chairman of the Big Five firms, the Big Six at that time, or the board of directors of the AICPA recommended a 2-year cooling-off period too. So I think it is an excellent idea.

Mr. LAFALCE. They recommended it?

Mr. TURNER. Yes, they recommended——

Mr. LAFALCE. What happened to the recommendation?

Mr. TURNER. It never went anyplace.

Mr. LAFALCE. That is the difficulty when something is volitional.

Mr. TURNER. It is still a recommendation.

Mr. LAFALCE. It was a recommendation to themselves, correct?

Mr. TURNER. Yes.

Mr. LAFALCE. Yes, OK.

Chairman OXLEY. The gentleman's time has expired. The gentleman from Louisiana, Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman. I wanted to compliment you, Ms. Roper, on the content of the Federation's analysis of the legislation. Obviously, there are points where you feel that modification is warranted, but on balance the approach seems to be one which has merit. And I think that is very helpful in the discussion we are having. At the request of the Chairman, we are going to have a number of hearings in the subcommittee over the coming weeks to receive suggestive criticisms and potential modifications to the bill before we would go to a full committee mark up. But I think it is appropriate to say based on all we have heard today, that we have got it pretty close and we are on the right track. And there are elements that need to be addressed, but we are certainly acting appropriately given the circumstances we face.

And to any who choose to respond, I think to a great extent many are looking at the problem as if we only have bad audit and bad audit individuals within a company where we have perhaps questionable management or maybe OK management. What troubles me, and I don't have a good sense of how we resolve this, is if you have a good auditor who is in a company where you have clearly badly motivated management. And where does that auditor go short of resigning from service to get assistance in balancing the act within the influence of management. If you have an independent audit team, that goes away. If you don't have good management, you are not likely to have an independent audit team.

If there were disputes as to the construction, oh let's say of an SPE, and whether it would be beneficial to shareholders or not. And the audit team said we think this ought to be disclosed, because it is not in the shareholder interest. And there was a dispute. How does that resolve today? Mr. Hills, is there a SEC phone number you call and say "I've got a problem, come help me"?

Mr. HILLS. Well, if you believe as I do that the failure to have a strong independent audit committee is a material weakness to the internal controls, the auditors have no right to take the assignment unless they first determine that there is such an independent audit committee. I think that is the law, but I cannot get anybody to say it.

Mr. BAKER. But assuming for the moment that that is the law and it is not an independent situation after you arrive on the scene, ought there not be a place where you could go and get an advisory opinion privately, not on the record, so that if later you were dismissed or if the management chooses not to abide by your recommendation that there is a methodology for protection of that audit team?

Mr. HILLS. Yes, I said in my written statement that the PRO that the bill provides for is an ideal place for the auditor to go and say, "I have this account, but I don't have an independent audit committee. Would you look into it?"

We try to do that once in a while with the New York Stock Exchange and they are willing, but they do not have the capacity to do that. So the ability to go to something like the PRO that is proposed in the bill to say, "I have got a problem here," is a tremendous assistance and I very strongly support that.

Mr. BAKER. And then with regard to corporate governance, one of the concerns I have is manipulation of revenue or the hiding of debt intentionally by management in the face of a non-cost option being exercised to drive up share price, retirement is in sight, and then 6, 7, 10 months later there is a restatement of earnings and the shareholder takes it and the individual who benefited from the precipitous increase in value does not have to give the money back. What about the advisability of some time period during which there is a disgorgement required and the difficulty is markets are volatile. You could have good management making good judgments, exercises the option in good faith as part of the employment contract and have these same circumstances develop.

Where are the equities in that argument, Mr. Hills?

Mr. HILLS. Well, the law is pretty clear if we can find people that are capable of enforcing it. And this again is a function of corporate governance. I can give you the example of Waste Management where many things like that happened, there is the right of the company to sue the former officers that did it. There is a shareholder derivative cases. The law is there.

Mr. BAKER. But, in that case we are talking evidentiary process, a court determination, the fellow is gone, the money is tied up with his lawyers. If there were an automatic clock, and then it would be maybe a hearing process, my thought was let the executive come in and make his case.

Mr. HILLS. Well, you have something called the bill of attainder and that is difficult. We have a legal system—I think you could spruce it up. I think it would not be wrong to have a specific procedure for the independent committee to decide that he is subject to it. That would give a road map for a lawsuit. You could make the lawsuit easier. I would be very reluctant to give up the notion that somebody could take substantial sums of money away from somebody without due process. You could make the due process faster or specific, but I think it is—and you could give the SEC the capacity to make the first decision as long as it was a subject of judicial review.

Mr. BAKER. I don't dispute that. The problem is that with the speed with which transactions are closed and the volume of dollars involved and the ability for individuals who chose to do so to move assets out of the reach of even the Government's control. I think we have a problem that is not appropriately responsive when given a judicial remedy.

Mr. HILLS. It is hard, but give the SEC a little more capacity. They have a judicial system. They have an administrative body. The SEC could have the right to come in and declare, you could have an automatic injunction relief that would be subject to judicial review. There are a lot of things you can do with the system you have.

Mr. BAKER. Thank you. My time has expired.

Chairman OXLEY. The gentleman's time has expired. Thank you.

Let me conclude, and I apologize for being out of the room, but I did want to first welcome all of you and we certainly appreciate your concern. It is always difficult on the second panel. But your testimony has been excellent and we have appreciated your being here.

I want to, first of all, probe generally where—given what we are faced with now in light of Enron and Global Crossing and other accounting issues that are in front of us in the legislation that we have, as well as the proposed regulations, where each one of you see the accounting, the Big Five/Four maybe accounting firms over the next 10 years, given your best judgment as to where you see these large companies going, where they resemble anything like they are today. What is your best guess, Mr. Hills, on where that might go?

Mr. HILLS. I think the most serious problem facing the country is the failure or the fact that we could lose our accounting profession as we know it. It is deteriorating. It has deteriorated as I said earlier. The caliber of people going into it no where near match what they were 20 years ago. We have a real responsibility to get them back into the profession. So it is a danger. As I said before, partly it is because the whole audit process has become a commodity. There is no quality involved in the securing of an audit assignment. So we have a basic responsibility to put judgment back into it, to bring people into it, to get the MBAs from the better business schools, among others, to come into the profession. I would say the accounting profession is in danger.

Chairman OXLEY. And where are those MBAs going now if they are not going into accounting?

Mr. HILLS. Well, they go to consulting firms. They go to investment banking. They even go to law school sometimes, unfortunately. They have other places to go and they are not being pulled in. Russ Palmer, some of you know, was the great dean of the Wharton School. He had long before that been the chairman of Touche Ross. Twenty-three percent of his graduates were going to the accounting profession when he was the dean. In the last 2 or 3 years, not one went.

Chairman OXLEY. Ms. Roper, do you think it is important that we have a strong public accounting firm, say five or whatever number large, multi-faceted accounting firms in existence, or do you think it ought to be shrunk considerably?

Ms. ROPER. We generally do not think concentration in industries benefits consumers, although it is not clear in this area that they compete on the basis of benefits to investors. But we do not look to shrink the accounting industry. And since the first place that shrinkage would likely occur would be with Arthur Andersen, I have to say there is the potential with the Volcker Commission for Andersen to emerge from this if it can survive as something of a model company. And we do not want to see Andersen destroyed by the current situation.

I do not claim any particular talent for predicting the future. And it seems to me that there are too many factors in question right now to be able to look into the future with any accuracy. We do not know what you will decide to do about auditor independence. And we do not know what you will decide to do about auditor over-

sight, although as we have said we see real progress being made here.

I think it is absolutely essential that we have strong independent accounting firms performing public audits. One of the things that has changed—we have had scandals in the past, one of the things that has changed since the 1970s and 1980s, when we had previous major accounting scandals is that most people did not invest then, and today most households do. And they invest primarily to save for retirement.

And there was a statement earlier that seemed to imply that this bill was designed to send the message to investors that it is Congress' job to protect them from stocks going down. It seems to me that this bill is designed, and Congressman LaFalce's bill, are designed to ensure that investors get accurate information so they can determine for themselves whether the stocks should go up or down and that they should not—it is not enough that Enron is now being punished when for years its stock was artificially elevated based on misinformation. And so we believe that if you take the steps toward really enhancing auditor independence, enhancing auditor oversight, doing a broad range of other things that we did not talk about today to improve the quality of disclosure, that you will significantly improve the ability of investors to make informed decisions based on accurate information instead of hype.

Chairman OXLEY. Mr. Turner, are you good at predicting the future?

Mr. TURNER. Oh, I am right up there with you.

Chairman OXLEY. I will look at your brackets for the NCAA if you are.

Mr. TURNER. I do believe the markets will drive where the firms go to some degree. And I think the markets are already reacting to that. In fact, there is evidence that the firms are already reacting to it. And just 2 years ago, we had a unique bonding arrangement with the firms when I was at the SEC over the auditor independence rules and they were not willing to give up a few things that they are now. Now that the markets have turned around and said we do not want you doing certain things, they are moving more in that direction. And I think, in fact, that what we will see in the future is the firms to some degree, not because of themselves, because I do not think they would ever do it on their own, but because the markets and the fact that now we have one out of ever two million American investors in the market, 60 percent higher than just 10 years ago, the investors are raising up after Enron, Global Crossing, and all the others and saying we want some independent auditors, I think it is going to drive them there.

Financially, that may actually leave them even stronger in some respects than what they have been for the last 10 years. Probably make them stronger, it takes them back about 30 years ago when 70 percent of the fees were just audit, they were principally audit and tax. In fact, if you go back to the mid-1970s, there was only probably 5 to 10 percent in each of the firms that were in consulting, and financially they did very, very well at the time.

When you look at the gross margins, and as my resume says, I have run one of these business units, the gross margin on the audit practice, and this came out in our public hearings as well, is actu-

ally higher than the margin that you make on the consultant. It has just been that consulting has grown at a much more rapid rate than the auditing, but that was because the economy was good. As the economy turns down now, the consulting won't be as important to them, the auditing will. Given that financial side of it plus what I think the market is demanding, as we have seen, and seen from the audit committees, I think they are going to step back from being consulting firms to becoming much more of an audit firm than they have been in the past, market driven. And certainly I would encourage the committee to take more steps in that direction to protect the franchise.

Chairman OXLEY. Thank you. My time has expired.

The gentleman from New York had a couple of extra questions before we close.

Mr. LAFALCE. Yes, first, just a brief comment. We focus an awful lot on accounting firms and the audit, but most investors do not have the vaguest idea of what that audit was, would not be able to read it if it was put in front of them, and could not interpret it, and that is why it is so important that we not lose sight of the securities analyst because so often the investor, and the less sophisticated the more this is true, relies primarily on the recommendations of the Wall Street analysts, and they have got to do a much better job. They have just missed too much for one reason or another, to the point where you could say some of their analysis has been grossly negligent or reckless with disregard for reality.

But I believe, Ms. Roper and Mr. Turner, you are familiar with both Chairman Oxley's bill and my bill. Mr. Hills, I am not sure if you are familiar with my bill.

Mr. HILLS. I am not.

Mr. LAFALCE. Pardon?

Mr. HILLS. I am not. I have been in Singapore all week.

Mr. LAFALCE. OK, well, to the extent that any of you are familiar there are similarities and then there are some clear differences too. And we are going to be airing those differences I am sure during the course of mark-up, which we anticipate will be after Easter.

Ms. Roper and Mr. Turner, since you are familiar with both, what do you think are some of the salient differences and why do you favor with respect to each of those differences one version over another?

Ms. ROPER. OK, on the issue of auditor independence, as I said, we believe that we need a broad ban on consulting services. And while your legislation does not go quite as far as perhaps we would, its provisions to go back to the original SEC rule proposal language on the whole range of non-audit services we think is very important, because although at the time the attention was focused primarily on the questions of internal audit and financial system design, all of those areas were weakened in the final rule. We think it is very important that once you define a list, once you have decided that you are going to take the approach of defining a list of services that are prohibited, that that list not be set in stone. And so we favor the idea that the SEC would have ongoing responsibility to review services that are provided to determine whether they create independence problems for the auditors and to do that

according to the set of principles that were included in the SEC rule proposal.

We also believe very strongly that the auditor should be hired directly by the audit committee and that if we are going to allow any non-audit services to be provided, that they should be directly and specifically approved by the audit committee in keeping with the idea that we need the board rather than the management to be controlling these decisions.

And in addition we believe that mandatory periodic rotation of auditors helps to reduce the inherent conflict of interest that exists when the auditor is hired and fired by the audit company and that an auditor who is looking at the—because of the low turnover in the firm, an auditor is looking at a 20, 30, 50 year engagement with that audit client has way more to lose than one who risks losing 2 years of audit fees because they are near the end of the term of their rotation.

I mean, we are not married to a single idea of how long that term would be. You have to balance the cost of the learning curve at the start of the audit with the benefit that we think it provides independence, but we do think that that is an approach that deserves attention. We are willing to look at other options as well to deal with that issue, but we think that is a credible solution to that problem.

And, on auditor independence, if you look at the constant flow of personnel from Andersen to Enron, or from Andersen to Waste Management, where you had at Waste Management, since 1971, no chief financial officer or chief accounting officer who did not come from the auditor, I think that creates a climate in which the outside auditors are viewed as just another part of the corporate community, and that that kind of intimacy is not conducive to true independence. And so we also strongly support the cooling off period for auditors.

Mr. LAFALCE. Mr. Turner, and also could you include any comments you might have about litigation reform efforts and where at least my bill would address that?

Mr. TURNER. I would be happy to. As far as the PRO goes, which both of them have, which is actually excellent, I think in your bill it is a much stronger SRO in that just in terms of the ability to compel testimony and document production, which is I think very important. It is probably more public—not only in public in terms of what it can do as it comes out of a disciplinary action, but also in terms of the board makeup itself.

In the area of auditor independence, I would echo what has just been said by Ms. Roper. Going further I think is needed at this point in time than what has just been mandated there, especially in light of what we have seen in a number of cases that have come out since we did our rulemaking. We have got Waste Management behind us now. We have got Enron behind us. Global Crossing. I think those all beg out for a much stronger independence standard.

On mandatory rotation, I certainly, having been an auditor, understand the concerns of the profession. But if you do a mandatory rotation, for example, once every 7 years, the additional cost is not going to be great. If you say the average audit for the 10,000 to 12,000 public companies is about 2,000 hours, real cost is going to

be in the first year. On average, you provide about a third additional hour in the first year. So over a 7-year time period, you would go from about 14,000 hours up to about 14,600, 14,700 hours. And in light of the losses that investors have incurred, that is a drop in the bucket.

And the issues with first year audits, there are also indications with the top 10 list that Congressman Sanders pointed out, there is probably much greater losses and exposure there in the continuing relationship the market has shown and the losses have shown, much greater damage and much greater exposure to problems if you don't have the mandatory rotation provision billed in. And they talked about Greece and Italy and some of the other countries, I don't know if I would use them as a model.

On the litigation issue, I certainly would urge the committee not to go back and undo the PSLRA. I have served as an expert witness, in fact, for some of the accounting firms and being a partner myself, there was too much ambulance chasing quite frankly, and so I would not go back and roll that out.

But I think there is a reasoned approach to dealing with that today. These are not all frivolous litigation. In fact, most of the cases have got some validity to them that are being brought. I think that is one of the benefits that we have got out at the PSLRA, the fact that there has been an increase in litigation, just the increase itself does not mean anything unless you turn around and look at it. There has not been as much increase against the accounting firms, if you actually go in and dig into the numbers. But what the surveys do show is that, in fact, the incidence of financial misstatement wrongdoing has increased significantly. Given that, I would expect that there would be an increase in the amount of litigation. I think the PSLRA has avoided frivolous litigation, but perhaps swung—you heard the accounting firms talk about "unintended consequences," maybe one of the unintended consequences of that bill was it swung way too far to one side. And I think we need to bring it back into the middle and perhaps the best way to do that would be to undo the Central Bank case and bring back aiding and abetting.

Mr. HILLS. May I make one comment, Mr. LaFalce? As an alternative to mandatory rotation, the notion that every 3 years the audit committee has the specific responsibility with independent consultants to analyze the performance of the auditors and must affirmatively decide it is in the best interest of the company to retain them, that keeps authority and responsibility in the audit committee. The mandatory rotation for all practical purposes takes total responsibility away from the audit committee. They no longer have any role to play.

Mr. LAFALCE. I understand where you are coming from Mr. Hills, but the difficulty with that is I remember my days in the Army when you had to be rated, if you were not rated in the top 1 or 2 percentile, you were really doing terribly. And I am afraid that it might become automatic.

Mr. Hills, I have no idea where you stand on the issue of overturning the Central case and once again permitting lawsuits based upon aiding and abetting liability. Do you have a judgment on that? It seems to me that the accounting profession is likely, if they

only have proportional liability rather than joint and several, and most especially if they are not subject to private litigation from an aggrieved party for aiding and abetting, they are much more likely to be lax in their standards. What are your thoughts on that? And I shouldn't ask the question unless I know the answer and here I don't know the answer so I am proceeding at my own peril.

Mr. HILLS. If you look at the 16 committees I have served on, a whole lot of those audit firms paid a whole lot of money to settle the claims that we brought. And I would say to you that the punishment of the courts is really quite severe. In the Waste Management case, in the Enron case, the monies offered by, you cannot hardly think they could offer much more money.

So something works. What works is conferring independence. What works is a good independent audit committee. I say bolster them. Give them the authority to do their job and you will have a much better climate.

Mr. LAFALCE. Thank you.

Chairman OXLEY. The gentleman's time has expired.

Let me just close if I can, Mr. Hills. What role does Congress play in this? That is, there was some concern expressed in the first panel with trying to many I guess put a one-size-fits-all solution to auditor independence and so I am wondering exactly what we need to do? I am concerned that if we do so, that we step in, we almost federalize the auditing profession and I have some real concerns about that. Do you share those concerns? And if you do, shouldn't the auditing committees, as you indicated, and the SEC step in and deal with these issues?

Mr. HILLS. I think your Section 9 is an extraordinarily good way to go about this. The SEC will respond very strongly to that kind of request. The SEC can do most of the things you want. They can require for example that the audit committee affirmatively decide whether to retain the auditors. They can decide whether or not there must be an independent nominating committee. They can decide those things if you push them to do it or you can legislate. I do believe that we have gone a long time in a limbo. The audit committee reached a certain pinnacle, maybe 10, 15, 20 years ago and it stayed there, and we have not pushed them over to that last part. I think this committee can do it. I think the Senate Banking Committee can do it because the Commission will be responsive. It may take a little bit of legislation, but I think a little bit of legislation will provoke a wonderful response.

Two things the SEC has done since September. One they said the auditors must propel the directors to understand the alternative ways to understand the financial papers. That is a big change.

The second thing happened just 3 weeks ago when the chief enforcement officer or the chief accounting officer of the enforcement division, said, "By the way, the fact that you satisfy all the rules does not mean that you are not violating the laws if it is not overall fair." Those are huge differences.

Now, when I was a kid, I thought those were the laws. But they said it again and this committee can tell them well done and make sure he does mean it.

Mr. LAFALCE. Anything wrong with that 30 year old case that has been rediscovered and codifying that into law?

Mr. HILLS. I think that is a good idea.

Mr. LAFALCE. Thanks.

Mr. HILLS. I mean. I think there is a place for a push, a barb, if you will.

Mr. LAFALCE. Yes.

Chairman OXLEY. We thank you so much for your patience and excellent testimony and response to a myriad of questions from the committee.

And with that the hearing stands adjourned.

[Whereupon, at 2:10 p.m., the hearing was adjourned.]

H.R. 3763—THE CORPORATE AND AUDITING ACCOUNTABILITY, RESPONSIBILITY AND TRANSPARENCY ACT OF 2002

WEDNESDAY, MARCH 20, 2002

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The committee met, pursuant to call, at 10:00 a.m., in room 2128, Rayburn House Office Building, Hon. Michael G. Oxley, [chairman of the committee], presiding.

Present: Chairman Oxley; Representatives Roukema, Baker, Royce, Ney, Kelly, Gillmor, Weldon, Ryun, Ose, Shays, Cantor, Hart, Ferguson, Rogers, Tiberi, LaFalce, Kanjorski, C. Maloney of New York, Bentsen, J. Maloney of Connecticut, Hooley, Carson, Sherman, Meeks, Inslee, Schakowsky, Moore, Capuano, Ford, K. Lucas of Kentucky, Crowley, and Israel.

Chairman OXLEY. The hearing will come to order. Good morning and welcome to the committee's second legislative hearing on the Corporate and Auditing Accountability Responsibility and Transparency Act of 2002, or CARTA.

Last week, the committee held its first hearing on CARTA. We heard from a diverse panel of witnesses, including former SEC officials and representatives from the securities industry, a leading consumer organization and the accounting profession. The testimony was very instructive. Our witnesses represented a broad spectrum of views about the securities markets and the role of Government in protecting investors. Some of the witnesses said that CARTA regulates too much. Others said not enough. Clearly we must be on to something that is reasonable.

CARTA was carefully crafted to strengthen the oversight of the accountants who audit public companies without federalizing the accounting profession. The legislation requires companies to give investors accurate and immediate access to important company information without drowning issues in red tape, and the bill would make it a crime for company officials to mislead auditors, ensuring both that corporate officers act responsibly and that auditors can do their jobs effectively.

CARTA encourages business leadership by prompting executives to act in the best interests of shareholders. It requires greater transparency and prevents insiders from benefiting when their employees cannot.

Today's witnesses will further eliminate the important issues that face the committee as we seek to reassure investors in the strength of America's capital markets. Already the committee has held extensive hearings in the wake of the Enron bankruptcy. Going as far back as December of last year, the Financial Services Committee has held hearings on the Enron collapse to ensure we fulfill our obligation to protect investors. Our hearings have revealed that while some bad actors may seek to take advantage of

investors, ultimately the laws in the marketplace will catch up with them.

No one should doubt that America remains the best place to invest not only for the ability of our workers and the ingenuity of our entrepreneurs, but also because America does not tolerate cheats. CARTA represents our further efforts to strengthen America's capital markets so that they may remain healthy and vital, and I look forward to the testimony of our witnesses.

I now recognize the Ranking Member, Mr. LaFalce, for an opening statement.

[The prepared statement of Hon. Michael G. Oxley can be found on page 296 in the appendix.]

Mr. LAFALCE. Thank you very much, Mr. Chairman. As we continue our consideration of legislation to address the serious systemic weaknesses that have undermined confidence in financial reporting and in our capital markets, I think it is useful to reflect on some of the testimony we have heard thus far.

One witness warned last week that we should not overreact to the failure of Enron. If Enron were an isolated instance it would be one thing. But unfortunately, it is not. The use of deceptive accounting practices to paint a false picture of a company's financial health has become much too common at some of our largest companies.

Enron is no longer even the most recent major failure linked to accounting concerns. SEC and Justice investigations into the failure of Global Crossing have again raised the specter of another major United States company using accounting practices to hide its true condition.

The safeguards intended to protect investors have been overwhelmed by the temptations for companies to either cheat or overstate or obscure financial disclosure, largely to improve short-term results and meet analyst or investor expectations and therefore enhance market capitalization.

Virtually all of our witnesses last week spoke of the need for auditors to be willing to stand up to management and for audit committees to take real responsibilities for audits and auditors. To do this, I believe that we must fundamentally alter the relationship of the auditor to its client and we must strengthen the functioning of audit committees and we must provide meaningful and ongoing oversight of the auditing profession. Auditors and audit committees should be the first line of defense in protecting investors, and our task in these hearings is to determine how we can best restore the vitality of these critical investor safeguards.

Equally important, we must ensure that the restoration is permanent and not merely evolutional and therefore most likely a temporary response to the headlines of the day. We should not delude ourselves into believing that the market will provide a lasting solution to the issues we have identified.

Now I have introduced legislation that seeks to do exactly that, the Comprehensive Investor Protection Act, CIPA. The measures included in CIPA on auditor independent, corporate governance and oversight of the audit profession have been strongly endorsed by both consumer and institutional investor groups. The auditor independence requirements of my bill are comparable to auditing

standards adopted by the General Accounting Office and proposed by New York State Comptroller Carl McCall, who will be testifying before us this morning. They were crafted after the very closest consultation with many outstanding individuals, including, amongst others, the former chief accountant of the SEC, Lynn Turner.

I look forward to working with Chairman Oxley, Members of this committee and you, Chairman Pitt, as we seek to find a legislative response that will help to restore confidence in the financial reporting system on which our markets rely.

Chairman OXLEY. Gentleman's time has expired.

The gentleman from Louisiana, Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman. I commend you for calling this hearing with regard to the important reforms contained in CARTA. I certainly want to point out the work that has already been done with regard to the reform of endless conduct with Chairman Pitt and the exchanges under Chairman Oxley's leadership, and I do believe that the provisions contained in the underlying bill with regard to audit reform are significant, important and I think timely for the committee to pursue.

My focus today will be more toward the issue of corporate governance and how we can incentivize those who are in managerial responsibility to manage for the long term. It appears that the events of Enron would indicate there was manipulation of corporate assets for the benefit of enhancing executive compensation, and it is not a unique, but very troublesome problem in the business world today that management is under extraordinary pressure to beat short-term quarterly earnings estimates in order to maintain their positions in the particular corporation they manage, all to the disadvantage of the long-term shareholder interest and corporate growth. I think we should explore with all diligence any remedies that would incentivize management to work for the long haul and not to manipulate the stock price, for example, that would enable them to exercise no cost options that then results perhaps in a few weeks later a restatement of earnings all to the shareholders' detriment with no downside risk for the executive. I think we should at least explore disgorgement as a result of these events or any other mechanism that would make it clear to management that short-term manipulation of values to enhance one's own compensation is unacceptable behavior in today's world.

Given the complexity of very large corporations and the difficulty that the common investor has in understanding the true financial condition, the executives find themselves in a very advantageous position with no liabilities for this performance.

I commend you, Mr. Chairman, for your work and I look forward to engaging the witnesses today in pursuit of remedies for the public interest and for the working families. Thank you.

Chairman OXLEY. The gentleman's time has expired.

The Chair would observe that we have a vote on the floor, and I would like to recognize the gentleman from California for a brief opening statement, and the Chair would recess the committee for two votes on the House floor and return immediately. Gentleman from California.

Mr. SHERMAN. Mr. Chairman, we have got a lot to do. There is a lot of talk about how the fees for non-audit services are significant. We ought to be looking at the amount of those fees rather than the particular services rendered. Even tax services can pose a conflict of interest as you plan to set up 100 Cayman Island corporations and then accrue a tax liability to determine whether those corporations are going to succeed in avoiding Federal income tax.

We need clear accounting principles. We need a structure of our auditing firms so the technical review department makes the final decision with all the information, not the engagement partner whose chief job it is to go golfing with Ken Lay.

Finally at the SEC, I wish that you had read the Enron financial statements and those of the top thousand corporations in America with the same care that you read the little $15 million and $10 million IPOs that I was involved in long ago where you made sure that the filings for those small offerings were clear and complete, but the Enron financial statements clearly did not meet that standard.

Thank you very much.

Chairman OXLEY. Gentleman's time has expired.

The Chair would now declare a recess for a vote, and then we will be pleased to hear from the Chairman of the SEC.

[Recess.]

Chairman OXLEY. The hearing will come to order. We are pleased to welcome back once again to the committee the distinguished Chairman of the Securities and Exchange Commission, Harvey Pitt. Mr. Pitt, it is good to have you back again and it has been a real pleasure to work with you through some very difficult issues over the last several months, and I want you to know that the Chair, and I am sure I speak for all the Members, appreciate your diligence and hard work and positive attitude as we work through some very difficult issues. So welcome and good to have you back.

STATEMENT OF HON. HARVEY L. PITT, CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. PITT. Thank you, Mr. Chairman, and it is a pleasure to be back. Mr. Chairman, Congressman LaFalce, Chairman Baker, Members of the committee, I am pleased to be here to discuss H.R. 3763, the Corporate and Auditing Accountability Responsibility and Transparency Act of 2002. As you will recall, on February 4 of this year, I testified before Chairman Baker, Congressman Kanjorski, and Members of the Subcommittee on Capital Markets about possible solutions to problems arising in the wake of the Enron implosion. The leadership and Members of this committee have worked diligently since then to explore the substantive issues at stake and to develop well thought out reform proposals intended to help restore confidence in the integrity of our financial markets.

Mr. Chairman, I would like to commend the leadership you have shown, and I would like to commend the efforts of Ranking Member LaFalce as well as Chairman Baker and Congressman Kanjorski and all the Members of the committee. These are difficult issues. These are difficult times, and your leadership has been remarkable. We appreciate the opportunity to work with you and

your staffs on many ideas in your legislative proposals, and we look forward to our continuing cooperation. Whether by legislation, regulation or some combination of legislation and regulation, we will work with you to make our Nation's Federal securities laws more responsive to the current day needs of investors.

I also want to say how very much the entire Commission and its staff appreciate your support for funding pay parity and for your concern for our agency's resources at this especially critical time.

The past several months have tested the mettle and resiliency of our markets and the investing public's confidence. With the events of September 11, Enron's bankruptcy and last week's indictment of Arthur Andersen, we have all witnessed how critical our capital markets are to the country's strength, security and spirit.

In the aftermath of Enron's meltdown, our staff is investigating whether violations of Federal securities laws occurred and, if so, who perpetrated them. Until that investigation is completed, we cannot address the specific conduct of Enron and those involved with it or the activities under investigation. The public can be confident, however, that our Enforcement Division is conducting a thorough investigation and that we will address any and all wrongdoing and wrongdoers swiftly and completely.

Even prior to Enron, we were working to make disclosures and financial reports more meaningful and intelligible to average investors. Investors are entitled to the best regulatory system possible. To reassure investors and restore their confidence, we must address flaws in our current disclosure and accounting systems that languished unaddressed for many years.

The Commission intends to reexamine our rules and regulations in light of Enron. There are fundamental longstanding flaws in our system. Now they are on the table. No one yet knows what the final answers are or should be. But, at the end of this process, we will have taken the best system of corporate disclosure, regulation of the accounting profession and fidelity to fiduciary duties by corporate managers and directors, and made that system even better.

In the President's State of the Union address, he appropriately demanded "stricter accounting standards and tougher disclosure requirements" to hold corporate America more accountable to employees and shareholders and to hold them to the highest standard of conduct. We share and embrace these principles and are firmly committed to achieving them.

We can achieve needed improvements by improving standards and our regulations in three principal areas. First, disclosure by public companies must be truly informative and timely. Second, oversight of accountants and the accounting profession must be strengthened, and accounting principles that underlie financial disclosure must be made more relevant and timely. Third, corporate governance must strengthen the resolve of honest managers and directors who oversee management's actions and make them more responsive to the public's expectations and interests.

The Commission already has statutory authority to adopt rules to implement virtually all of the President's program as well as other improvements necessary to address systemic problems brought to light by Enron's collapse. We will work closely with you to ensure that the regulatory framework we ultimately propose ac-

commodates your views of what is appropriate and in the public interest.

We have endeavored to move forward as quickly as we responsibly can on these issues. First, in cautionary advice on December 4 of last year, we gave guidance on the appropriate use of, and limits on, pro forma financials. In further cautionary guidance on December 12, we set forth initial requirements and guidance on the obligations of public companies to disclose critical accounting principles.

On December 21, we announced our Division of Corporation Finance would monitor annual reports submitted by all Fortune 500 companies in 2002. This initiative significantly refocuses and improves our review program for financial and non-financial disclosures made by public companies.

On January 17, we announced our preliminary concept of a new private sector regulatory body to oversee the accounting profession. On January 22, we identified issues in Management's Discussion and Analysis to be addressed in 2001 fiscal year end reports regarding off balance sheet financing arrangements.

On February 4, the securities industry and its self-regulators, acting under the leadership of Chairmen Oxley and Baker as well as Ranking Members LaFalce and Kanjorski, announced proposed rules to create more transparency for analyst recommendations.

On February 13, we announced proposals to address aspects of corporate disclosure meeting improvements. On the same day, we called upon the New York Stock Exchange and Nasdaq to look at specific components of corporate governance. And just this past Monday, in response to the Andersen indictment, we released orders and temporary rules to assure a continuing and orderly flow of information to investors and the U.S. capital markets.

In addition, over the past several months, we have been seeking input broadly, from all concerned on both corporate disclosure and auditor regulation. To that end, we held roundtables on March 4th in New York and March 6th in Washington, with distinguished business executives, lawyers, accountants, academics, regulators, and public interest representatives. We have scheduled our next roundtable for April 4th in Chicago, and plan to hold additional roundtables in the next 2 months. This May, we will hold our first ever "investor summit" to solicit additional investor input.

Congress, however, must make the final judgment whether legislation is necessary or appropriate. We intend to continue working with Members in both Houses and on both sides of the aisle regarding legislation. We will continue these efforts and will commit to implementing any legislative changes Congress ultimately believes are necessary.

Last month, Chairman Oxley and subcommittee Chairman Baker introduced H.R. 3763. This proposed legislation addresses many of the key issues facing our capital markets today, most notably, creating a statutory public regulatory organization to oversee the public accounting profession. In my formal testimony, I have addressed some of the key aspects of this proposed legislation and I do ask that my formal testimony be included in the record in its entirety.

Chairman OXLEY. Without objection.

Mr. PITT. Thank you. For present purposes let me offer a brief overview on my comments on this legislation.

First, given our existing authority, combined with Section 12 of the bill, we believe that this legislation would give us ample authority to enforce the bill's directives, if enacted.

Second, the proposed public regulatory organization the bill mandates and our proposals for a public accountability board share many common attributes and characteristics.

Third, if legislation is enacted, the key is giving us both the authority and flexibility to ensure comprehensive and effective regulation of accountants and accounting.

Fourth, the Commission shares the bill's underlying philosophy of holding auditors to the highest standards of independence, competence and ethics. We think it unwise to cast solutions to issues of auditor independence in legislative stone, but we do agree with the bill's fundamental precept that auditor independence is a critical issue which requires constant attention.

Fifth, the Commission embraces the bill's core concept that financial disclosures must be timelier, more comprehensive, more relevant and provide greater transparency.

Sixth, we agree with the bill's concept that the Commission, through its staff, must significantly expand its review of financial and non-financial disclosures. We must also try to use our resources more effectively by targeting our reviews at the most important areas of disclosure at any given point in time.

Seventh, the bill requires us to perform or participate in several studies that we believe would shed light on possible additional reforms. We support each of these initiatives, and yesterday the Commission voted to commence a formal inquiry of rating agencies and their regulation.

Finally, a companion bill increases our authorized funding. We have identified current needs and have worked with OMB to reach common ground. OMB supports our additional request for 100 additional personnel. It does not as yet support appropriating funds for pay parity in fiscal 2003. We hope to persuade OMB to fulfill the implicit promise of pay parity once the legislation authorizing pay parity was enacted into law.

Mr. Chairman, Congressman LaFalce, Chairman Baker, Members of the committee, I thank you for the opportunity to testify today, and I am pleased to try to respond to any questions the committee may have.

[The prepared statement of Hon. Harvey L. Pitt can be found on page 302 in the appendix.]

Chairman OXLEY. Thank you, Mr. Chairman, and let me first indicate we will help you on a bipartisan basis on your issue on pay parity with OMB. This Congress spoke very clearly on the pay parity issue along with the SEC fees legislation that were contained therein, and we want to be equal partners with you on convincing our friends at OMB and the Administration that pay parity is the law of the land and that we have a firm commitment to that ideal and we are going to continue on that best effort.

And let me also congratulate you on a number of initiatives within the SEC and working with our committee. It is frustrating somewhat, I am sure it is to you, that many of these initiatives go rel-

atively unnoticed in the popular press while high profile hearings get most of the attention, but I have to tell you I think I share that with the other Members of the committee. We understand the hard work it takes to undertake these initiatives. And clearly the news conference we had with you along with Mr. LaFalce and Mr. Kanjorski and Mr. Baker on the analyst issue was a good example, I think, of what we can do when we work together, and I want to thank you for all of your help in that area and many others.

Let me begin the questioning, Mr. Chairman, with a question that was raised last week. One of our witnesses testified that the market incentives for responsible corporate governance and accurate accounting are incredibly powerful. How would you characterize the practices of post-Enron America from your viewpoint?

Mr. PITT. My belief is that the response in the post-Enron era has been all that one could hope for in terms of articulation of commitments to fiduciary obligations and companies reexamining the qualities of their disclosure. We have had an upsurge of companies coming to us asking for advice and assistance on a number of these issues. That doesn't, in my view, obviate the need either for legislation like yours and Mr. Baker's or further regulatory work. But I do believe that the market has now created very powerful incentives for people to do the right thing, and, with the proper legal framework, we can ensure everyone that that fidelity won't be short lived.

Chairman OXLEY. That is an excellent point, and it is the goal of our legislation, as you know, to provide for more timely disclosure, more transparency, not necessarily more difficult rules and regulations, but indeed to allow the great forces of the marketplace to work effectively based on those concepts of early disclosure and transparency, and we thank you for your support in that regard.

Let me ask you, what is the relationship, if any, between the Private Securities Litigation Reform Act of 1995 and the ability of investors to recover for actual fraud?

Mr. PITT. In my view, the Private Securities Litigation Reform Act, which was a bipartisan effort, reflected sound approaches to the problems it was designed to deal with. We have taken a look at the statistics since the adoption of the Act in 1995. In fact, there has been no diminution in the number of class actions that have been brought on average in the 7 years since it was enacted, and the average value of settlements has increased. In point of fact, by encouraging large institutions to take more of a role to ferret out the frivolous from the meaningful, I think we are seeing a better use of the class action mechanism, and in my view those who suggest that the Private Securities Litigation Reform Act is somehow responsible for any aspect of what we see in Enron, or any of the other high profile matters, are very much mistaken.

Chairman OXLEY. We have had some witnesses and other commentators to say that there is a real danger if Congress tries to create audit only firms. What kind of ideas do you have in that regard?

Mr. PITT. This is a subject that I think is very critical, and you are correct to hone in on the significance of that. In my view, there is no direct correlation between consulting work and auditing failures, but there is a problem with respect to the independence of

auditors. Independence is the bedrock on which the accounting profession was founded and all steps have to be taken to strengthen it.

My concern is that, if we go to the absolute separation that some people are proposing, over the next 5 years the quality of audits will diminish, not improve. It stands to reason that if accounting firms doing audits only engage in auditing, they don't become more independent, they become more dependent on their audit work. To me the problem is twofold. On the first hand, and the most important aspect, are those on the immediate firing line: the engagement partners and all of those who do the audit work. Those people must scrupulously adhere to independence notions. In my view, cross selling compensation to those people, that is, enabling them to sell other services, is absolutely inconsistent with the notion of independence.

On the other hand, you have the firms as a whole. Most people have tried to deal with this issue as if it were a firm wide issue and not as if it were the engagement partner and engagement team's problems. For the firm, the issue is to provide appropriate incentives and sanctions if the firms do not properly supervise those people who are on the engagement front line.

So, it is a twofold problem, but most people have looked away from the individual audit partners and have looked at it as if it were a firm wide problem.

In addition, one other point—and I apologize for going on, but this is a very critical subject. If we take away much of the expertise that auditing firms have developed, for example, in the tax area, they will not be competent to perform audits. Getting into the issues of tax work enables auditors to have a clear sense of where the company is and how the issues can be handled.

Chairman OXLEY. The Chair's time has expired.

The gentleman from New York, Mr. LaFalce.

Mr. LAFALCE. Thank you very much. Since you were just discussing the separation of the auditing and the consulting function and you mentioned taxation in particular, in my bill I call for a separation, but not a complete separation, same way as people can advocate a separation between church and state, but we have never had a complete separation within the United States. And I specifically would exempt the tax function.

Now, Chairman Levitt did articulate a rule, and I supported it at the time although many others in the Congress generally opposed it. What is the status of that rule right now and where do you agree or disagree with the former Chairman of the SEC, Mr. Levitt.

Mr. PITT. I appreciate that question, because again I think it goes to the heart of this issue. Eighteen months ago, the Commission adopted its independence rule, and at that point Chairman Levitt said, and I am quoting this from memory, but I have the exact quotes: "the rule we put in place today is better than an absolute ban." I happen to agree with him. I don't think 18 months has been a sufficient time for us to allow the rule to take effect.

Mr. LAFALCE. How did that rule compare with his original proposal, which was not an absolute ban?

Mr. PITT. Exactly. He did not have an absolute ban. My view is that——

Mr. LAFALCE. My question is how did the rule that was promulgated 18 months ago compare with his original rule? Was it watered down significantly, somewhat, not at all?

Mr. PITT. No. What I am saying is I have read some people say that the rules were watered down. Chairman Levitt's comment, with which I fully agree, was not that the rules were watered down, but that they were better than the absolute ban.

Mr. LAFALCE. No. You originally said that he said they were better than an absolute ban. You did not originally say that he said that they weren't watered down. And so are you now saying that he also said that the rules that were promulgated were not watered down from his original proposal?

Mr. PITT. I will tell you this. I have looked at, I think, every statement I can get through computerized research and at no time did I hear Chairman Levitt suggest, because I don't think he believed it nor do I believe he should have, that the rules were watered down. There was a process of discussion and analysis with accounting firms, but eventually the rule that he enacted he thought was much better than what he had originally proposed, which was an absolute ban.

Mr. LAFALCE. One of your predecessors other than Mr. Levitt, Mr. Hill, argued last week before this committee, and you were his General Counsel when he was Chairman, that we should confer on audit committees a more formal legal status. He argued that the SEC should make it clear the failure to maintain an independent auditing committee constitutes a material weakness in a company's internal controls.

My first question is do you agree with that?

He also recommended that independent directors should be nominated by an independent nominating company rather than by the CEO or chairman of a company and that this was in the program of the SEC. Do you agree with that? Two specific recommendations of your former Chairman, and do you agree or disagree?

Mr. PITT. It would be hard for me to question former Chairman Hill's judgment since you are right, I did serve as General Counsel during his tenure. But my view is that, if you do not have a validly constructed and operating audit committee, that that is a material weakness. I believe that former Chairman Hill——

Mr. LAFALCE. Well, is it necessary for you to promulgate a rule to that effect to make that operative?

Mr. PITT. No. I don't believe——

Mr. LAFALCE. He suggested that it was.

Mr. PITT. I think what I read him to say and certainly what he has said in private discussions and communications with me is that the Commission should make that point loud and clear. I think I have just done that.

Mr. LAFALCE. Could you explain that more explicitly in some writing somewhere because the response to my question is one thing. But something a bit more formal in writing would carry a bit more weight, I believe. So I would be anxious to see that.

And now to the second question regarding his recommendation for an independent nominating committee or the board of directors

as opposed to taking the recommendations of the Chairman or President or CEO.

Mr. PITT. I believe that those suggestions are quite constructive. And as you may be aware and as I indicated in my opening statement, we have asked both the New York Stock Exchange and Nasdaq to come forward with corporate governance standards.

Mr. LAFALCE. Which they can do or which you can do, correct?

Mr. PITT. I believe they can do that, yes.

Mr. LAFALCE. And you can also too, can you not?

Mr. PITT. I believe we can do that. I believe it raises some significant questions, and indeed there is an opinion in the DC. Circuit, the Business Roundtable rule, that suggests that the Commission has some limitations on its authority.

Mr. LAFALCE. I would suspect you disagree with that, do you not?

Mr. PITT. I don't agree with the decision.

Mr. LAFALCE. I thought so. You think you have the plenary authority. I thought you would.

Chairman OXLEY. Gentleman's time has expired.

The gentleman from Louisiana, Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman.

Chairman Pitt, when CEO Berardino appeared before the committee he responded to a question from me as to the ownership issue of the financial statement in that it belonged jointly to management and shareholders. I was a bit taken aback by that view. Recently the GAO has issued a significant report in which one of the recommendations of that report is to statutorily define that the financial statement should reflect the financial condition of the corporation for the shareholders' evaluation and not be the subject of managerial influence or control. Would it be of help to the Commission if there was a provision of law that made it clear that the financial statements should be prepared to reflect accurate financial condition of the corporation for the benefit of shareholders?

Mr. PITT. The law already provides that, and I would be concerned such a provision actually would create an implication that the law does not require that.

Mr. BAKER. Terrific.

With regard to incentives, it appears that there are significant conflicts, whether it is an audit firm which is consulting and is paid $50 million in the aggregate or whether it is simply a $50 million dollar audit. There are 50 million reasons in both cases to be influenced. Likewise, for management to manipulate earnings, revenue streams, obfuscate debt, the consequence of which is to increase stock values. It is all too often the case that part of the employment contract incorporates no cost options which are obviously intended. If you do well and manage the company properly, those options become more valuable, you exercise them. But then subsequently if there is a restatement of earnings within some short-term period, the shareholder takes the consequences of that loss while the executive is able to retain those proceeds. I don't know the appropriate remedy, but in both cases are there incentives that could be considered by this committee for inclusion in the mark, which would cause one to invest for the long term, not for the benefit of the quarterly report, and are there further incentives that

might be provided for the audit side of the function, for example, a cooling off period, where if you are the principal audit firm engaged by a corporation, that you could not be employed by that corporation in an executive capacity for some period of time after you conduct the audit, traditionally known as a cooling off period? With regard to either of those, do you have recommendations or could you make those at some future point to us?

Mr. PITT. I do. With respect to incentives, I could not agree more with you that there is a need to make sure that management's incentives align with shareholders' interests. Just last week, we brought a case that is a bit unusual for the Commission in which we have sought to have a former CEO of a public company disgorge his compensation in stock options and bonuses because the appearance of profitability was an illusion. I believe that the Commission has to be much more aggressive in targeting misconduct. And where serious misconduct has occurred, I think one incentive or sanction has to be removing any benefits and making certain that benefits are seen as a long-term proposition and not as a short-term.

The other thing, and this is a place where we do need legislation, is that I believe that the Commission should be given administrative authority to bar officers and directors of public companies who commit violations of the Federal securities laws from serving as officers and directors. We can do that in the securities industry. The banking agencies can do it with banks. I believe we should be able to do it with public corporations, obviously subject to review.

Mr. BAKER. Let me jump in with one quick statement. Finally, with regard to our whole accounting system, although we are taking important steps with the bill, as to the overall system we have today, which tends to be historic in nature, reporting activities 90 days old, we need to look more thoroughly over the long term toward real-time forward disclosure as opposed to the regular FD approach, which appears in retrospect not to have worked very well at all. If reg FD was intended to provide the investing public with a thorough understanding of the markets, it would appear given recent circumstance that it has been a failure at best and we have a long-term project ahead of us to reconstruct our whole accounting methodology to give investors real-time information that is helpful to the forward direction of the company. My time has expired.

Mr. PITT. One of the propositions in the bill I support that you and Chairman Oxley have authored is the notion of moving to more current disclosure. My concern about regulation FD, which I share in terms of the remarks you made, is that you can satisfy the rule by saying nothing to anyone. We are proposing affirmative disclosure requirements, and I think that solves the concerns that the former Chairman had about selective disclosure, but does so in a way about informing the market rather than keep information away from the market.

Chairman OXLEY. The gentleman's time has expired.

The gentleman from California.

Mr. SHERMAN. Thank you. Let me first suggest something that I think you could probably do next week and might not be terribly controversial, and that is to require that every audit report filed with the SEC be signed by the head of the technical review depart-

ment within the accounting firm after seeing all the information and that we not have a circumstance where the final decisionmaker as to whether Arthur Andersen's signature appears at the bottom of a report is made by the billing partner, the engaging partner, the golfing partner, but is instead made by someone whose loyalty is to the firm as a whole and who is selected on the basis of the technical expertise. Can you do that next week?

Mr. PITT. I don't know if we can do it next week. But I will say this, we are very much in favor of the concept you are articulating, which is that in order to make sure that firms apply their supervisory responsibilities, the national technical office be assigned to every audit and not leave the final decision in the hands of the engagement partner. We think that would produce even better audits than we presently have, and most firms I think are doing that.

Mr. SHERMAN. There was one Big Five firm that wasn't.

Mr. PITT. You are right.

Mr. SHERMAN. The SEC under the Chairman's bill will be reviewing, I believe, the top 500 firms when they file their accounting statements with you, reviewing them I hope as you review initial public offerings by small firms. I hope I have that right. But can you provide us with how much money you will need to do an outstanding job of reviewing either the 500 most important financial statements or the Fortune 1,000 or the top 5,000 and would it be necessary to increase your budget by 50 percent or 100 percent so that we get the same kind of review process there as I commented earlier I was used to with smaller companies? Obviously you can't plan your budget on the back of that envelope in front of you, but if you could submit that for the record so that we know? And can you also comment now, do you have the independence as the head of an independent agency to come to Congress and say I need my budget doubled or are you under the thumb of OMB and under the thumb of those looking at the macro-budget situation from the Administration?

Mr. PITT. I would like to assure you that, with the exception of my four children and my wife, I am under the thumb of no one. I will say this, that we have had a very positive and constructive working relationship with OMB. We have differences of view and at my confirmation hearing I stated under oath that I will always come back to Congress and inform you whenever there were differences of view if Congress wanted to know what we had asked for.

Our major difference with OMB only relates to funding pay parity for 2003. And, because I believe we have a good relationship with them, I believe that we will ultimately prevail, although I am an optimist by nature.

Mr. SHERMAN. You may disagree on that one point, and that is how much your existing people get paid. You seem to comment favorably on the idea of the SEC at least reading and demanding clarification of the financial statements filed with you. That is a lot of additional work. The President doesn't have a penny in his budget to allow you to do that work. I assume that all your people are working hard now and that they don't have free time. So I would hope that you would submit to us something that I guess would be your second potential difference with the Administration, and that

is how much you would need to carry out either the kind of review that I believe the Chairman's bill calls for and I am asking you also to expand that, not from 500 firms, but to 1,000 and then 5,000.

Mr. PITT. May I just say this. When we testified before the Senate Commerce Committee on March 7, I had indicated that in order to deal with the incredible vigor with which we are approaching financial fraud cases and to deal with our review of Fortune 500 filings we need 100 additional people. OMB supported that, and indeed, after our testimony, my understanding is that they asked whether, rather than waiting until 2003, we would prefer to have it immediately, which, of course, we would. I do want you to understand what the relationship is.

I also believe that the Commission is not a separate government. I believe the SEC has to be part of an overall government and it is my view that we are under an obligation to respect the fact that there are a lot of budget priorities.

With regard to the point you make about how many more people we would need, I do think one point is critical to stress. My hope had been that I would have taken the first couple of months in office and done a thorough assessment of how many people I thought we needed, whether there were efficiencies. A funny thing happened to me on the way to the Commission. And we are now dealing with our third crisis, and so I haven't had the time. This week we will be announcing, however, a 4-month in-depth internal review of our deployment of resources and with an effort to figuring out before 2004 budget time what our actual needs are, and we are devoting substantial attention to that. But you should be aware, and this is the one concern I have, there is not enough money and there aren't enough people to give you the kind of guarantee that I think we all would like to have. And so there are always tradeoffs.

But, one thing we did the minute Enron hit was to redeploy our assets in the Corporation Finance Division to review Fortune 500 filings. And one of the things that we want to do with the additional 100 people is to hire risk management specialists who will direct us to look for places where the greatest likelihood is that problems will arise. I think that will help us strategically.

Chairman OXLEY. The gentleman's time has expired.

The gentleman from Ohio, Mr. Ney.

Mr. NEY. Mr. Pitt, can you give your view on how accounting firms maintain their independence of their auditors when members of their firm work for years with the same company? And what I am trying to get at, the question I had asked in the earlier hearing a few weeks ago, I raised the issue about how Andersen employees were intertwined with Enron and were actually mistaken for Enron employees. They even went as far as to wear Enron golf shirts and went on Enron retreats and some of the people thought they were Enron employees.

Could you tell us, in your opinion, if the reforms proposed in H.R. 3763, whether the reforms you suggest will ensure independence of future auditors, not just with golf shirts, but——

Mr. PITT. I believe they will, because both H.R. 3763 and the proposition that the Commission has put forth are designed to create a board that exclusively deals with the ethics, the quality con-

trol and the independence of public accounting firms. One concern I have is that we not write something in stone, because if we put it in stone today we may discover tomorrow that it creates a different problem, and that I would like to avoid. But I believe both the legislation and our proposal would respond to that concern of yours, which I think is a legitimate concern.

Mr. NEY. And still have flexibility.

Mr. PITT. Yes, we would have flexibility.

Mr. NEY. The other thing, Mr. Chairman, is it possible for a company to meet the GAAP standards and still provide a full, fair and complete picture of a company's financial condition? If so, would the bill improve the standards to solve that problem?

Mr. PITT. I believe that it is possible and it has happened that companies may comply literally with GAAP and still have financial statements that may prove misleading. About 40 years ago—actually less than that, but almost 40 years ago, Judge Friendly in the Second Circuit in the U.S. Against Simon case rejected as a defense the notion that financial statements were done in accordance with GAAP and therefore the accountants could not be held criminally liable. He held just the opposite.

Judge Stanley Sporkin in the Lincoln Savings case held the same thing, that you can still create a misleading impression. Notwithstanding that, we think there is a strong need to change the way accounting principles are adopted and the way accountants look at those principles. The current set of principles facilitate a check the box mentality. That is something that we believe has got to be changed.

We want professionals as well as management to ask themselves, if I were an investor, does this disclosure tell me everything that I would want to know. And the fact that it may comply with GAAP is only one issue. If it still creates a misleading impression, it should not be satisfactory to anyone.

Mr. NEY. Does it tell you everything you need to know and also in a timely manner, also information gets there obviously as quick as it can?

Mr. PITT. Absolutely.

Mr. NEY. One other thing, if updating the accounting standards has been lengthy and arduous, which I think we all agree in recent years that task has been tough, do you think the reforms that we are discussing today can change that?

Mr. PITT. I am sorry, can they change——

Mr. NEY. It has been a lengthy process to update accounting standards. Do you think that the reforms we are discussing today will change that process, open it up, or is it still going to be a lengthy and arduous task and possibly should be?

Mr. PITT. I believe that, both under our proposal and this legislation, we could improve the way accounting standards are articulated. The FASB, which presents a full-time reflection on accounting principles, is a wonderful concept. Its implementation however, is troublesome. First, its funding is not truly independent, because it is voluntary, and we believe it needs to be mandatory. Second, we think that the Commission in the past has been lax in overseeing what the FASB has been doing, how quickly they do it and what matters they attend to.

One of the most important subjects in accounting is revenue recognition. For 27 years, there has not been a statement of principle on revenue recognition. So I believe the Commission has to have clear authority to direct the FASB to respond to questions.

And finally, I believe accounting principles have to be principled and not Tax Code formulated. They have to be designed to make use of professional experience and knowledge without giving people such a detailed approach that all they do is check the boxes. At the same time, they have to be promulgated rapidly. The notion of taking 5 or 10 years or, as I said, 27 years, with respect to revenue recognition just doesn't cut it, and it has been allowed to go on way too long.

Chairman OXLEY. Gentleman's time has expired.

Gentleman from Massachusetts, Mr. Capuano.

Mr. CAPUANO. Thank you, Mr. Chairman.

Thank you, Mr. Pitt. Before I ask you questions, I just want to make sure you note that the budget that is on the floor today, in the Budget Committee, an amendment to fund pay parity this year was voted down. Mr. Moore made the motion and it was voted down along party lines, just as a little footnote. So your difference is not just with OMB, but with Members of Congress as well.

I guess I need to go back about a month or so ago, and this is the first time you have appeared before this committee. Mr. Berardino testified at the same table. And during my questioning he made a comment that I found a little shocking, because I suggested every auditor has an opportunity, if they differ with what a client wants to do, to either add a comment to the audit report or qualify that audit report, which is a kiss of death on many levels. And his reaction was something along the lines, well, we can't do that under GAAP, which I found a bit shocking. And at some point if you could clarify my understanding of that, because I am still under the impression that any auditor can either add a comment at the least or qualify that audit report any time they find a client kind of crossing the line or not doing something within the four square of what they need to do.

Mr. PITT. Let me say that the concept that you articulate is one that I embrace, which is I believe that auditors have to have the responsibility as well as the backbone to question and take issue with management's selection of auditing principles or their application. Whether or not current law permits a qualified opinion, which is generally given under certain circumstances, may be a more technical question, but as your question suggests, we shouldn't be interested in technicalities. That is one of the reasons why we have proposed and will be implementing the rule which requires companies to identify their critical accounting policies, explain what would have happened if they had chosen different policies and also discuss what assumptions they made and what would have happened if they had operated under different assumptions. We believe that is going to get us to the place that you want to be and, as I say, I support the notion that we have to have accountants reflect independent judgment on the financials they review.

Mr. CAPUANO. And the other thing I suggested to him is in the final analysis even if you feel hamstrung you can always walk away from the client, which in this particular case I think in the

final analysis is going to be proven to have been less expensive walking away from a $100 million client than what is going to end up happening. But we will let history be the judge of that.

And that leads me to the next question and some of my concerns on both the bills that are filed before us is on proper influence. Arthur Andersen was my auditor when I was the mayor of my city, and one of the ways they kept me from doing some things I wanted to do to make the city look good on the books is if you do that we are going to have a qualified report. If you do that, OK, fine. My job was to make the city look as best it could in front of investors, as is the job of anybody else.

So my concern in some of the language that is used in this improper influence, what is the line that I can't cross. My job is to push. The auditor's job is to say that is enough, you can't cross this line. And my concern with some of these languages, improper influence, what does that mean? I understand if I say I got a picture of you and your girlfriend, that is improper influence. But for me to say I want to go here, I want to report this in this manner and don't you think you should count this revenue, under some of this language I am a little concerned that could be considered improper influence. And as we go through these bills, I would like you and your people to kind of keep that in mind, because I don't want this committee doing something that I don't think we really want to do.

Mr. PITT. Let me again say I share with you the underlying principles that your question implicitly raises. Both the bill and the Commission's proposal would set up an independent body that would be reviewing the quality of audits, not just providing discipline when something has gone wrong, but reviewing every major accounting firm on a yearly basis. Unfortunately, the present mechanism, the public oversight board which had been in effect for 25 years, was dramatically flawed. It wasn't given the powers and authority it needed. Under the proposal that we have raised and under the bill, you have a body that would effectively go through quality review and have the power to strip an audit firm of a client if it found that the audits were not of the highest quality. We believe that will create exactly the kind of incentive that you want to see occur.

Mr. CAPUANO. Though my time is out, I would like to add a footnote. If and when that is the way we end up, I would hope that such action on your behalf would be somehow publicly notified. If it is a private thing in the back of a room and nobody knows you did it, it really won't accomplish much.

Mr. PITT. Let me say that discipline in secret does not achieve its purpose. When we take disciplinary action, when the stock exchanges and the NASD take disciplinary action, we publicize it. The public has a right to know if people have not lived up to appropriate standards.

Mr. CAPUANO. Thank you, Mr. Chairman.

Chairman OXLEY. The gentleman from Connecticut, Mr. Shays.

Mr. SHAYS. Thank you, Mr. Chairman.

Mr. Pitt, thank you for being here. I have a number of questions. Let me begin by saying, by asking this question. Some have told this committee that there is a danger in creating audit-only firms. Do you agree or disagree?

Mr. PITT. I agree completely with that. I think it is a simplistic solution to a complicated problem. And it will produce worse audits than we presently have. I believe that, as I have said earlier in response to I think a question from Chairman Oxley, that the problem is a twofold problem. One is with the engagement team, where they must have absolute scrupulous impartiality and independence, and then at the firm level, there has to be incentivization to make sure that the firm enforces the right supervisory techniques.

Unfortunately, this issue with a total separation would only deal with the firm-wide question and not deal with the real problems here.

Mr. SHAYS. Let me get to another question. A witness on our next panel has taken the position he supports mandatory audit firm rotation, and what is your position on that?

Mr. PITT. My view is that mandatory audit rotation would write in stone a process that could prove detrimental. I believe that when an audit firm is not living up to the highest standards, then a disciplinary body should require mandatory rotation of that client. But I don't believe that setting in stone a rote process of a new auditor every 7 years is beneficial. There are a number of reasons for that.

Mr. SHAYS. Let me get to that later in the 5 minutes that I have. In the Oxley-Baker bill, which I am a cosponsor of, is there any new authority that you would like to see in the bill that is not in the bill now?

Mr. PITT. The principal authority that we would like to see included is our ability administratively to bar someone from serving as an officer or director of a company if we find that they have engaged in egregious misconduct.

Mr. SHAYS. Is that the primary addition?

Mr. PITT. That is the principal one.

Mr. SHAYS. Would you send that to this committee, suggested powers that you want that aren't in the bill? Let us know what they are.

Mr. PITT. Well, there are——

Mr. SHAYS. In writing.

Mr. PITT. Yes, I would be happy to do that.

Mr. SHAYS. In 1992, the SEC, the Treasury and the Federal Reserve in a joint report recommended legislation to repeal the GSE's exemption from the Federal securities law. As you know, Fannie Mae and Freddie Mac are the only two publicly traded firms that aren't. Does the SEC still adhere to the Commission's 1992 report?

Mr. PITT. We have not changed our general position, but we have focused on it again. I will say that in this day and age I believe transparency has to be the order of the day. To the extent that the exemptions permit anything less than transparency, which I believe is the case, I believe at least that portion has to be removed. Frankly, I could care less whether the GSEs pay registration fees or things of that nature. But I do believe that disclosure is critical for the GSEs as well as for other public companies.

Mr. SHAYS. You say it fairly strongly. But in your statement where you say comprehensive information is the lifeblood of strong and vibrant markets, our system and the global markets supporting that system require accurate, complete and timely disclosure of financial and other information. The current system of Fed-

eral securities regulation is premised on a full and fair disclosure of this information. Companies choosing to access the public capital markets must provide material information about their financial results and conditions, businesses, securities and risks associated with investments in those securities. Could I use this as a strong support in some cases of such disclosure?

Mr. PITT. Yes.

Mr. SHAYS. Thank you. I yield back, Mr. Chairman.

Chairman OXLEY. The gentleman yields back.

The gentleman from Texas, Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman Pitt, I have a few questions for you. I want to talk for a second about the audit firms. Under the MSRB, isn't there a rule for auditing firms that audit the books of issuers of debt of public entities, cities, states, whatever, that during that period of time those firms can't conduct other services for that issuer? And you may not know off the top of your head, but I just wonder if we already have some experience.

I understand your concern about complete separations and bans, but what I don't know, is there something wrong if we are already doing it, is there something wrong with saying if you are going to audit one firm, you can't consult with them, but you can consult with everybody else? If you have 17,000 public companies, there is plenty of business to go around.

Mr. PITT. Let me say that neither the MSRB nor anyone else, to my knowledge, has thus far taken the position that a firm may only do audits as a way of business. What a firm can or should be allowed to do for an individual client is a very real issue. And there can be conflicts, for example, where the other services would involve the auditor in reviewing its own work. That would be a situation clearly where auditors shouldn't be allowed to undertake those particular functions for a client. What I was addressing, and what I continue to urge upon this committee, is the notion that stripping down accounting firms so that the only thing they do is audits will produce worse audits in the future than we presently have.

Mr. BENTSEN. I agree with that. I guess what I am saying is just on a client-by-client basis, you know, the number one can do the audit, the number two can do the other consulting business. Whether or not there is merit in that, in saying you just can't do both when one is say a public issuer.

Mr. PITT. The problem with any generalization is that somebody will always find circumstances to create problems, and the tax area is a good one. If accounting firms provide tax services to audit clients, they will be far more familiar with the company they are auditing and they will be developing the kind of expertise that is critical to do a qualified audit. So my view is that if a particular function creates the possibility of a lack of independence, it should not be allowed. But I don't think we should have an absolute ban.

Mr. BENTSEN. Let me go to the public regulatory organization because I am curious about that. I think it is generally—I think it is a good idea. I am curious about exactly how you would envision it working and the ideas of setting principles or guidelines for auditing firms to meet which the Commission would have oversight over both the drafting of those principles and the enforcement of

those principles, if I understand your testimony correctly. Are we heading down a path where basically the Commission would be overseeing the quality of audits and in effect you would have to be giving an opinion just like you give a qualified tax opinion for an issuance of debt or securities, that you would be giving a qualified opinion that the audit meets the standards as established by the PRO? And that may be where we want to go. I just don't know. What do you envision how this ultimately will come out?

Mr. PITT. I think what we have in mind is somewhat different from that. What we have in mind is having a vigorous body that both can discipline individual accountants as well as whole accounting firms or offices of accounting firms, that can do quality control review to make sure that, even if there hasn't been a violation, the standards are the highest, a body that can enforce ethical requirements and that can enforce existing auditing standards.

With respect to accounting principles, my view is that I would leave that in the FASB. But in both cases, what I think is critical is that the Commission has to provide meaningful oversight. And I think over the last several years the Commission has not provided meaningful oversight to those functions, and that is something that we are pledged to change.

Mr. BENTSEN. So this would be a form of registration for—any auditing firm of a public company that is going to have a registered issuance would then have to meet the principles and would be subject to greater oversight than what is under existing law or rule by the Commission?

Mr. PITT. Any firm that wanted to be an auditor of public statements by public companies would have to belong to the PAB, as we call it, or the PRO, as the Oxley-Baker bill refers to it. And they would have to adhere to all of the standards, and they would have to be subject to discipline, and they would have to be subject to all of the rules and requirements of that organization. That is what we believe is a necessary approach to restore public confidence in the accounting profession.

Chairman OXLEY. The gentleman's time has expired.

The gentleman from California, Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman.

Thank you, Chairman Pitt. Let me ask you if you envision any practical way of ensuring that the board of directors for public traded companies are held accountable in their duty of directing management with a view toward optimizing company performance and increasing shareholder wealth. One of the things you talked about was specifically giving the SEC the ability to bar anyone who was engaged in egregious conduct. I agree with that. But looking at it from the incentive side for a minute, are there any changes that the Federal Government can make to its best practices recommendations in regard to board member selection and in regard to remuneration that would incentivize members to pursue the interests of the stockholders themselves rather than the interests of management?

Mr. PITT. I think you will hear about that on the next panel, among others from Mr. Livingston, who is with Financial Executives International. At our request FEI reviewed its existing code of ethics, which I thought was excellent when it was promulgated,

to see whether there ought to be some changes, and indeed they have recommended a change in that. And, in addition, they have taken a position on 12 critical issues relating to this entire aftermath of Enron.

I believe that corporate officers and directors have to be held to much higher standards. The question is how those standards are articulated. If they can be articulated even through the stock exchanges' listing standards, or through such codes of ethics as the FEI has proposed to me, that is a very sensible way of getting to the right result. And I think that it would provide a real incentive, particularly if we have the power to effectively sanction people who don't live up to those highest standards.

Mr. ROYCE. We talked about incentives. Let's talk about deterrence then. Short of having those involved in egregious conduct simply barred, which is a good idea, what are some of the other tools that the SEC would use or how would you envision other sanctions on those corporate leaders who do not act responsibly?

Mr. PITT. Well, one of the things that we have discussed here, but I think is worth mentioning again in response to your question is the notion that whatever incentives corporate officers and directors receive for performance should be honestly earned. So, if officers and directors have been compensated either by stock options or salaries or bonuses for producing results that turn out to be shams, they should have to give back every penny that they took from the shareholders. That is another thing that we are proposing, and, as I said, last week we filed a case in which we have sought that against a former CEO of a public company.

Mr. ROYCE. Do you feel at this point in this legislation are you crafting language that would give the SEC that ability?

Mr. PITT. Well, on the removal of unearned incentives, I believe that all the authority that is needed exists. When we go into court, we can ask the courts to provide that relief. Obviously if the courts don't agree with our case or for whatever reason they think it is not an appropriate remedy, we are not going to get it. But that system has worked quite well.

Mr. ROYCE. We would certainly with legislative intent in this bill amplify that and state that it is Congress' desire that you do have these powers, which you are now exercising or attempting to exercise in the Enron case, but just to clarify those powers to further assist in your court proceedings. I think that would be a wise policy.

Mr. PITT. I think that would be helpful.

Mr. ROYCE. I will be happy to follow up with you on that language if you could assist me in developing the language that you think would be most effective toward that end. And I thank you very much. I thank the Chairman of the committee.

Chairman OXLEY. The gentleman's time has expired.

The Chair now recognizes the gentleman from New York, Mr. Meeks.

Mr. MEEKS. Thank you, Mr. Chairman.

Chairman Pitt, let me ask, the regulatory structure that you advocate for the auditing profession would move quality review and discipline to an organization controlled by public members rather than accountants. And it leaves the standards that the auditors

must meet subject to the rules of the industry control organizations. Wouldn't it make more sense to have the same entities set standards and enforce those standards, you know, at one body as opposed to having two separate?

Mr. PITT. I think that is a suggestion that is worthy of consideration. My own view is the difficulty isn't with the ethical standards that have been promulgated. The difficulty is with the adherence to those standards and the enforcement of those standards. If we had reason to believe that the ethical standards were lacking in some way, then I think your point would be very well taken. At the present time it seems to me to be a problem of enforcement, not of standard-setting.

Mr. MEEKS. Let me ask this question, then. I believe in your testimony earlier you said that the—it was too early to tell if the auditor independent rules that were in place in the year 2000 needed to be amended. As a result of the additional corporate disclosure required under those rules, we have already learned that some companies are paying the auditors as much as 30 times more in fees for non-auditing services as they do for auditing services. Auditing services have been turned into a loss lender to enable firms to get contracts for non-offered services. Do you think that it is appropriate for them to make so much more consulting?

Mr. PITT. I don't really feel that the question should focus on whether that is appropriate or not. The question that I think those facts suggest is whether or not that situation could give rise to a lack of independence. That is what is implicit in the question. I have to say it is always possible that at some level, fees could create problems. But I think that there are ways to deal with that issue. I don't think, for example, that you and I sitting down together—I know you and I could reach agreement—but I don't think that, if you and I sat down together and said, fine, you can only make 50 percent of your revenues from consulting, that that would necessarily produce better audits.

In fact, I think if you look at the history of some of the failures in the 1960s and 1970s, long before consulting was a factor, you will find that we had some enormous audit failures. And they had nothing to do with the consulting fees.

My concern is that we should be sensitive to the problem of where the fees are coming from, how much auditors are earning. But I don't feel that there is a right number or amount of fees. What I think is there is a right way to conduct an audit and there is a right way to discipline auditors who don't meet the highest standards. That is what is critical.

Mr. MEEKS. Finally, it caught my attention also you mentioned your concerns about the time period to roll out FASB standards and what they should be based on. Do you believe the adoption of standards based on a simple majority would be better than what is now instituted, the super majority, especially when you consider there are only seven members on the board?

Mr. PITT. My answer is unequivocally "yes." And the reason is that we simply can't afford to wait. There is very little unanimity on anything, any issue of the day. What we need are principles that are sound, that are overseen by the SEC to make sure that they are in the interest of shareholders and that they promote full

disclosure. But a reduction of the size of FASB, which has been proposed to five, and then having principles adopted by a 3-to–2 vote seems to me to be perfectly sufficient. This body operates by standard majority. It is the way the Senate operates. And I think it is appropriate for the FASB as well.

Mr. MEEKS. Thank you, Mr. Chairman.

Chairman OXLEY. The gentleman's time has expired. If I could just follow up briefly. Is it your understanding that the Commission, the SEC, could overturn any decision made by FASB?

Mr. PITT. Absolutely.

Chairman OXLEY. Thank you.

The gentleman from Virginia.

Mr. CANTOR. Thank you, Mr. Chairman.

Mr. Chairman, I just have a question concerning the Private Security Litigation Reform Act of 1995, and there has been some, I guess, renewed vigor around discussing sort of the impact of that Act and opposed to the Enron situation that we are in. I was just curious about your thoughts on the relationship between the Act and the ability of investors to receive any kind of results for actual fraud under the Act and then if you think there was or is a relationship with the Act and the Enron collapse.

Mr. PITT. Let me say first that, if I thought that the Act in any way created the possibility that we might have more failures, I would be back here urging you to reconsider aspects of that legislation. As I have said repeatedly, I don't think any issue can be off the table. We have checked with a number of entities, independent entities, that keep statistics, including one run by Professor Grundfest at Stanford. The statistics that have been reported to us show that the number of class action suits has remained constant, may even be a little bit larger, but that the amount of awards has increased significantly. If anything, I believe that the legislation on private securities litigation has actually strengthened bona fide cases while weeding out those cases that are frivolous and that simply seek to take advantage of a downturn in the market.

In my view, there is absolutely no connection that has been shown between the collapse of Enron and the Private Security Litigation Reform Act. Absolutely none.

Mr. CANTOR. Thank you very much. Yield back, Mr. Chairman.

Chairman OXLEY. The gentleman yields back.

The Chair now recognizes the gentlelady from New York, Mrs. Maloney.

Mrs. MALONEY. Welcome, Mr. Pitt. And I commend you and some of the initial steps that the accounting and security industries have take in recent weeks to eliminate conflicts of interest. And I represent many employees in the accounting business, and for the most part the vast majority of these professionals are hard working and honest people. Yet I very much support the Oxley bill and the LaFalce bill and really the statement of the accounting firms themselves that we should separate accounting and consulting and create a strong public regulator for accounting. And many of our members have stated that you could do consulting for other firms, but at least separate it, as former Chairman Levitt advocated so strongly, to put a firewall between auditing and consulting, and I think this should be the first step. Even the consulting firms and

auditing firms themselves have called for this and say they are doing it voluntarily. So we should put the statutory strength behind it.

You mentioned that there is a difficulty in enforcement and a number of professionals have come forward with an idea to ensure that accounting firms do their jobs correctly without heavy Government interference. And what do you think of the proposal that the SEC could require that all publicly traded companies hire a second auditing company to review its books every 3 years? That would be built-in oversight without heavy governmental interference.

Mr. PITT. The difficulty with that suggestion, which I believe is well motivated, is that there are only five major accounting firms. And my concern is that would create a taxation on investors effectively that wouldn't produce the results you want. I think the goal is right.

Mrs. MALONEY. A taxation on investors and accounting firms?

Mr. PITT. Because both accounting firms would charge fees. If you just take the Enron situation for example, it has been reported that Andersen received $25 million for its audit. So if you brought in a second firm, we have now upped it to $50 million. Somebody is going to have to pay that.

Mrs. MALONEY. We are talking about rotating every 3 years.

Mr. PITT. You are talking about rotation. I apologize. I misunderstood. I am in favor of rotation where it has been shown that an accounting firm has not lived up to the highest standards of auditing professionalism.

Mrs. MALONEY. But, it is difficult to see if you are living up to the highest standards of auditing professionalism. Enron was believed to be a model of a well run company up to months before it failed. And I find it tremendously troubling that Enron's techniques that duped the public were blessed by one of the world's most prominent accounting firms. And it is equally troubling that Enron is not an isolated case. It is by far the largest and most spectacular of several failures and near failures over the past several years, but they all had the same elements.

So in many ways I see the Enron scandal, debacle, as the 9/11 for the financial industry that we need to do something about it. They were condoning what has been alleged to be fraudulent accounting practices by one of our top accounting terms. So if you rotated it, it wouldn't cost more money and it would build in competition and build in oversight without increasing bureaucracy which——

Mr. PITT. My concern on that is there have been studies, the Cohen Commission, the Treadway Commission and others, which have shown that a large percentage of financial frauds occur in the first 2 years of an audit-client relationship. I believe that any per se mandatory rule removes flexibility from our society, and what it might produce are worse audits rather than better audits. You would have audit firms that weren't as familiar with the companies they were auditing and would be more susceptible to not catching fraud than they would otherwise.

My view is that, if we establish a public accountability board, as we have proposed, which would do quality control review, not just where there has been a breakdown, but would do quality control

review every year for the major firms, we would hopefully make certain that firms were providing the best quality services. And, if they failed to do that, they would lose their clients. The client would be automatically removed.

Mrs. MALONEY. But we have a case before us and other similar cases that took a tremendous toll on middle and lower income company employees that were left impoverished while politically connected insiders at the top walked away with millions. And the practice was condoned by one of our best accounting firms, or was considered to be one of our best accounting firms. So I feel that we need to do something and the Oxley and LaFalce bill certainly get us going in the right direction.

Chairman OXLEY. The gentlelady's time has expired.

Mrs. MALONEY. May I please respond to his study and request permission to place into the record another study that was cited in *Business Week* recently that showed that companies that use their auditors as consultants tend to manage earnings, including moving debt of the books into partnerships, the MIT, Michigan State and Stanford study that demonstrates that this practice is widespread and cites that steps need to be taken statutorily.

Chairman OXLEY. Without objection. The gentlelady's time has expired.

[The following information was subsequently furnished by Hon. Carolyn B. Maloney for the hearing record.

The gentlelady from New Jersey, Mrs. Roukema.

Mrs. ROUKEMA. I am sorry, Mr. Pitt, that I was not here for your testimony and I unfortunately could not be here for all the questioning, because I was in a markup in another committee. But I read with great interest the *Business Week* article which features an article called "The Reluctant Reformer," and they identified Harvey Pitt. Do you know him as the rereluctant reformer? It did raise some questions in my mind, and I wonder whether you have already responded to these in one form or another. But, for example, where you were asked a few questions and gave an answer, I have a question mark beside a number of them, particularly, and I think this will bear repeating even if you have gone over it, because I think it is essential and the core of the issue before us. And the question was posed to you do you still oppose a rule that bans a firm from doing audits and consulting work for the same company?

I know previously you had opposed any such rule. Your answer here is not quite explicit. Could you give us a precise answer as to your recommendations about audits and consulting firms from the same company. Because I believe they have to be separated. And I think our legislation indicates that requires that.

Mr. PITT. Let me——

Mrs. ROUKEMA. Or should, anyway.

Mr. PITT. Two things. First of all, those who know me know that I am seldom right, but never in doubt. There is nothing reluctant about me so ever.

Mrs. ROUKEMA. You sound like quite a few people I know in Government.

Mr. PITT. And secondly, reform is something I pledged to do when I came in. With respect to your question, do I believe that

there are certain combinations of certain consulting activities that can create a conflict for accounting firms? Yes, and those should not be permitted. What I don't believe is prudent is an absolute separation of accounting from consulting, that is to provide that a firm may only do auditing work. That, I believe, would be a mistake.

Mrs. ROUKEMA. Can you explain that? Because it sounds to me as though you are endorsing the great potential for conflict of interest here.

Mr. PITT. Not at all. And, if I thought there were any potential for that, I would move swiftly to prevent it. My view is this: That restricting firms solely to audit work will deprive those firms of the ability to produce more revenues that will help them do better training of their auditors; second, it will deprive them of critical knowledge that would be useful for auditors to have when performing an audit; and third, it will create——

Mrs. ROUKEMA. Excuse me. That was your answer here. But it does not address the question of the conflicts of interest. How do you protect again the conflict of interest potential?

Mr. PITT. I have said that there are certain types of consulting work that inherently create the potential for conflicts, such as an auditor reviewing his or her own work, and auditors effectively acting in a management or a managerial capacity. Those things have to be wholly prohibited.

I have also said that the SEC 18 months ago, under my predecessor, adopted a series of rules to define what could be done and what could not be done. And I believe that those rules should be given a fair chance to see whether they solve the problem or not.

What I am opposed to are the proposals that have been made by some that a firm that does auditing cannot do anything else for anyone. That is something I am totally opposed to at this point.

Mrs. ROUKEMA. Thank you very much.

Chairman OXLEY. The gentlelady's time has expired. Let me point out to the committee we have two votes on the floor. I would like to get through the Members who are here for questioning. And let's begin with the gentlelady from Oregon, Ms. Hooley.

Ms. HOOLEY. Thank you very much. Mr. Pitt, thank you for coming today. I want to make sure that we are all on the same wave length, and as we look at all of these issues that we are all here to protect the investors. Is that a common goal?

Mr. PITT. It absolutely is.

Ms. HOOLEY. OK. To something that one of the other Members, Mr. Sherman, talked about, do you pay enough money to your auditors to be able to hire well qualified auditors in your department?

Mr. PITT. I am sorry?

Ms. HOOLEY. Are the salaries of your auditors enough to hire well qualified auditors?

Mr. PITT. I think at the present time the salaries are not enough, and I think that there is a need for improvement. If you are talking about the private sector, my own view is that——

Ms. HOOLEY. I am talking about within the SEC.

Mr. PITT. We have steadfastly urged the passage of pay parity, and funding for it. Since we don't have that funding for 2003, I believe that our people do not make enough money.

Ms. HOOLEY. Let me just give you an example of a friend of mine who has worked for a couple of different CPA firms, large ones. One of the things that—comments she made to me recently was, you know, in all of these large companies they pay—this is the starting point for everyone. This is their training. This is where they put their newest, most lowest paid employees is out on auditing to sort of earn their way. What are we doing—a company can do that. They can do whatever they want. But what are we doing to make sure that we hold those companies to some standard so in fact they are not putting their least experienced out on the auditing road?

Mr. PITT. Well, that to me is one of the gaps in the existing set of regulations, including the Public Oversight Board. In my view, it is absolutely critical that people be appropriately trained as well as sensitized to both legal requirements and ethical requirements in the accounting firms, and then that there be diligent review by an independent body to make sure that firms live up to those standards.

At the present time I don't believe that that is happening. That is why we have proposed a public accountability board, and Chairman Oxley and Chairman Baker have proposed a public regulatory organization.

Ms. HOOLEY. Let me mention one other comment that another person made, and she was doing some temporary work at a company who I won't name. And she said half the people that worked in that financial department had all come from the auditing firm. And she said I can guarantee you when the auditing firm they came in, they knew one another and they said they were never going to get a very tough audit. And she said, and they knew all the people working for this company got paid more than they got paid as the auditors because they were the lowest paid. Do you ever hear any comments about that? Is that common or——

Mr. PITT. I do.

M. HOOLEY. Again, how does that protect the investor?

Mr. PITT. I am concerned about the so-called private sector revolving door problem. I think it is a legitimate issue, and one that requires some attention. My big concern is that, for middle and smaller size companies, it may not be possible for them to attract from a wider pool of talent. And my only concern is making certain that before we adopt any restrictions—and I think there is a need for some guidance here, and some guidelines—but, before we adopt an absolute restriction, we make sure that smaller firms are not somehow being disadvantaged. But the issue is a fair one.

Chairman OXLEY. The gentlelady's time has expired.

The gentleman from Pennsylvania, Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Pitt, am I to assume that you are opposed to term limits? I mean, it seems to me limiting an auditor's ability to stay with a corporation to a certain number of years is very analogous to term limits of Members of Congress. I think that was a very popular, easy solution in the early 1990s that has since faded. I expect that you favor or are opposed to term limits in that regard, as you are for the auditors. Is that correct?

Mr. PITT. Well, let me say that I don't think that there is a direct correlation between term limits on politicians and term limits on auditors.

Mr. KANJORSKI. So you would like us to have term limits, but not the auditors?

Mr. PITT. I haven't said that. I just said that the—I think the issues——

Mr. KANJORSKI. I am opposed to term limits. I was using the analogy to say it seems to me the problem is the electorate. The electorate, in this case, is the shareholders in the corporation. They are the ones that elect the board. The board is to proceed using due diligence to protect their interests. They are allowed to make mistakes, I guess. They are allowed to hire foolish or fraudulent auditors, as members of the electorate are able to elect foolish or fraudulent Members of Congress.

Mr. PITT. Although that hasn't happened yet, to my knowledge.

Mr. KANJORSKI. No, that never happens, right?

I am a little worried about this rush to decision and structuring a lot of rules to accomplish what appears to be a lot of good purposes, but in the end, could result in great damage to the system. So, when people come up with these definite rules, it concerns me. What is the next thing? Well, are we going to term-limit lawyers? Can we have a law firm representing a corporation for only 4 years? That is ridiculous. They are hiring professionals. The relationship is of such a nature that you do not want to have someone telling you that you can not hire your auditor or lawyer. Those are the people you have the most trust in. They in turn have the professional responsibility to perform to the highest standards.

In between there, we have a board of directors, or governors, to oversee and be sure that these professionals protect the interest of the shareholders. If the shareholders find they do not do that, they can kick them out. The only problem is, it ends up Enron occurs before there is any value in the shareholders having a meeting.

The one area that I——

Mr. PITT. I share your concern about destroying what is good about our system. That is a very real concern.

Mr. KANJORSKI. I will hope that you will constantly remind us up here to not be overly rambunctious in what we do, but try to act deliberately and deliberatively, and hopefully take our time on this.

It seems to me—of course, I am just a simple lawyer from Pennsylvania—but it is awfully complicated stuff. I do not know how many of our graduate professors up here are fully aware of what the ramifications may be consistent with the speed by which we seem to be moving.

But, there is something you said earlier in your testimony that I just wanted to correct. We have an opportunity here to assert that the *New York Times* made a fatal error when they reported on February 3, 2002, you are reported here as saying: "Now some in the group"—and this is referring to the people that supported the change of the law in 1995, like Senator Dodd—"have been having second thoughts about their opposition to the tougher accounting rules. Others, like Harvey L. Pitt, the Chairman of the Securi-

ties and Exchange Commission, say they are beginning to rethink the wisdom of some provisions of the 1995 law."

You were obviously misquoted in that article.

Mr. PITT. No, I believe the reporter who wrote that is very careful, and quoted me accurately, at least on that proposition. I think nothing is off the table. I believe that people have legitimately raised an issue about the PSLRA and therefore I thought it was appropriate to start collecting statistics and look at the issue. What I have found thus far leads me to believe that the Act has actually served its purposes and is not responsible for Enron. But I believe that we have to be open to changes in any aspect of our system in light of what we have seen in Enron.

Chairman OXLEY. The gentleman's time has expired.

The gentleman from Tennessee, to wrap things up.

Mr. FORD. Briefly. Thank you, Chairman Pitt. I know we are fresh out of time here. When we had Mr. Barandino before the committee, we talked a little bit about his announcement, I guess, and some of the other accounting firms—and forgive me of not going through all the pleasantries, you are great, I am glad to see you here and all those things. We will do that another time—but that they would no longer offer financial information systems designed for implementation to their audit clients. My friend Chairman Oxley's bill would prohibit auditors from offering these services to audit clients as well as internal audit services. This is probably a good start. But there a whole range of business consulting and other services that can and do create the possibility, at least the appearance, of conflict of interest.

How significant are financial information systems consulting and internal audit services to the non-auditing revenue collected by accounting firms? And, two, what other areas of consulting business do you believe could pose these conflicts of interest? And in interest of time, that we have two bills up here, Mr. LaFalce and Mr. Oxley, and I hope we work everything out, but in Mr. LaFalce's version he has a provision that would require accountants to preserve records and documents relating to audits for 7 years after the audit is completed. I am not going to be facetious and say do you think that could have helped to at least expose some of the challenges and problems involved with Enron. Obviously probably it would have. But shouldn't we have a clear standard for recordkeeping, I guess, is the larger and broader question that is obvious to this committee and Congress will soon address. I know we have a vote. I wanted to talk a little faster than my part of the country expects me to. So if you could answer that, I would appreciate it.

Mr. PITT. A broader standard as to what might constitute a conflict?

Mr. FORD. I was speaking to the 7-year mandate for recordkeeping, number one, and do we need a clear standard. And, yes, could you extrapolate clear standard even on conflicts of interest. I didn't ask it that way, but that may be a better way of framing it.

Mr. PITT. Let me make a few observations on that, if I might. First, before Enron reared its head, I had given a speech in which I said that the Commission would not tolerate people who come in

and lie to us in investigations, people who obstruct investigations or destroy documents.

Without commenting on the particular Enron situation, destruction of documents cannot be condoned, because once somebody gets away with it, everybody will try to get away with it and the system falls apart. So I have very, very strong views on document destruction and obstructing an investigation.

As to how long records ought to be kept, in my view, some rational period may be useful. And with computers, now there is an ability to store information electronically that may enable them to be archived so that we have access to it even after 7 years. But I believe that auditors should, and I believe they generally do try to, maintain records that reflect what audit practices they went through in conducting a particular audit for 5, 7 or 10 years after the audit is completed. Not everything that gets generated in the course of an audit needs to be retained.

Chairman OXLEY. The gentleman's time has expired. I thank you for the time. The Chair would note that Under Secretary Peter Fisher has submitted written testimony for this hearing. I would like to thank the Treasury Department. Without objection, Secretary Fisher's testimony will be entered into the record.

Mr. Pitt, thank you, Mr. Chairman, for your appearance today. And the committee will reconvene at 1:00.

[The information can be found on page 409 in the appendix.]

[Recess.]

Chairman OXLEY. The hearing will reconvene. Here comes the Ranking Member.

Let me introduce the panel. Let me introduce our distinguished panel: Mr. Franklin D. Raines, Chairman and CEO of Fannie Mae, on behalf of the Business Roundtable; Mr. H. Carl McCall, Comptroller, State of New York, Office of State Comptroller; Mr. Joseph V. DelRaso, Partner, Pepper Hamilton, LLP; Mr. Philip B. Livingston, President and CEO of Financial Executives International; Mr. Jerry Jasinowski, President of National Association of Manufacturers; and Mr. Peter C. Clapman, Senior Vice President and Chief Counsel of Corporate Governance TIAA-CREF. Gentlemen, thank you all for appearing and your willingness to appear here today. Let me yield to the gentleman from New York.

Mr. LAFALCE. I too would like to welcome every member of the panel. And so many of you I know so well: Mr. Raines with whom I have had a long working relationship before his days at Fannie Mae and the Administration; Mr. DelRaso with whom I have worked over the years through the auspices of the National Italian American Foundation; Mr. Jasinowski, going back 20, 30 years now; but most of all, I want to welcome Mr. Carl McCall, the Comptroller of the State of New York. Again, Carl has been one of the most outstanding public servants it has been my pleasure to know, whether it was a State senator, whether it was as a United States Ambassador, whether it was as a Commissioner, whether it was in the private sector as a leading vice president of one of the major financial institutions in the world, and he has been elected to statewide office in the State of New York by overwhelming margins on two separate occasions. And one of his distinctions, among

many, he is also a member of the board of directors of the New York Stock Exchange.

So, not to slight the other members of the panel, but I just don't know you quite as well. Thank you, Mr. Chairman.

Chairman OXLEY. Thank you. All you New Yorkers stick together, I notice that. I understand Mr. McCall has some issues and has to get back to New York, and I appreciate that.

Let us begin with Mr. McCall.

STATEMENT OF H. CARL McCALL, COMPTROLLER, STATE OF NEW YORK, OFFICE OF THE STATE COMPTROLLER

Mr. MCCALL. Thank you, Mr. Oxley. As I said in my prepared remarks, I had a note here that I am to start off by saying good morning. I guess that is not now appropriate, but thank you for this opportunity. And, unfortunately, I do have to go back to New York, but I hope I can stay for some of the questions.

Chairman OXLEY. Mr. Raines is shaking his head because he has been on several second panels. So good afternoon.

Mr. MCCALL. I want to thank the Ranking Member, Congressman LaFalce, for all he has done, and I appreciate the long relationship I have had with him and to all the Members of the committee.

I want to thank you for giving me this opportunity to address issues of corporate accountability and investor confidence. In the past few months, Americans have learned that the integrity of the financial markets and, in fact, the economic well-being of our country depend on these issues.

I commend this committee for holding a hearing. It is essential that we have a national discussion on these issues. I assure you our future depends on it. We need action at the Federal level to prevent another Enron in the future.

I applaud my good friend, Congressman LaFalce, for his leadership in introducing the Comprehensive Investor Protection Act of 2002. As comptroller of the State of New York, I serve as the sole trustee of the State's $112 billion Common Retirement Fund, the pension fund for nearly 1 million New York State and local government employees and retirees. The fund owned nearly 4 million shares of Enron through its index portfolio and active managers prior to the company's catastrophic downfall. Our losses are expected to exceed $58 million.

While our fund is strong enough to absorb the financial blow inflicted by this corporate collapse, we are deeply shaken by the lack of diligent oversight by the independent auditors, board of directors, rating agencies and analysts on whom investors rely.

And we are not alone. In fact, I believe that the loss of investor confidence is the most devastating effect of the corporate collapse experience over the last several months. And if we don't restore that confidence quickly and completely, the consequences will be immeasurable.

The bill before the committee today, the Corporate and Auditing Accountability Responsibility and Transparency Act of 2002, offers measures for enhanced auditor oversight. However, this is no time for small steps. I believe additional standards are necessary to en-

sure the restoration of investors' confidence in auditors and their findings.

The Comprehensive Investor Protection Act that Congressman LaFalce introduced goes much further toward that goal. I urge the committee to consider a legislative compromise that includes some form of the provisions included in the Comprehensive Investor Protection Act that would correct what is currently a failed regulatory structure. I am speaking in particular of provisions that align with recommendations I have made as New York State comptroller.

Let me explain. First we need standards to make auditors more independent from the companies they audit. I submitted proposals to the Securities and Exchange Commission and to the Big Five auditing firms and called on companies to take three steps:

One, prohibit auditors from providing non-audit services to audit clients except under limited circumstances.

Two, limit audit relationships to a maximum of 7 years.

Three, restrict auditors from accepting employment with clients for 2 years following work on an audit.

In short, auditor independence is critical to long-term shareholder value and confidence. That is why I supported the SEC's proposed revision of auditor independence requirements in 2000. And that is why I submitted these proposals, and that is why I pushed for change in my various roles as a public official.

I have introduced legislation that would require all New York State agencies to adopt these standards in their relationships with auditing firms. In addition, I issued an executive order to implement these standards in the Office of the State Comptroller. I believe these are important steps toward achieving meaningful auditor independence.

But we can't achieve comprehensive reform on a State-by-State basis. We also need a national effort. For this reason, the provisions in the Comprehensive Investor Protection Act that promote auditor independence are extremely important. As a shareholder, I have adopted a proxy voting policy to oppose the appointment of any auditor that also performs non-audit services to the company. I also sent a letter to the Common Retirement Fund's 50 largest portfolio companies, explaining our proposed standards and requesting information about how long companies have retained their current auditor.

As comptroller, I can take these steps at the Common Retirement Fund, and I can encourage my counterparts around the country to do likewise, but it is essential that we hear from Washington on these matters. It is essential to know that our legislators share our commitment to investor protection.

The work of this committee sends a vital signal to all investors. To ensure that I continue to develop appropriate proposals to increase investor protection, I have also created a panel of advisors who will focus specifically on measures that enhance board independence and corporate accountability and minimize conflicts of interest in the marketplace. As a last resort, I have also taken legal action against Enron. I have filed a notice of joinder in United States District Court for the Southern District of Texas in support of a legal application to freeze the assets of directors and execu-

tives who may have benefited from stock sales based on information that was not available to other shareholders.

I applaud this committee for seeking input from a variety of sources, especially from the private sector. As a member of the board of the New York Stock Exchange, I serve as co-chairman of a recently created Committee on Corporate Accountability and Listing Standards. The committee will review corporate governance and shareholder accountability issues such as the composition of corporate boards and committees, disclosure requirements and the role of independent audit committees. The committee will also consider new listing standards that will have a profound impact on the marketplace.

In closing, I would like to say that I am acutely aware of my fiduciary responsibility to the retirees and hard-working people of New York State. Their ability to enjoy an economically secure retirement depends on the faithful and prudent investments of the Common Retirement Fund. In 9 years as comptroller, I have never heard from as many members of the pension systems as I have in the past few months. They are nervous and frightened and beginning to question the rationality of equity markets generally. This is not an encouraging sign for the marketplace. We must restore their confidence, each of us, fiduciaries, legislators and regulators. We all have a role to play.

I thank you for your reasoned and constructive approach to the important issues before us. I look forward to working together with you to restore investor confidence and ensure the long-term viability of the American marketplace.

Again, I thank you, Chairman Oxley, Ranking Member LaFalce, and Members of the committee for allowing me to testify today.

[The prepared statement of H. Carl McCall can be found on page 302 in the appendix.]

Chairman OXLEY. Thank you, Mr. McCall. And feel free to stay as long as you possibly can. Hopefully we can get to questions before you have to leave.

Now I am pleased to go back to regular order and introduce the gentleman, Mr. Raines.

STATEMENT OF FRANKLIN D. RAINES, CHAIRMAN AND CEO, FANNIE MAE; CHAIRMAN, CORPORATE GOVERNANCE TASK FORCE, THE BUSINESS ROUNDTABLE

Mr. RAINES. Thank you, Chairman Oxley, and thank you, Ranking Member LaFalce and Members of the committee. My name is Franklin Raines and I am Chairman and CEO of Fannie Mae. I am here today as Chairman of the Corporate Governance Task Force of the Business Roundtable, and I appreciate the opportunity to express the views of the Business Roundtable with respect to the topic of today's hearing.

Before I do that, Mr. Chairman, let me take this opportunity to recognize the foresight and leadership of this committee in raising and addressing issues of financial institution safety, soundness, and transparency, well before the collapse of Enron brought these issues to national attention. Let me recognize your leadership and that of Ranking Member LaFalce, subcommittee Chairman Baker, and subcommittee Ranking Member Kanjorski, for your consistent

and strong leadership over the years on issues of corporate responsibility, transparency and market discipline.

The Business Roundtable is recognized as an authoritative voice on matters affecting America's business corporations and, as such, has a keen interest in corporate governance. Indeed, as leaders of some of our Nation's largest businesses, the Roundtable has the strongest interest in corporate governance practices that secure the confidence of shareholders, employers, policymakers, and other constituencies.

The Roundtable has been involved in corporate governance issues since 1978. In 1997, we published our statement on corporate governance, which suggests best practices regarding matters including the functions of the board of directors, board structure and operations, and shareholders' meetings. We are pleased with the number of large corporations that have adopted these practices.

In light of recent events, the Roundtable is reviewing its 1997 statement regarding corporate governance, and we expect to issue a new statement on this subject later this spring. The Business Roundtable has prepared a detailed analysis of H.R. 3763, and with your permission I would like to submit that analysis for the record.

[The following information was subsequently furnished by Franklin D. Raines for the hearing record.]

Chairman OXLEY. Without objection.

Mr. RAINES. This afternoon I would like to summarize what the Business Roundtable believes should be the guiding principles of corporate governance. The Business Roundtable has issued a public statement regarding the issues related to the bankruptcy of Enron, in which we expressed our view of Enron's collapse and a set of principles we believe should guide the discussion of proposed changes, practices, regulations and laws.

With respect to Enron, the Business Roundtable believes that a number of the actions and behaviors revealed in the report of the special committee of the Enron Board of Directors, which contributed to the collapse of the company, are unacceptable. The Powers report describes a pervasive breakdown in the norms of ethical behavior, corporate governance, and corporate responsibility to internal and external stakeholders. The Enron situation appears at this point to derive fundamentally from a massive breach of trust.

We understand why the American people are stunned and outraged by the failure of corporate leadership and governance at Enron. It is wholly irresponsible and unacceptable for corporate leaders to say they did not know, or suggest it was not their duty to know about the operations and activities of their company, particularly when it comes to risks that threaten the fundamental viability of their company.

The success of the American free enterprise system follows from the merger of corporate responsibility with individual responsibility, and the Business Roundtable believes that responsibility starts at the top.

The United States has the best corporate governance, financial reporting, and securities market systems in the world. These systems work because of the adoption of best practices by public companies within a framework of laws and regulations.

The collapse of the Enron Corporation is a profound and troubling exception to the overall record of success. Other less dramatic exceptions may also exist among the thousands of United States public corporations, but there are exceptions in systems that have generally worked very well.

In light of the public interest and issue drawing out of the Enron situation, we thought it would be useful to articulate a set of guiding principles of corporate governance:

First, the paramount duty of the board of directors of a public corporation is to select and oversee competent and ethical management to run the company on a day-to-day basis.

Second, it is the responsibility of management to operate the company in a competent and ethical manner. Senior management is expected to know how the company earns its income and what risks the company is undertaking in the course of carrying out its business. Management should never put personal interests ahead of or in conflict with the interest of the company.

Third, it is the responsibility of management under the oversight of the board and its audit committee to produce financial statements that fairly present the financial condition of the company and to make sufficient disclosures to investors to permit them to assess the business and financial soundness of the company.

Fourth, it is the responsibility of the board and its audit committee to engage an independent auditing firm to audit the financial statements prepared by management and to issue an opinion on these statements based on generally accepted accounting principles. The board, its audit committee, and management must be vigilant to ensure that the corporation or its employees do not take any actions that compromise the independence of the independent auditing firm.

Fifth, it is the responsibility of the independent auditing firm to ensure it is in fact independent, is without conflict of interest, employs highly competent staff and carries out its work in accordance with generally accepted auditing standards. It is also the responsibility of the independent accounting firm to inform the board, through its audit committee, of any concerns it may have about the appropriateness and quality of significant accounting treatments, business transactions, and about any weaknesses in internal control systems. The firm should do so in a forthright manner and on a timely basis, whether or not management has communicated to the board or audit committee on the same matters.

Six, the company has a responsibility to deal with its employees in a fair and equitable manner. Employee benefit plans, once established, should be operated in a manner that is fair and equitable to all employees. These responsibilities and others are critical to the functioning of the modern public corporation. No law or regulation alone can be a substitute for the voluntary adherence to these principles by corporate directors and management and by the accounting firms retained to serve American corporations.

Several thoughtful proposals have been offered to create new regulations or laws to deal with what appear to be breaches of trust and failure of responsibility at Enron. Two weeks ago, the President announced his plan to improve corporate governance. The President's personal involvement in seeking reform is welcome and

underscores just how fundamental ethical and responsible corporate governance is to the health of the American economy.

Chairman Oxley, you and Mr. Baker have put forth a number of laudable proposals to improve corporate governance we are considering today, as has Mr. LaFalce and others. Some legislation and regulatory changes are necessary and advisable. The Business Roundtable worked closely with policymakers to help ensure that any necessary changes to laws and regulations are effective and efficient, taking care that our responses to the unusual circumstances presented by Enron do not inhibit U.S. Public corporations' ability to compete, create jobs, and generate economic growth.

Mr. Chairman, that concludes my statement, and on behalf of the Business Roundtable and its member companies, thank you for the opportunity to participate in today's hearing.

[The prepared statement of Franklin D. Raines can be found on page 320 in the appendix.]

Chairman OXLEY. Thank you Mr. Raines.

And I now call on Mr. Joseph V. DelRaso.

STATEMENT OF JOSEPH V. DelRASO, PARTNER, PEPPER HAMILTON, LLP

Mr. DELRASO. Good afternoon, Chairman Oxley, Ranking Member LaFalce, and distinguished Members of the committee. Thank you for this opportunity to present my views on H.R. 3763, legislation which I believe will do much to restore the faith of investors in the way in which public companies report their financial results.

I commend the committee for its level-headed and responsible approach, especially at a time when many pundits and commentators are generating more heat than light on these important issues.

I am a partner in the law firm of Pepper Hamilton in Philadelphia. My practice focuses on corporate and securities matters, particularly on matters arising under the Investment Company Act of 1940 and the Investment Advisors Act of 1940. I served as an attorney advisor with the Securities and Exchange Commission in the 1980s, and I serve as a member of the board of directors of both public and private companies and non-profit institutions.

Having experience on the regulatory side as a lawyer in private practice and as a corporate board member, I believe I offer the committee an important perspective on the practical effect of key aspects of this legislation. Because this committee has already heard a wealth of testimony on auditor oversight provisions, I will focus my comments on other sections, particularly the transparency of corporate disclosure provisions of section 6, corporate governance provisions of section 9, and accredited rating agencies of section 11. Each of these sections, the committee should ensure that studies and activities undertaken do not attempt to fix things that are not broken.

Federal Reserve Board Chairman Alan Greenspan in his earlier testimony to this committee noted a pronounced move toward more transparent reporting and improved corporate governance practices in the wake of the Enron collapse. As Chairman Oxley said at the committee's hearings last week, while Government may still need

to take action, that action should not stifle the ability and initiative of the financial markets to self-correct.

In my practice as a lawyer, the vast majority of boards of directors, especially those of publicly held companies that I represent, take their responsibilities very seriously. In the last few years in particular, I am sure even more so now in the post-Enron and post-Global Crossing world, independent directors have become increasingly aggressive in acting as watchdogs over their respective shareholders' interests.

Audit committees have already been required to adopt charters governing their operations.

But perhaps they even need more guidance in this area. And I concur with some of the remarks earlier today that the stock exchanges and the other self-regulatory organizations may look into other areas with regard to adopting rules to help guide audit companies in their role as the watchdogs on the financial side of the shop.

Whether or not these policies and procedures are aggressively enforced, obviously, vary from company to company. On the one hand, given the proclivity of the plaintiffs' bar to act as a self-appointed protector of shareholder interests, even the most diligent board of directors is constantly checking itself to avoid costly unnecessary litigation. This serves as an important catalyst for directors instituting improved corporate governance policies and procedures.

This also points to the need for appropriate government action to craft legislation and implement rules that are clearly understood and not easily manipulated.

Appropriate implementation and enforcement is just as critical as the legislative effort. Again, while the actions of the plaintiffs' bar keep directors and officers focused and diligent, the appropriate deterrent is and always and will be government enforcement and prosecution. The spectre of criminal sanctions and incarceration for the most egregious behavior or civil fines and sanctions for other transgressions serves the public interest much more sensibly than allowing certain members of the bar to extract their self-imposed penalties from companies in the form of their sometimes very large contingency fees. A more direct distribution of funds to compensate victims of corporate malfeasance, or fines that are used to further bolster Government enforcement efforts might be preferable, and indeed are just plain common sense in some circumstances. Any effort to roll back securities litigation reform may make business only more expensive by increasing insurance costs and the like and still produce inferior results.

Again, we heard studies undertaken by the SEC that point to the fact that the plaintiffs' bar is alive and well and still impacting the markets. On the other hand, prosecutorial judgment most times is a markedly more effective approach to handling some of these problems rather than "strike suit" targeting.

Below the board level, the President's Working Group, referred to in section 9, should examine how the financial markets can deter managers and other employees from interfering or influencing third-party professionals, whether they be auditors, rating agencies, and other parties that are relied upon in one way or another to put their imprimatur on corporate actions.

From a practical perspective, any additional Government overlay from either a statutory or regulatory standpoint might further dampen the enthusiasm of qualified people to serve as independent directors. On the other hand, appropriate sanctions for inappropriate behavior would be welcome. The overwhelming majority of independent directors has been and continue to be good corporate citizens, dedicated to discharging their duties to protect shareholder interests.

Further initiatives, including personal liability expenses, except in the most egregious cases of willful and wanton misconduct, and other erroneous regulatory sanctions or requirements may merely serve to deter good individuals from accepting positions as independent directors.

Finally, corporate governance ties in with the provisions in section 6 regarding the need for improved transparency of corporate disclosures. Boards should be able to discern from transparent reporting the correct state of affairs. There should be little excuse for a well-informed board of directors to fail or be victimized by obfuscation and financial high-jinks constructed as off-balance-sheet transactions and other clever financial tricks. Uniform standards of financial reporting will not only sustain a level playing field, but will uphold the integrity of the process.

I applaud the work of this committee in seeking improved transparency, for without it, the efficient functioning of our financial markets may be impeded. Financial investors expect to see, and will demand more than ever, quality of earnings that can be reported via clear and concise accounting standards consistently applied. This is especially true in dealing with non-exchange traded financial instruments and other instruments that are not readily tracked in public markets. This legislation, I believe, will put the "fair" back in fair-value accounting.

Finally, with regard to credit agencies, I believe many of the issues I noted regarding the corporate governance procedures also apply in this field, particularly the overwhelming need to avoid conflicts of interest. This again is essential to the efficient operation of our financial markets. Just as a "seal of approval" is expected by the auditor certification accompanying audited financial results, the grade awarded by rating agencies will only be worth the strength and integrity of the name behind it.

Finally, Mr. Chairman Oxley and Ranking Member LaFalce, I would like to thank you again for this opportunity to testify today on this important piece of legislation. The dark cloud of Enron and Global Crossing, while obviously dire to investors, employees, and those most immediately affected, may have some element of a silver lining if, as I believe, it serves as a wake-up call to responsible independent directors and corporate officers and if it provides the Congress the impetus to enact some long-needed reforms to ensure responsible reporting of corporate financial results.

[The prepared statement of Joseph V. DelRaso can be found on page 360 in the appendix.]

Chairman OXLEY. Thank you.

And I recognize Mr. Livingston.

STATEMENT OF PHILIP B. LIVINGSTON, PRESIDENT AND CEO, FINANCIAL EXECUTIVES INTERNATIONAL

Mr. LIVINGSTON. Thank you, Chairman Oxley and Ranking Member LaFalce. I am here today to represent FEI and its strong support for H.R. 3763 and the leadership of this committee. As Chairman Pitt kindly recognized this morning, the FEI released its own recommendations for improving financial management, financial reporting, and corporate governance. These recommendations dovetail nicely with H.R. 3763.

Financial officers know that good corporate control requires broad frontline defense mechanisms to prevent problems. As a result, that is where our suggestions begin. Our most important recommendation is that all senior financial officers adhere to a special code of ethical conduct. We recommend that this bill include an additional provision calling upon the SEC to work with the stock exchanges to develop a requirement that senior financial officers of all public companies adhere to a code of ethical conduct similar to that in use by FEI members today. We believe adherence to such a code is a crucially important cornerstone of sound management, appropriate atonement at the top, and successful fiduciary stewardship.

In order to reinforce management and board awareness in the maintenance of a strong ethical climate, we strongly recommend that all senior financial officers annually sign such a code and deliver it to their board. I will tell you that one of our leading CFOs has required all of his company's 3,000 financial professionals worldwide to sign such a code and deliver it back to their corporate headquarters.

Unfortunately, the Enron case once again demonstrates the need to improve audit committees. Three years ago, the Blue Ribbon Panel on Audit Committee Effectiveness called for all audit committee members to be financially literate and for each committee to have at least one financial expert. Unfortunately, the criteria for meeting the standard was set so low that no real change or addition to audit committee personnel actually occurred in the time leading up to Enron's demise.

We must get on with truly raising the bar and adding real expertise to audit committees. We need Congress and the stock exchanges and the SEC to act on this matter. The stock exchanges should be required to write tougher standards into their listing agreements. Explicit experience in financial reporting must be required of such experts.

FEI is also proposing recommendations as to the issue of auditor independence. As recently as last year, I testified before the Senate Banking Committee in opposition to former Chairman Levin's proposal to split audit and non-audit services provided by accounting firms. I tell you, it is still my strong personal opinion that consulting services do not corrupt the integrity of independent audits. The truth, in my view, is exactly the opposite. Consulting projects enable the auditor to get out of the accounting department and learn about the intricacies of the business and, in the end, conduct a more effective audit.

However, the accounting profession is suffering from a post-Enron crisis of confidence. Therefore, certain restrictions should

now be imposed on non-audit services supplied by the independent audit. They should no longer provide clients with internal audit services or consulting on computer systems used for accounting. We strongly believe that tax services should be allowed, as well as acquisition due diligence, audits of employee benefit plans, and other statutory audits. We do strongly recommend that audit committees approve all large non-audit services provided by the auditor.

I also want to address the controversial issue of stock option accounting. Unfortunately, the current crisis has encouraged some to attempt opportunistic initiatives to advance narrow and unconstructive agendas with little regard for the important matters in front of us. These very tactics were too often employed over the last 10 years and are at the core of many of our problems.

Unusable accounting standards and dysfunctional financial statements result from processes and regulatory environments unable to recognize the real problems, yet set out to achieve narrow political- or governance-related objectives.

Stock option accounting is such a case. This debate has a long and acrimonious history between shareholder activists, enraged by cases of excessive executive compensation, and the corporate preparers of financial statements that find employees' stock options as hard to accurately measure as an Enron energy contract or put agreement to sell broadband capacity. A charge to the income statement for stock options is the Trojan horse in the battle over governance controls of options and executive compensation.

When recently asked about the ongoing accounting debate, Sarah Teslik, the CEO of the Council of Institutional Investors, was quoted as saying: "If we can't get the vote on these things, then we have to punish them on the balance sheet." Her comments reflect the reality of the issue. It is about the practices and the quantities of option grants, not the quality of the income statement.

A real reform would be for shareholders to approve all stock option plans and therefore control abusive levels of shareholder dilution in the few cases that it occurs. Because of the intense controversy around this subject, Congress can do a great service by mandating shareholder approval of employee stock option plans, and we urge you to act.

Briefly, FEI would like to add its continuing support for the Private Securities Litigation Reform Act. The PSLRA is working today and there is no need to change or modify the current law. Enron's employees and shareholders will not be hindered by the PSLRA in seeking restitution of their losses. Now is the time for real reform, not opportunistic grabs of narrow agenda items.

FEI also recommends that we increase the SEC's budget and that a significant portion of the additional funds be earmarked for attracting new high-caliber professional staff. Further, FEI supports the creation of a new regulatory organization for the auditing profession. We believe it is important to clarify that the two-thirds members specified as "not members of the accounting profession" be further defined as individuals who are not currently practicing CPAs, but do have extensive education and experience in financial management of public companies, auditing, or accounting.

That concludes my remarks, and I would like to thank the Chairman and the Members of the committee for allowing FEI this opportunity.

[The prepared statement of Philip B. Livingston can be found on page 365 in the appendix.]

Chairman OXLEY. Thank you.

Our next witness is Mr. Jerry Jasinowski. I was so used to having you testify in the committee across the hall, and we are facing in different directions from the past, but I think this year you made an appearance before our committee. Welcome. And it is good to see you again and particularly under these circumstances.

STATEMENT OF JERRY J. JASINOWSKI, PRESIDENT, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. JASINOWSKI. Thank you very much, Chairman Oxley, for your leadership on this, and allowing us to testify before this committee.

With 14,000 manufacturing companies, both large and small, we are a user of the auditing information and a producer of the auditing and financial information, and so have a particularly unique perspective on this and have thought very carefully about it. Although we have not concluded all of our decisions on it, we certainly feel that your bill 3763 is a good framework.

I want to acknowledge, Congressman LaFalce, also our longstanding relationship, and we look forward to working with you in terms of the legislation you propose.

In our press release, Mr. Chairman, we put the emphasis on best practices and enforcement, and suggest that we have a very good system in this country which has been badly damaged by Enron, Andersen, and other misjudgments which Frank Raines has articulated rather well, and I would associate myself with his remarks.

Our 14,000 members are outraged by what appear to be certain transgressions on the part of both companies and auditors, and feel that the bulk of our membership are absolutely opposed to anything like that and strongly want to affirm the need for honest and complete information. In fact, as we indicate in the statement—which I would like included in the record—information is critical to our capital markets, and I think without it, we will not be able to have the growth and productivity that we so badly need.

Let me make five points. And the first point is to stress your bill H.R. 3763, although we do not yet endorse it, we certainly feel it provides the framework for the kind of reform—thoughtful balanced reform, that we need.

Disclosure beyond GAPP is important in getting better information, public regulatory oversight, as you suggest, is the kind of thing that we think is important in the legislative area.

Having said that, we really put a lot of emphasis in our testimony on best practices and the need for the private sector to further improve the quality of the information that they have—and not just the auditor, but also the companies. We do have the best system in the world. But as Chairman Pitt said, we can make it a lot better. And I think there are many ways in which we can.

At the heart of that, of course, is strengthening the audit committee and strengthening the oversight of the management, having

a more independent board, focusing on such matters as the critical accounting policies and practices that have come out of the SEC, and other matters where we think a good system could be made much better if, in fact, it is fully employed. I think the tone of much of your bill puts the emphasis on that and we would want to associate ourselves with that.

And we think we have an obligation, Mr. Chairman, to speak out to our own members and say look, we know most of you are doing a fine job, but not everybody is, and you can do better; and we will certainly encourage that within our own membership.

As I said, I thought that Chairman Pitt was very helpful in terms of his proactive emphasis on enforcement, information and clarity. We think we ought to be very tough with wrongdoers. People make mistakes, they ought to pay. And it is important that society generally, the SEC, and the Congress assure that that happens.

Having said that, there may be some opportunities for legislative reform, as you suggest, in your bill and beyond that. Certainly the public regulatory organization to oversee accounting standards, as you suggest, is something that we think merits careful consideration. Also, it might surprise some, but we think it is important to increase the funding for the SEC in order to have the kind of education, clear information, and enforcement that they need. We cannot expect to get this job done if we do not have adequate resources there, and we support that.

I am sure there are other measures as these hearings continue, and in the market session we will support legislatively. But again let me repeat, we don't think there needs to be a whole set of new laws. There is an enormous set of good laws on the books that, with proper enforcement and good action on the part of the companies, will lead us to improve this system as it now stands.

We think it is, finally, important not to take on some measures which will do real harm; that is, to produce a lot of new legislation, new liabilities, try to reinvent the wheel. This committee, your own leadership, Congressman LaFalce, and the SEC have been working on this for some time. The Enron-Andersen affairs require us to redouble our efforts, to strengthen our laws in some cases, but let us not try to reinvent the wheel. Certainly we don't need new liability provisions for the most part, and we ought to avoid increases in costs.

Having said that, again, I think it is important for us in the private sector to take responsibility to further improve our own management and implementation of the accounting provisions.

Thank you, Mr. Chairman.

[The prepared statement of Jerry Jasinowski can be found on page 388 in the appendix.]

Chairman OXLEY. Thank you, Mr. Jasinowski.

Mr. Clapman.

STATEMENT OF PETER C. CLAPMAN, SENIOR VICE PRESIDENT AND CHIEF COUNSEL, CORPORATE GOVERNANCE, TIAA-CREF.

Mr. CLAPMAN. Thank you. Thank you, Chairman Oxley, Ranking Member LaFalce, and Members of the committee. I am Peter Clapman. I am speaking from an investor and shareholder perspec-

tive on the issues of the day. I will be talking not only about the accounting regulation issues, but the board of corporate governance issues as well.

TIAA-CREF has a fiduciary responsibility to over 2–1/2 million members of our pension system, which is the largest pension system in the world. We have approximately $275 billion under management. I also chair the most prestigious global corporate governance organization in the world, and I must say that the Enron episode has had a real detrimental effect on the reputation of the United States and corporate governance.

TIAA-CREF has been a leader in corporate governance. We are convinced that our initiatives to better corporate governance will produce better returns for our pension participants and shareholders. We also believe that it is our responsibility to monitor the managements of our portfolio companies and hold them accountable. Good corporate governance depends critically on the performance of the board of directors and, in particular, its most important board committees: compensation committee, auditing committee and nominating committee. If the board is not independent, if the directors lack the proper qualifications, and if the directors do not pay sufficient time and attention to fulfill this role, an Enron is not only possible, but it is also likely. Are there other Enrons out there? We can hope that there are not, but prudently cannot trust that will be the case without reforms.

And I will now address some of the needed corporate governance reforms and how I suggest they best be accomplished. One area that must be addressed involves the conflicts within the key professions. Too often accountants and lawyers, ostensibly representing the company, in fact wind up representing only its senior management. Such conflicts were at the heart of the problems of Enron.

The professional organizations themselves have a key role and must do a better job through education and discipline to minimize these abuses. The regulation of the accounting profession demands change, and already excellent proposals have been made.

TIAA-CREF CEO John Biggs has urged, among other things, that companies assure the integrity of the auditing process by not giving the same audit firm that does its audits, consulting work. We are not advocating the split of auditing and consultant work for the organization, but that each company should be conscious of this potential issue of conflict and split its auditing and consulting work on that basis, and also by periodically rotating the auditing firm or at least considering such action.

He also proposed that an independent board oversee the accounting profession, with its own funding source, and with the legal authority to enforce rules and impose sanctions for wrongdoing.

But on a broader scope, a related corporate governance reform needed for more accurate financial reporting is on the subject of executive compensation, particularly affecting the use of stock options. The reforms needed are twofold: require that the cost of options be reflected in the financial statements; and, two, require shareholder approval for dilution of option plans, introducing greater accountability in this most important area of executive compensation. Stock options are overused and abused, with the accounting rules largely to blame for this problem. The true cost of

fixed-price options escape the earnings statement, encouraging this overuse and abuse. This structural failure of corporate governance must be addressed.

The National Stock Exchange as the New York Stock Exchange and Nasdaq must be an important engine for needed reform. The exchanges, however, have dual objective organizations. While they must regulate companies and brokers in the public interest, as businesses they also seek listings from the very companies they must regulate. To the credit of Chairman Harvey Pitt, the SEC has already requested that the exchanges evaluate which corporate governance reforms are necessary. The exchanges must respond by imposing stronger standards of director independence, requiring shareholder approval of all material, equity plans promoting education of directors, and implementing more stringent policies to ferret out conflicts of interest. If the exchanges fail to act, the SEC, using its regulatory powers and persuasive influence, should press for needed reforms.

The education of directors is a major concern. Directors on audit committees only recently had to meet a standard of financial literacy; literally, to have the ability to understand a financial statement. Directors on compensation committees often do not take a proactive role on behalf of their company, because they lack an understanding of compensation issues and do not obtain independent consultants when needed. The abuse and overuse of stock options results from inadequate performance of many compensation committees and the board as a whole.

What is the role for Congress? It is not clear to me how many new laws are needed. But as a minimum, your oversight role is critical. At some point, memories of Enron will fade as other issues take center stage, but the corporate governance problems that I have highlighted, and are highlighted by the Enron experience, should be fixed.

I have outlined a number of corporate governance issues in which I believe reforms are both necessary and possible:

One, dealing with the conflicts among the professionals.

Two, better regulation of the accounting profession.

Three, reforms in the area of executive compensation, particularly in the area of stock options, and to require shareholder approval.

And in the role of the stock exchanges, to deal with issues in the public interest and recognize their responsibility there.

And, finally, the education of directors.

You may be sure TIAA-CREF is an organization that will continue to press for these reforms. We hope the current widespread public interest in such issues will provide focus and impetus for such reforms.

Thank you very much.

[The prepared statement of Peter C. Clapman can be found on page 397 in the appendix.]

Chairman OXLEY. Thank you Mr. Clapman.

Let me begin by asking Mr. Raines, what role corporate management plays in assuring that audit firms are independent, and how is it similar or different to the role of the audit committee itself?

Mr. RAINES. As we stated in our principles, it is not only the obligation of the auditor to be independent, but it is also the obligation of both management and the board to not take any steps that would compromise its independence. And that means from the management standpoint, that management should not ask the auditors to undertake activities that may be inconsistent with their role as independent auditors, and must ensure that the practices with regard to the personnel of the auditors and to the provision of information needed for the auditors to do their work are consistent with the auditor's independence.

Sometimes it is easiest, if you have a task and you have a professional firm working for you, to simply use the firm who is there and use a different department of that firm. But that easy path can lead to independence questions. If, for example, you used the consulting arm of an auditor to create your financial systems, and then the auditors then have to audit those systems, that can impinge on the independence of the auditors. So it is in part management's job to not even suggest to the auditors that they put themselves into positions that may create independence concerns.

Chairman OXLEY. Mr. DelRaso, you mentioned that Congress should be careful in trying to fix things that aren't broken. What proposals specifically are you concerned about?

Mr. DELRASO. I think the CARTA legislation has done a pretty good job of addressing the problems without going too far. But I am still concerned about two areas in particular: one, the groundswell that may be developing in terms of rolling back the reforms made on securities litigation; and, number two, I think in the area of auditor independence, Congress should take a careful look at the real role of the modern-day accounting firm and the services they provide across the board, audit and consulting.

We have seen the worst in these recent cases. I represent a number of companies that deal in the global markets, and I think a little more work may have to be done to take a look at the role of these firms in the non-audit areas, especially overseas. When global companies are setting up subsidiary operations and other types of international functions, the auditing firm is the law firm in that jurisdiction and it provides other areas of advice and, quite frankly, it is the best source of that advice in that particular market. And at the same time, that firm also has the institutional knowledge of a particular client.

There are, I think, a number of functions that really aren't necessarily in as deep a conflict as we believe.

Chairman OXLEY. I don't know whether you were here for Mr. Pitt's testimony, Chairman Pitt, but I think you and he share the same concerns that perhaps I do as well; that is, we would be very careful about putting things in stone, as Chairman Pitt said, because it is much more difficult to extricate ourselves from a bad decision. Better it be left for the most part to the private sector, and indeed to regulators.

Let me ask, Mr. Jasinowski, Chairman Greenspan testified a couple of weeks ago to this committee and, in response to a question, seemed to indicate that in many cases, the marketplace is the best way of disciplining unwanted behavior. What do you think

your members would fear the most, Government reprisals or market reprisals?

Mr. JASINOWSKI. I think the market reprisals are already taking place, Mr. Chairman, as you know, and I don't think there is a company in my membership which isn't reviewing all of its procedures to be absolutely sure they are not only sound, but they are made stronger. And I think the markets, the equity markets, have also reacted already. So we don't have any choice about the private markets except within running our own companies, where we do have a choice, and I think we are going to do a lot better there.

I think the biggest concern is that people are going to try to create a whole new legislative, regulatory, liability system to go after some particular transgressions. And I think one of the reasons why your particular legislation is appealing is that you respond legislatively, you set up a framework to use the SEC, you try to involve the private sector, and at the same time, you have punitive actions if they are necessary.

I think you have got to have a balance. You have got to have perspective. That is what all our members are really looking for, and we are concerned that Congress may overreact.

Chairman OXLEY. Mr. Livingston, while I may share your philosophical opinion regarding the division of labor between accounting and consulting, the fact is that several of the accounting firms have already indicated that it is their desire as the corporation or partnership to divide those. Some would say that we need to make sure that maintains, by passing a law that would forever divide those functions. What is your reaction to that?

Mr. LIVINGSTON. I think it would be a great role for the new oversight body that we are talking about for the accounting profession. And the main reason it would be a great role for that body is because there are many, many nuances. And our group, while it feels strongly about continuing to get tax services from the auditor, because most of that work is compliance work, it is related to the tax return and ties into all the work they do on the audit, there are areas in tax preparation, tax advisory, that might be good for this oversight body to be concerned about; tax structurings and tax shelters that have been in the news, and where there are contingency fees and tax savings. And that just illustrates the kind of nuances that an oversight body could react much more quickly to in a more focused manner.

Chairman OXLEY. Thank you. My time has expired.

The gentleman from New York, Mr. LaFalce.

Mr. LAFALCE. I think everybody agrees we need to have some type of oversight board, correct? So I guess the question is, what powers should it have and who should serve on it? Now, with respect to powers, does anybody doubt that they have should have their own independent investigatory powers, that they should have their own ability to subpoena, to promulgate standards, and see to its enforcement, adequate staff resources to do the job? Does anybody have any quarrel with any of those concepts?

Mr. Jasinowski, do you have a quarrel with those concepts?

Mr. JASINOWSKI. I do in the sense that it is not clear what the relationship is to the SEC in that whole articulation.

Mr. LAFALCE. It surely would be subject to the SEC.

Mr. JASINOWSKI. I think as long as the SEC is the one who has the determination with respect to investigation.

Mr. LAFALCE. I assure you, anything coming out of this committee will absolutely ensure that the board is subject to the jurisdiction of the SEC, which is subject exclusively to the jurisdiction of this committee.

Having said that, the question is, who is going to be on it? We know that Charlie Boucher resigned when he heard of the appointment of certain individuals to a new board created by Mr. Pitt. We know yesterday that Charlie Boucher said that the new board should consist exclusively of public members. And I don't know we have to go that far.

Suppose we put in legislation that the SEC's appointive power of members of the board should be based upon recommendations made by certain institutional investors; that TIAA-CREF should make certain recommendations; that the Council of Institutional Investors should make certain recommendations; that private employees' pension plans and public employees' pension plans should make certain recommendations. A slate of candidates could then be decided upon by the SEC.

How does that sound to you, Mr. Jasinowski, because it is important who is on it. Mr. Boucher would have rejected out of hand those individuals that Mr. Pitt wanted.

Mr. JASINOWSKI. You have a lot of shareholders here, like you, Congressman LaFalce, and employers are some of those. Management, auditors, pension funds.

Mr. LAFALCE. We want to check the employers, because it is the employers that are the CEOs with the stock options, the CFOs with the stock options that are the first line of defense against earnings management or manipulation. Then it gets to the audit committee who very often also has the same stock options, perhaps not in the same quantity, and very often have a policy of passivity that permeates the board. And so we need to check that. And it is my judgment that the best check is to have at least a majority of members coming from individuals representative of these pension funds' institutional investor groups.

It is not unreasonable in any event?

Mr. JASINOWSKI. No.

Mr. LAFALCE. Thank you. Let us go to the next issue. Is there anybody here who thinks we should permit auditors to immediately leave the audit firm and become an employee of the firm that they were auditing? Don't you think we ought to have some ban on the time period? Wouldn't that be a good thing to put in the legislation?

How about you, Mr. Raines?

Mr. RAINES. We believe there ought to be a period of time when someone who worked on the audit is not eligible for employment.

Mr. LAFALCE. OK, good. Anybody who disagrees with that concept? We can accept that.

Mr. LIVINGSTON. That ought to be a company-driven thing, a policy adopted by the companies. And I don't think you should legislate.

Mr. LAFALCE. You can say it, and I would strongly disagree with it, because the problem is that 90 percent of the companies you

don't have to worry about would adopt it, and the 10 percent that you might have to worry about wouldn't adopt it. And that is why you have laws. Most people don't murder, but you have laws against murder. Publicly traded corporations, if we are talking about publicly traded corporations—and we are not talking about private corporations, Mr. Livingston—publicly traded corporations subject to—invested by public at large.

Let us go on to some other issues. Mr. Jasinowski, you were very worried about adopting new laws dealing with grievances in the securities markets. What about a return to old laws? Would you consider that? I mean, you are opposed to new laws. What about return to old laws?

Mr. JASINOWSKI. We are not opposed to new laws.

Mr. LAFALCE. Let me focus in particular. What provisions in the 1995 Securities Litigation Act were so important that you think they are so wonderful that they shouldn't be changed? What was done in the 1995 legislation that reformed or changed securities litigation that was so important that you think it should not be revisited? Would you please explain that?

Mr. JASINOWSKI. I think in general——

Mr. LAFALCE. Not in general, in specific.

Mr. JASINOWSKI. I don't see any reason we ought to be changing that law.

Mr. LAFALCE. What did it do that it should not be changed? What did it do specifically that is so good that we shouldn't change it?

Mr. JASINOWSKI. I am not in a position——

Mr. LAFALCE. All right. Thank you. OK, good. I know you came out strongly.

Mr. JASINOWSKI. Again, it is not altogether new laws; I didn't say we ought to go back and change that particular law.

Mr. LAFALCE. That is the law you said should not be changed, but it was enacted in 1995. And I want to know what did it do that was so good that it ought not to be changed? And I have a nonresponse. But I understand that this is an institutional response as opposed to a specific response. Is there any problem with making sure that it is the audit committee that has the responsibility for the hiring and the firing of the auditor? Is that a good idea?

Mr. JASINOWSKI. Congressman LaFalce, I particularly like that aspect of your legislation, and I think having an independent nominating committee making a decision about the audit committee and establishing in-house as independent an audit committee as you can have is a very good idea. Whether or not you need to codify it in legislation I don't know, but I think it's something we ought to be striving for.

Mr. CLAPMAN. You made the point that the audit committee should have the right to hire and fire the accountant. I think that is embedded currently in the law. Whether it is followed in practice is a different issue. But it does tie into——

Mr. LAFALCE. What if we make it a material breach if they do not?

Mr. CLAPMAN. I think it already is.

Mr. LAFALCE. Well, then, there is not an awful lot of material breaches, I would suggest, that have not been——

Mr. CLAPMAN. That is true. There is a tie-in to the consultant aspect of what the audit firm does and why we take the position that we do.

Mr. LAFALCE. Speaking of the consultant, we do not say that certain firms have to be auditors and can't be consultants. We say they can't be the auditor and consultant for the same employer. They could be a consultant for some other employers and still retain all that capacity. And, of course, I do think certain types of consulting such as tax should be allowed for the same employer.

Mr. CLAPMAN. But there is an aspect of that point that goes to the heart of your question, and that is that the consulting services typically will not be retained by the audit committee. Typically, the consulting services are obtained by the management of the company. And that is where the potential conflict comes about: How does that firm view their loyalties? Do they view their loyalties to the audit committee and the shareholders, or do they owe their loyalties to the senior management of the company? And that is the effect of having large-scale consulting services by the same firm that does the audit being hired by management, and how the audit firm then assesses where their bread is buttered.

Mr. BAKER. [Presiding.] We will come back for another round.

Mr. RAINES. If I could differ. My experience is different than that. Audit committees typically are, in fact, shown the entire workload by the audit firm, whether or not it is audit-related or consulting, and it is the responsibility of the audit committee to supervise that entire relationship; and in the firms that I am aware, where best practices would include the audit committee supervising the entire relationship, regardless of the scope of services.

But on the scope of services issue, I would urge the committee to make, as you are thinking about the legislation, to not fall into these definitions of audit, audit-related, and consulting, because they are in many ways very false distinctions. Some of the audit-related are in fact audits of the pension plan, and they are indistinguishable from audits of the financial statements. So I think most people would believe having the same auditor doing auditing is not a problem.

On the other hand, there are some things that are called "consulting" that look a lot like what you think an auditor should do, such as looking and verifying information that is going to be used for securities offerings. So, rather than using these broad definitions, I think it is far better to try to come up with something that says things that are consistent with the attestation role of an auditor, where they are not to do broad-gauge management consulting, but to provide assurance to third parties that something is accurate. And I think that is far better than these distinctions that are currently being used, because I think they really confuse what it is that the auditors are doing.

Mr. LAFALCE. I think if you look at Mr. Levitt's recommendations, they were about an inch or two thick. And clearly, it would be the job of the SEC to articulate regulations. We have separation between church and state, but very often there must, of necessity, be a merger of the two. It is absolutely impossible to have a complete separation.

Mr. BAKER. The gentleman's time has expired.

Mr. Raines, I want to pursue this line you just initiated with regard to the manner in which the Congress should act. And I sense from a number of the other members of the panel that with regard to the Congress being able to circumscribe current business practice by certain definition and thereby preclude inappropriate conduct in years to come, all of you are very bright people who can construct a business model that would meet whatever rule Congress comes up with, and that we should address principles of governance and then empower the SEC to enforce those principles where they don't already have the authority to act—which I believe they do have authority to act.

To that end, I think it was inappropriate for Enron officials to have exercised no-cost options when, at the same time, constrained employees may have been prohibited at different intervals from acting on the exercise of their own stock options. And if there had been a subsequent accounting, there certainly would have been a restatement brought about which would have caused shareholders, if they had been a viable corporation still standing, to take significant loss while the executives earned significant compensation during that same environment.

Is it your understanding that participants generally in the Roundtable, as a matter of business ethics, have in place today some prohibition on those generalizations that I have described? Or how can we construct rules that encourage long-term earnings growth versus short-term profit and the extreme pressures that I understand management faces?

Mr. RAINES. I think you outlined the core problem, and let me give you my perspective on that. For example, in our statement with regard to the treatment of employees and treating them fairly, I think it would be entirely appropriate for Congress to say that one of the tests of fair treatment under the pension laws is that the fair treatment would go to questions of when can individuals trade or not trade. That is a broad principle that doesn't go to the Enron case, that says in this particular instance, here is what the rules can be. And then the Labor Department, as necessary, can begin to elaborate on how that might apply.

But we don't believe there should be special treatment for one set of employees of the corporation versus another as to when they have access to the market. And most companies have tried to hold any such periods to be very small. But I think it would not be unreasonable for that specification to be there, because it establishes a principle without establishing exactly how it should be done for all times; because, you know, 20 years ago we didn't have 401Ks. And 20 years from now we may have something different that is in place.

But, I think the broad principle that employees should be treated similarly in the implementation of these plans and should not be disadvantaged vis-a-vis other employees in the exercise of their rights to purchase or sell stock, I think is a broad principle that would make an enormous amount of sense.

Mr. BAKER. Do shareholders generally today, as members of the Roundtable, have the authority to approve or disapprove option plans?

Mr. RAINES. The vast majority of option plans are presented to the shareholders for approval; not all, but the vast majority of the plans are presented to shareholders for their approval, and they are not always approved. Indeed, a number of the shareholder activist groups have taken very strong positions with regard to the size of these plans, and many corporations go to great efforts to comply with the views of these shareholder activist groups when they put their plans together.

Mr. BAKER. I have suggested, as one incentive to preclude manipulation of stock value, exercising no-cost option with a subsequent restatement of earnings, to require disgorgement within a certain time period of the restatement occurring if there is a finding by the SEC of manipulation of stock price. And the reason for that mechanism as opposed to the litigation route is the SEC can act while there are still resources available to act upon, where if we rely on litigation under Section 10(b)(5), it could be years. What is your reaction to that general line of thought?

Mr. RAINES. Mine? With regard to disgorgement, the SEC does have authority now to undertake that. And in cases where there has been wrongdoing that leads to a misstatement of the information given to the public that has a material impact on the stock, I don't believe it is unreasonable at all for the SEC to pursue disgorgement among the senior management of the proceeds from options that would have occurred under those circumstances. I think you are going to have to define who was covered and what the circumstances will be. But as you described the situation, that would be a prime case in which the SEC should take action.

Mr. BAKER. As a general matter for the panel, does anyone dispute the observation that the financial statement should be an accurate reporting of corporate financial condition for the shareholder, and that it is not the property of the management? Does anyone dispute that particular view? Because we had the CEO of a significant accounting firm indicate it was a joint property of management and the shareholder, and I found that to be a bit distressing that that conflict would be publicly acknowledged by a CEO of an auditing corporation.

Did you want to comment?

Mr. CLAPMAN. Yes, I did. I just wanted to add to the response of Mr. Raines to your question about whether shareholders have the right to approve stock options. I think the vast majority of the companies within the Business Roundtable do present their stock option plans for shareholder approval, but we have been tracking this and there are, increasingly, companies adopting plans without shareholder approval. So if you want to look at the direction, without some reforms in this area, the direction is toward more plans being put into effect without shareholder approval at the current time.

Mr. BAKER. I am sure we may come back to a second round, but Mr. LaFalce wanted to get 15 seconds.

Mr. LAFALCE. Mr. Chairman, pursuant to rule 11 of the Rules of the House and rule 3 of the rules of our committee, I would like to have an additional day of hearings on the matters related to comprehensive reforms and, most particularly, both Mr. Oxley's bill and my bill so we can see the best merits of each.

Mr. BAKER. I thank the gentleman.

Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman, and welcome to all the panelists.

I would like to ask Mr. Raines, we currently have five big accounting firms, and with the indictment of Andersen there is a possibility that we may soon be down to four; and doesn't the fact that only four auditors will be reviewing the financial statements of America's largest companies require that the industry regulator be a stronger public entity than those that have been proposed by the SEC? Could you comment on what the impact may be with only four firms?

Mr. RAINES. Well, I think that it is a bad thing that we might face the prospect of having only four major accounting firms in the United States. There are other accountings firms other than these current five. But I think the reduction in the number of accounting firms is not a good thing. I think competition in that market is a good thing. I think having multiple firms is a good thing. And that is a matter of concern, and I hope that is taken into account in future years as firms look to merge or otherwise reduce the number of competitors.

With regard to an oversight body, I agree wholeheartedly that it needs to be a strong body and needs to be one with the power to actually investigate and the power to actually come to conclusions and to make determinations that might include penalties. And you ought to have on it those people who can both instill confidence in the public, but also those people who have some knowledge of the profession and the work to be able to come to decisions.

But it should not be a body that is nearly honorific. It ought to have the ability to not only discipline, but also to look at the quality control procedures within accounting firms to ensure that they are working to become better and they are becoming better at what they do; because I believe the biggest impact they could have is not on the penalty side, but it is in quality control. It is ensuring they are hiring good people and they are training them and they have systems of conflict of interest in place; that they are enforcing their own internal rules, in fact, and actually going to look and review periodic audits and see if those audits meet standards. I think that kind of approach from an oversight body can have a tremendous effect on the quality of audits.

Mrs. MALONEY. There were two questions that have been asked by the prior panel by members of this company. One was rotating auditors, your feeling on that. And another of, say, every 3 years having an auditor come in and look at the audit. And what is your response to those two proposals?

Mr. RAINES. In terms of the rotation of auditors, there are instances, and particularly in public bodies, that do require rotation. The concern that you have is that in the first year and last year of the audit, you may not have the same quality of the audit that you were looking for. I believe the SEC's evidence is that more frauds occur in the first year of a new audit relationship than in any other time. So I believe the members of the Roundtable would say it ought to be on a case-by-case basis.

In our company we have adopted the practice now of essentially requiring a de novo review of our auditor each year where we would have the same process we would have as though we were doing a new audit selection, where they have to present their credentials and identify their quality control and all the aspects to make a determination should they continue to be the auditor in the next year. And I think that practice can take the place of an automatic rotation, as a rule.

Mrs. MALONEY. With the proposal having, say every third year, another auditor review the work.

Mr. RAINES. Well, currently there is a process in the auditing profession of having another firm come and do a review. But this is a relatively private process in which the SEC is informed of the results, but it is a relatively private process. I personally believe that that is a process that should be overseen by the new oversight body, and that these reviews are used as a way to improve audits, not only to say how did this one firm do, but what did you learn in this case, in this type of a firm, or this type of an industry, and let other people know so that if they run into the same problems, they will know how to go about handling them.

We don't have a good enough feedback loop so people are learning about what went right and what went wrong in audits. If you have someone come in every 3 years to review the entire audit, that is a massive undertaking for multinational companies that may be in 100 different countries, that to go replicate that audit would be a massive undertaking. I think it would be impractical. But I do believe having these periodic quality reviews, taking random audits and really thoroughly looking at them, could be a very important learning tool.

Mrs. MALONEY. Last week, former SEC Chairman Robert Hills suggested before this committee that audit committees should be given more formal legal status and that independent directors should be nominated by an independent nominating committee rather than by the CEO or chairman of a company. And what is your view of these suggestions?

Mr. RAINES. At least my experience since last fall is that audit committees have quite a status now within corporations. I think our general view would be that designating a particular committee as being independent of the board itself is not a good idea. Committees are just subsets of the boards. Audit committees should be populated by independent directors. And all committee assignments should be made, in our view, through a nominating committee, and that no one person——

Mrs. MALONEY. An independent nominating committee?

Mr. RAINES. Nominating committee of the board.

Mrs. MALONEY. But most board members are appointed by the CEO, so then you would have the CEO control.

Mr. RAINES. I don't believe the Chairman was really talking about a nominating committee that was independent of the board. I believe he meant an independent committee made up of independent board members. So it would be the nominating committee within the board that would be approving that. That is the practice of the corporations that I am familiar with personally in any event. Certainly the CEO is likely to have ideas, but I also know that very

often that the CEO's ideas don't prevail in well-managed companies and that the nominating company ultimately has responsibility of picking both committee Members and members of the board.

Mrs. MALONEY. There has been some suggestion after the Enron debacle that there is a massive hole in our financial services regulatory system for entities like Enron, entities like Enron that act as financial services companies, but do not fit the current regulatory scheme. And do you believe that simply the reporting requirements for public companies to the SEC is regulation enough for these companies? In many cases, banks are very heavily regulated. And in many cases, these entities like Enron are larger than the banks in practicing formal banking practices. So either the bank shouldn't be regulated or possibly these entities should be regulated.

Mr. BAKER. That will be your last question, because your time has expired.

Mr. RAINES. I think you have raised an important issue. We have been talking here about the regulation of financial disclosures. But you are talking about as important, if not more important, safety and soundness regulation. Enron could have disclosed much of this and still have been unsound. And the rise of financial institutions who are not subject to safety and soundness regulation is a matter of concern, because just as surely as a large regulated financial company could cause concerns in the economy and concerns with other investors, you could have that same concern arise with a financial company that does not have a safety and soundness regulator.

So I think it is important to keep in mind that we need to have appropriate disclosure, but also we need appropriate safety and soundness regulation to ensure that our financial institutions are contributing to a sound economy and not putting our economy in danger.

Mrs. MALONEY. With Enron, do you think there is a gaping hole for these type of entities? Should there be some type of regulation?

Mr. RAINES. I believe that that is an issue that ought to be given very careful regulation. Enron was becoming a financial company. It had no safety and soundness regulation or oversight of any kind. And where we see very large companies becoming financial institutions without safety and soundness regulations, I think that is a concern.

Mr. BAKER. Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman. I want to go back to a comment you had a few moments ago and this whole issue of whether or not you preclude an auditor from providing other services. And I agree that you don't want to get caught up in the minutia of saying, well, it can't be this or that, and I understand there is some synergy between tax return preparation and auditing.

But you raise an interesting point which I was trying to raise earlier today with Mr. Pitt; and that is, there are certain things that auditors provide that are verification oriented for investors. And it would seem to me, and again I recall—you may recall from your prior experience—I seem to recall there was an MSRB rule or other rule that precluded auditors from providing other verification numbers in the same issuance that was being done.

Now, I may be wrong about that, but it does seem to me that is really what we are trying to get at. And I would be curious and, Mr. Livingston, I would like your comments, because you talked a little bit about this in your testimony, whether or not if we proscribe something a little more broadly in the way that Mr. Raines discussed it, that that would be an acceptable form of separating out, saying if you are going to be providing auditing for public companies and even tax return preparation that you can't—at least in the same issuance of a registered issuance—provide other forms of verification. Because I think our concern is not just that there is perhaps padding of other accounts in order to get a more favorable audit, but I think our other concern in the case of Andersen was that they were providing qualified opinions and verification for off-balance-sheet financing which, had they put all the pieces all together, they very likely would have said perhaps it wasn't being properly disclosed.

Mr. RAINES. I may not have been clear, but let me try to answer that. It has been 20 years since I looked at any MSRB rules. I think in my experience in dealing with entities, both entities in financial trouble and entities that are financially strong, is that the auditing firm often is the only consistent source of information. And well done, they require that numbers in one place match up with numbers in another place. And it is a very valuable service that they provide and they typically are very loath to sign off on anything that they haven't had a chance to verify what the source of the information was.

And that is something we don't want to discourage companies from having; having someone who sees all the numbers, so you don't have a case where companies can show part of the numbers to one audit firm and another set of numbers to another audit firm and no one ever compares the two.

So I think you want to try to have your verification things in one place. But I think what you don't want to do is take the person who is doing verification and then have them doing fundamentally different things that will get them off of what their particular expertise is and into this.

There was an unfortunate phase in the auditing profession where they stopped looking at themselves as auditors and assurance firms and got into being full-scale multipurpose professional services firms. And I think that was a mistake, and I think most of the auditing firms are correcting that mistake now. But I do believe that there is importance in having one firm that looks at all the numbers when you are verifying and making representations to the public, so you don't have things falling between the cracks.

Mr. LIVINGSTON. I would comment, a couple of years ago when we did pass the—the SEC enacted those rules they extended the list of services that auditors should not do, which resulted in a product on which they might end up relying upon. And the problem is, is that it gets—that is a good list of things that they shouldn't prepare the books and then audit the books or build receivable systems and then audit receivable systems.

But the problem gets into when a company is doing very complex transactions and they show the transactions to the auditor. And I think in the Enron case, the auditor may have gotten too involved

in the actual design and then auditing the transactions. It takes ethical conduct and professional standards at the local level to regulate that gray area.

Mr. BENTSEN. And I think that was the problematic situation with respect to Enron.

Let me ask you one other question, Mr. Livingston. In your testimony, you briefly referenced the need that your organization is calling for to review FASB and their rules. Can you expand upon that a little bit?

Mr. LIVINGSTON. Yeah. We have gotten into a bad circumstance in accounting standards over the last 10 years, and we have had accounting standards like FASB 133 which is accounting for derivatives, which is 850 pages long and is unusable by the most sophisticated local audit partners out in the field. There are a handful of people in the world that know how to apply this accounting standard. And that is the unfortunate circumstance we have gotten ourselves into.

We have gone too far in getting away from principle-based accounting standards. In this Enron and accounting for derivatives, FASB 133 has exposed the need to have a new process, a new mind-set, principle-based accounting standards that get back to substance of reform.

When I learned accounting and I studied for the CPA exam, there was one principle called "substance of reform" that we have lost in the last 10 years. Form over substance has taken over. And it is an unfortunate lesson, but I think the lesson has been learned and I think we are heading toward faster standard setting that are principle-based, that get back to substance of reform.

Mr. BENTSEN. You sound like the architects have taken over FASB, but I always thought of FASB as being more of an accounting-based institution, as it was. And you say it doesn't work in its current form.

Mr. BAKER. That has to be your last question.

Mr. LIVINGSTON. It has gotten too focused on narrow problems and not prioritized. It hasn't kept pace with the modernization of technology and hasn't thought about financial reporting as much as here is a problem and we are going to swarm in and spend a lot of time on that. The consolidations project, we spent a lot of time on that. There were many of us that encouraged the FASB to break up the consolidations project, which they worked for 20 years on, and break it up and focus on the SPE issue. And a lot of people said that. And they couldn't step back and divorce themselves of the other part of the consolidations project. They wouldn't let that go and focus on SBEs.

And that is part of the whole problem that has been going on for the last 10 years. I think we have a new mind-set and a new attitude, and I think we will get to the right place.

Mr. BAKER. The gentleman's time has expired.

Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman. I was going to ask Mr. Frank Raines of Fannie Mae, a lot of what we talked about today, one of the things we have focused on is compensation structure and making sure that when you have got a board of directors that you are increasing their independence and that you are ensuring that

the interests of the shareholder are being represented there on the board and not the interests of management. And I was going to ask, how does Fannie Mae compensate its own board of directors and its audit committee, with an eye toward that specific objective?

Mr. RAINES. Well, it has been our philosophy for quite some time not to concentrate the compensation of our directors or of our management using only one tool, so we use a variety of tools. Our board is compensated through an annual retainer, meeting fees, and then they also have stock options. And the idea there is to have their focus not just on what is happening this year, but also the longer-term interest of the shareholders.

Similarly for our executives, we compensate with a combination of salary, bonus that is focused on 1 year's performance. In some cases we have focused on 3 years of performance and then options, which is for the longer term. So we don't have any one focus. And, indeed, we provide a disincentive to try to move the stock in the short run, because if stock then goes down, you will disadvantage your compensation which is not going to be paid to you for 3 or 4 or 5 years. So we found that a mix gives us the right balance, that no one tool does the job, but also you don't overweight toward one thing or another.

Mr. ROYCE. You know, if there is a best practices approach to this, what would be gained or lost by requiring all publicly traded companies to submit to a structure—or do you think that is feasible?

Mr. RAINES. I think you can suggest best practice, but I don't know that any of us are smart enough to think that something is going to work in all of these different companies. The companies really all have different personalities and different circumstances. So I would be loath to say that I would know that our structure would be perfect for everyone. But I do think that in the compensation philosophy, these are the kinds of things that should be looked at. And, indeed, now the SEC requires that in proxy statements there be a report from the compensation committee stating the philosophy. And if investors believe strongly in one philosophy or another, that is their opportunity to communicate that to the company. And I think that process has worked for other kinds of reforms, including holding down the number of options so as not to dilute the interest of the shareholders.

Mr. ROYCE. One other question I was going to ask. How does Fannie Mae report management trades that occur in the company? How do you report those to the marketplace and what timeframe do you report those management trades in company stock?

Mr. RAINES. Fannie Mae is a non-SEC registrant. It doesn't report or use the forms of the SEC. But we have had an insider trading compliance program for many years which prohibits executives from trading at all, except during an open period, and that open period only occurs after we have reported our earnings for the quarter. So we only permit very limited windows. All trading done during that period has to be reported to the company, which is then—all the trading is reviewed by our counsel and reviewed by our regulator.

We have, though, taken note of the proposals that Chairman Pitt has suggested on contemporaneous reporting of these trades. And

so we intend starting next month to provide contemporaneous reporting. So within several days of the trades, we will post on our websites all trades by all insiders of the companies. And I believe that will make us one of the first companies to, in fact, implement the idea that Chairman Pitt has put forward.

Mr. ROYCE. I think that is a good move, and I would hope all corporations follow suit with the SEC's suggestion there. And, frankly, I think having that reported in real-time will do a lot to end the abuse there. But I thank you for answering those questions.

Mr. BAKER. Ms. Carson.

Ms. CARSON. Thank you very much Mr. Chairman. Let me assure you, gentlemen, that I come here with no preconceived notion in terms of what we need to do. What I seek personally are quality control, disclosure, consumer confidence and integrity, business ethics, fairness, understand what constitutes wrongdoing and how the shareholder and then the stakeholders are protected throughout the process.

And I would also hasten to add that I think it is very troublesome that an institution like Arthur Andersen, who has for years been one of the premier accounting firms in this country, has had to go down based on the acts of a few bad apples in a bushel. I am not one who believes you need to throw the bushel out.

I have two quick questions, one of Mr. Raines in terms of on behalf of the Roundtable. You said it is the responsibility of management under the oversight of the board and its audit committee to produce financial statements that fairly present the financial condition of the company and make sufficient disclosures to investors to permit them to access the financial and business soundness of the company.

Can such responsibility be legislated by the United States Congress? I just sent back my shareholder proxy yesterday, and always check yeah. Want to know if you want these people to be on the board, yeah; do you want this kind of committee. It doesn't make to me any difference because I trust the company.

I don't know how in the world Congress can legislate all these things. And additionally, because I know we have a vote on, there was an article in the *Wall Street Journal*, Mr. Chairman, that talked about Enron, and that is why we are here, this one company. Information was that servicing Enron's derivatives, trading may have been used to mask weaknesses in the company's other businesses such as fiber optic bandwidth, retail gas and power, and water systems.

Can any of you gentlemen tell me how we can as a Congress ensure that all of these lists of sundry outside entities under one big umbrella can be regulated and audited so that the stockholders and the shareholders will know fully well what the condition of a company is?

Those were two questions. If you don't have time to answer, you can write me, because I know we have a vote on.

Mr. BAKER. Let me suggest Mr. Sherman has a remark, and if you will work with me here, we have an end in sight; because if you don't, we are going to have to come back after a 20-minute delay. And hopefully that will encourage a prompt and courteous response to Mr. Sherman's inquiries.

And thank you, Ms. Carson, for your comments. We are asking for a direct written response, Ms. Carson.

Mr. SHERMAN. Thank you. I first want to comment that I hope that we move toward the most thorough rules with all the identifiable loopholes plugged, rather than just announce that we want to be principles-based.

I would point out that the form over substance principle is part of the rule now, and we never raised that, and it was completely insufficient. I think if we all sing patriotic songs and rededicate ourselves to form over substance, that might work for a year or two. But eventually the people who come to head the aggressive firms will be the aggressive financial managers, and the firms that are selling for 25 times reported earnings will be the aggressive firms, and maybe it will be the aggressive firms that claim that they are not aggressive.

And I am an old tax guy and I can just imagine what would happen if we went to a principles-based tax system. And keep in mind, the Tax Code and FASB regulations are doing the same things. There are two different systems for determining what your net income is. And if we just urged taxpayers to pay their fair share and relied on principles rather than the most definitive rules, we would have a lot larger deficit than we have now.

I wish I could ask a question, but you would have to stay for another 20 minutes. What I hope that we do is have a third day of hearings and invite those who represent investors to be here. One of the things that I think is one of the problems in this Enron situation is that those who represent investors, mutual funds, pensions, are not represented in Washington given the degree of their importance to our economy, and that most of the people who have come before us are issuers of financial statements, not those who read them with an interested eye. And I look forward to a third day of hearing, but not a 1 minute of questioning.

Mr. BAKER. I want to thank each of the witnesses for their appearance today, and I want to say a word, Mr. Livingston. I appreciate some of the recommendations your organization has made in the testimony today. The Chairman would want me to encourage you, in the days that remain before the committee would proceed to markup of this important bill, that you forward any recommendations or suggestions based on the exchanges you heard today. We have a significantly important task ahead of us, and we need all the best minds we can get to succeed.

Thank you for your testimony and our hearing is adjourned.

[Whereupon, at 2:45 p.m., the hearing was adjourned.]

H.R. 3763, THE CORPORATE AND AUDITING ACCOUNTABILITY, RESPONSIBILITY AND TRANSPARENCY ACT OF 2002

TUESDAY, APRIL 9, 2002

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The committee met, pursuant to call, at 2:05 p.m., in room 2128, Rayburn House Office Building, Hon. Mike Ferguson presiding.

Present: Chairman Ferguson; Representatives Roukema, Baker, Gillmor, Cantor, Ryun, Biggert, Rogers, LaFalce, Kanjorski, Watt, Bentsen, Carson, Sherman, Inslee, Shakowsky, Capuano, Hinojosa, Israel, Maloney of New York, Meeks, and Maloney of Connecticut.

Chairman FERGUSON. The hearing is called to order.

Today, the Committee meets for the third day of hearings on H.R. 3763, the Corporate and Auditing Accountability, Responsibility and Transparency Act. Today's hearing is being held at the request of the Minority.

The Chair now recognizes himself for a brief opening statement.

Good afternoon. Welcome to the Committee's third legislative hearing.

Last December, this Committee, which oversees the financial and capital markets, held the first congressional hearing on the Enron collapse and its impact on investors and employees in the financial markets. When the Committee set out to investigate the Enron collapse, we had several clear goals in mind.

First, we wanted to make sure the Congress now knew how the biggest corporate collapse in American history occurred.

Second, we wanted to work toward restoring the confidence of investors in accounting, regulators and the rules governing our markets.

Third, we wanted to formulate an appropriate response that would ensure that the free market system and the regulatory system that underpins it emerged stronger as a result of our work.

The American people deserve to know the facts directly and to hear them specifically from those most directly involved. I commend Chairman Oxley for working closely with major investigators, the Justice Department, the SEC and Enron and Andersen's internal teams to achieve these goals.

The introduction of the Corporate and Auditing Accountability, Responsibility and Transparency Act, or CARTA, represents the culmination of this process. It has allowed us to move forward and investigate comprehensive and practical solutions that will undoubtedly strengthen the overall financial system.

The past few legislative hearings have been very constructive. We have heard from a diverse group of witnesses representing a broad spectrum of views regarding the securities market and the Government's role in protecting investors. The distinct difference is in the testimony of these individuals, including former SEC officials and representatives from the securities industry, a leading

consumer organization and the accounting industry have confirmed that the Committee has taken the necessary steps to improve the current regulatory system through CARTA.

CARTA is clearly the product of a multitude of views and months of work by the Committee to improve the public's confidence in the capital markets and to strengthen the overall financial system in the most appropriate manner. CARTA is effective because it gets to the heart of these foundational issues that will prevent future Enrons without drowning businesses in a sea of red tape. It is important that this legislation avoids the temptation to overreact and legislate in a manner that will cripple the entire business community.

In fact, Federal Reserve Chairman Alan Greenspan has testified that the Enron collapse has already generated a significant shift in corporate transparency and responsibility, highlighting the market's ability to self-correct. Overlegislating would be counterproductive and make it impossible for the markets to function properly.

Despite these concerns, there is no dispute that Congress must be involved in some capacity to ensure that the free market will emerge stronger than ever. America needs a strong, vibrant and healthy accounting industry to keep companies financially sound and to provide investors with solid information. CARTA was carefully crafted by Members of Congress to provide our current system with this base without overstepping our boundaries in a way that could ultimately have a negative impact on the world's strongest markets.

CARTA rightfully establishes new firewalls and increased oversight to ensure independent reviews and avoid conflicts. It establishes a new public regulatory body under the SEC with strong oversight authority and prohibits firms from offering certain controversial consulting services to companies they are also auditing.

This legislation also requires accountants who audit financial statements of publicly traded companies to be federally certified by the public regulatory organization and highlights the concept of corporate responsibility by requiring companies to ensure their accountants are in good standing.

The oversight board has the authority to discipline individuals who violate securities laws or breach standards of ethics or independence.

Investors of all types rely on accurate and accessible information to make their financial decisions. In the Enron debacle, thousands of investors were deprived much-needed resources to make sound investment decisions. It is an outrage that any company would prohibit its employees from selling their stock within their retirement plans, while at the same time its executives were selling millions of dollars of stock because they were privy to more up-to-date information.

This legislation meets our responsibility to shareholders and employees of publicly traded companies who deserve to know more and know it in real-time about a company's financial well-being. It also fittingly prohibits corporate executives from buying or selling company stock when 401(k) plan participants are unable to buy or sell securities.

We have a moral obligation to ensure that safeguards are established to prevent the disasters of this magnitude in the future. CARTA correctly holds corporate America more accountable to the employees and shareholders through stricter accounting standards and stiffer disclosure requirements.

But legislating should not be the end of Congress's role in addressing these issues. The collapse of Enron represents a combination of irresponsible actions on the part of decisionmakers with knowledge of the company's financial well-being and a meltdown of the financial safeguards used to identify problems at a stage when corrective action might still be taken.

We must work directly with the private sector to instill a spirit of corporate responsibility by challenging America's business leaders to meet the highest standards of ethics and responsibilities to their employees and shareholders.

There have been dozens of legislative measures introduced by both sides of the aisle to address these issues. It is time to put partisan squabbling aside and to move forward with practical solutions that will actually help. These hearings have helped the Committee assess the effectiveness of CARTA in preventing future accounting and stock irregularities in publicly traded companies. However, to ensure that no questions are left unanswered, Chairman Oxley has agreed to this final hearing before we move forward with the consideration of CARTA.

I want to thank the witnesses for their attendance, and at this time I would like to yield to the distinguished Ranking Member, the gentleman from New York, Mr. LaFalce.

Mr. LAFALCE. Thank you very much, Mr. Chairman.

Let me put this in perspective. In your opening statement, you just said that the Chairman has agreed to this hearing. This is a hearing which we demanded as a matter of right under the rules of the House and the rules of the Committee. The timing for it was set over the recess for 2 o'clock today, a day when the Congress does not begin voting until 6:30. If we didn't demand our rights, we would have just proceeded to a markup on Thursday with but 2 days of hearings.

So you have said it is time to put partisan squabbling aside. What does that mean, that we should just discuss and vote upon exclusively the bill that was prepared by the Republican staff to the Chairman of the Committee without Democratic input? That is not putting partisan squabbling aside. That is just saying "succumb to our will." So let us not kid ourselves or kid the public as to is going on here.

The Minority Members of this Committee wanted today's hearing out of a concern that we mark up legislation as soon as Thursday on issues facing our securities markets without giving adequate consideration to many aspects of the legislative proposals before us. There are many aspects of the legislative proposal before us in which no one has testified, much less haven't had a diversity of testimony. And there have been significant developments.

On Monday, you all read in the *New York Times*, the *Washington Post*, and so forth, about the role of investment banks that has been added to the Enron lawsuit. We have not explored that. That

is certainly within the jurisdiction of our Committee. It is an important issue to which we have given no consideration.

Today, you read in the *New York Times* and the *Washington Post* and the *Wall Street Journal*, and so forth, about the action of the Attorney General of the State of New York with respect to securities firms who were violating their own rules, flagrantly. These are allegations, but he was able to obtain a court order.

Under any circumstances, though, these come within the jurisdiction and concern of our Committee; and before we mark up legislation, we should give attention to those issues.

It is clear to me that this should not be the last hearing before we go to markup. It seems to me there would be a rush of judgment, and the judgment should be a very partisan one. That is, go along with the bill prepared by the majority staff ab initio.

Well, there is consensus on certain things. There is a consensus that we need a new public oversight body for the accounting profession, but there is not a consensus on the attributes such a regulator must have to be credible and effective, and there has been no conversation between the Democrats and the Republicans, at least as far as I am concerned, on this issue.

For example, my bill explicitly establishes the powers and duties of the new regulator, while H.R. 3763 leaves these matters exclusively to the SEC rulemaking, effectively leaving these rules up for jump ball, totally up to the SEC.

Now, certainly the SEC must make rules and they must have a certain amount of discretion, but I think, given what we have seen, we ought to have certain legislative powers that are clearly established. And that is a serious issue. I think that the new regulator should have the authority to set quality standards rather than just enforcing industry standards and should have clear disciplinary and investigative powers. And that is not in the Chairman's mark, and it is in my bill.

We need a discussion of that issue. What should the legislation have? Should the legislation establish the clear disciplinary and investigative powers of the regulatory body?

Auditor independence. We have barely scratched the surface in considering that issue. We have not discussed the services that create conflicts for the auditor or measures to give the audit committee authority to determine the non-audit services the auditor should provide. Other corporate governance reforms that would enhance the functioning of the audit committee and are inextricably linked to auditor dependence. As the Enron collapse made sure, we also must ensure that the independent directors of our public companies are truly independent.

Now, my bill includes these provisions. They deserve further discussion. They have not been discussed before our Committee.

The Committee has given little consideration to the role of the securities analysts in the Enron collapse. My bill would do more to reduce the conflicts that cause analysts to look the other way when companies present rosy but misleading pictures of financial health.

As the New York State Attorney General said yesterday in bringing action against Merrill Lynch, such actions jeopardize the integrity of our securities marketplace, and we should examine that issue fully.

Finally, we must consider the need to enhance the ability of private litigants to enforce the securities laws, particularly with respect to aiding and abetting by accountants and other professionals. We restored the ability of the SEC to bring aiding and abetting actions in 1995, and we should consider restoring the ability of private litigants to do the same, and we have had no hearing devoted to that extremely important issue.

Further, I am pleased to announce that today I introduced another bill, a bill that would give legislative substance and real teeth to meritorious portions of President Bush's 10-point plan on corporate disclosure and accountability. The Corporate Responsibility Act of 2002 requires disgorgement of incentive compensation and certification of financial statements and allows the SEC to administratively bar unfit officers and directors from serving in public companies.

There is much to be done. I look forward to working with Chairman Oxley and all of the Members of the Committee to bring about a strong legislative response. I think we need additional time and hearings and consultation and conversations and compromise in order to bring that about, and I thank the Chair.

Chairman FERGUSON. The gentleman's time is expired.

The gentlelady from Illinois, Mrs. Biggert, you are recognized for an opening statement for 5 minutes.

Mrs. BIGGERT. Thank you very much, Mr. Chairman.

Mr. Chairman, this morning hundreds of Andersen employees in my district rolled out of bed with a simple question on their minds. When I return home tonight, will I still have a job? If I do make it through the day, will my job be there at the end of the week or the month? Sadly, for many of them, the answer will likely be no. Through absolutely no fault of their own, they will be looking for employment elsewhere. As Andersen finalizes plans to cut its workforce, my thoughts and prayers are with the more than 500 Andersen employees in my district and the thousands more across the Nation who had nothing whatsoever to do with the case at hand, but nonetheless are feeling the aftershocks.

We can debate privately or publicly the end result of the actions taken over the past months and how actions can lead to unintended consequences. As one Andersen employee from my district asked in a letter to me last week, if one out of our 535 Congressman and Senators gets in trouble, should you all be fired? The short answer is no; and yet it is true that, to a certain extent, we all lose public confidence when one Member abuses his or her office. It is not right, and it is not fair, but it is what happens.

I think everyone can agree that change is needed in the accounting industry, and I think several good proposals are on the table. We must, however, strike the right balance to ensure that the decisions we make in the coming days will help solve the problems at hand without creating those unintended consequences down the road.

H.R. 3763 is an important step in the right direction. With this legislation, we will avoid any more blanket charges against groups of accountants and instead punish the particular accountants at fault. H.R. 3763 provides more immediate and closer scrutiny of

the accounting profession in general and specific accountants in particular.

I should add that, at the same time, there is much more that the accounting industry must do. They should not wait for Congress to point them in the right direction.

A good place to start is with the recommendations of former Federal Reserve Board Chairman Paul A. Volcker. I commend the efforts that he has made to begin to restore some of the credibility that is much needed in the accounting profession.

I look forward to hearing from the witnesses today and thank you very much and yield back the balance of my time.

Chairman FERGUSON. The gentlelady yields back.

The gentleman from California, Mr. Sherman, is recognized for 5 minutes for an opening statement.

Mr. SHERMAN. Thank you very much.

It is good that we are having these hearings. It is unfortunate who is not here. We have those very many organizations who don't get fees as investment bankers, but do control trillions of dollars of capital—professional investors, mutual funds, pension advisers—who have been, I think, underrepresented in the overall process before Enron and even after Enron in giving us guidance as to what information they need and what steps need to be taken so that they can rely on that information.

CARTA I think is a good bill, but it is less than the minimum we should do, and I think our constituents will be unimpressed with those Members of this Committee who vote for final passage of CARTA, but vote against the amendments necessary to make it a strong enough and meaningful enough piece of legislation.

Alan Greenspan is correct when he points out that there has been a shift in business culture so that the greatest abuses of the past will not be repeated in the immediate future, but that is only the immediate future. The pressures that created the atmosphere of 2001 will return within a few years. The hottest executives at the hottest companies will be those reporting the hottest growth in their earnings and reporting the lowest liabilities. We need to legislate, not just rely upon what I fear is a short-term change in the business culture.

There are three amendments I am certain to offer to this bill.

The first is to tell the SEC they have to read the financial statements of the 2,000 largest companies every year, and then when they find something that is incomplete or confusing, they will then demand that additional material be filed. The request or demand for additional information will be immediately public. The material filed in response would be made immediately available to the public, and this is an answer to the fact that an awful lot of what is in those Enron financial statements isn't false. It is just unintelligible. Not unintelligible to the uninitiated. Unintelligible to anyone. The SEC doesn't read the financial statements filed by the big companies. They only read financial statements filed by the small companies. That has got to stop. And by the small companies, I mean the IPOs.

Second, Arthur Andersen was the one of the Big Five—then Big Five—that had its salespeople, the people in charge of selling more services to Enron and collecting the fee, the engagement partner,

in final control of whether to sign the audit opinion. The other Big Four accounting firms—or the other of the Big Five—put their quality and technical review people in charge of making that final decision. We should not leave it to the accounting firms to structure themselves any way they want. The people insulated from the sales decision and who are steeped in accounting literature need to make the final decision.

Finally, Mr. Chairman, recently Arthur Andersen indicated that, while it had offered over $700 million to settle, it was now cutting its offer to only $300 million because, oops, they don't have any capital. We need a minimum capital requirement for accounting firms of at least half a year's audit fees. Right now, Arthur Andersen is saying they don't have any money to pay those damaged by their inaction, and we cannot tell accounting firms that they can go practice virtually without malpractice insurance, with virtually no capital and then, if they make a mistake, the investors get nothing.

There are two other issues. One is that if we are going——

Chairman FERGUSON. If the gentleman could just wrap up here.

Mr. SHERMAN. OK.

Chairman FERGUSON. We are past expired.

Mr. SHERMAN. My time is expired. Let me simply say that those who don't learn from history are doomed to repeat it, and those who do not pass legislation triggered by recent history are doomed to see those same mistakes repeated.

Chairman FERGUSON. The gentleman's time is expired.

The Chair recognizes the gentleman from Louisiana, the distinguished Chairman of the Subcommittee on Capital Markets, Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman.

I think in the aftermath of the demise of one of the largest corporations in American enterprise it would be inappropriate for us to rely on additional lengthy studies or, worse yet, lengthy investigations with a failure to act. It would be really unacceptable consequences for the market as well as individual investors, and if we start in good faith today and act quickly, I can suggest to you that the congressional process will require a very long and tortuous path before we all wind up in the Rose Garden and exchange good wishes. So moving quickly at this juncture is not ill-advised. I think it is highly appropriate, especially in light of the fact the SEC, FASB, the GAO, the SROs and many other outside observers all have strongly held opinions about the directions we should be taking, coming to the consensus those elements will be enhanced by the legislative process. And I think it entirely appropriate for us to proceed.

I am particularly pleased with the panel of witnesses we have here today, to get their insights on the remedies appropriate in light of the consequences we face and to quickly implement not only their recommendations, but the 10-point plan outlined by the President, which I think was responsive to our current difficulty.

In fact, there are too many employees today watching every morning the fund balance in their 401Ks erode. Where retirement plans were certain, now we are thinking about second careers. The consequences of this are enormous not just for the individual em-

ployee, but for capital formation itself. The enhanced volatility in market performance is directly related to the fear that there is an undisclosed liability or inappropriate revenue stream that is not creating a correct and accurate picture of true financial condition. We all agree, disclosure, transparency and consequences for those who fail to comply by the rules. I think how we construct those rules are the difficult aspect, but as to the principles underlying the resolution of this terrible difficulty, I think we are in agreement, and we should move forward.

Thank you, Mr. Chairman.

Chairman FERGUSON. The Chair recognizes the gentleman from North Carolina, Mr. Watt, for an opening statement, 5 minutes.

Mr. WATT. Thank you, Mr. Chairman. I hope I don't take 5 minutes, but sometimes we don't know how long these things will take.

I, during the consideration of the Gramm-Leech-Bliley bill, was accused of being one of the few Members of the Committee who actually read the bill, and I have to confess that I have made the same mistake again, this time over the break. I have actually been reading these bills, and I want to start by saying something complimentary about the Chairman's bill. It clearly moves in the right direction. It would be a substantial improvement over nothing, and I think we should keep that in mind, but I hope that this hearing today and the markup itself, if we are going immediately to a markup, will result in a deliberation about improvements or revisions that can be made to the bill to make it stronger.

I think there are a number of instances in which I would prefer to have stronger language, stronger provisions in a number of respects. The Chairman's bill punts just a whole panoply of issues to the Securities and Exchange Commission or other bodies. Maybe some of that is necessary and desirable to get more information and input over time, but I think there are some basic principles that the legislative process has already agreed upon or should agree upon to put into the bill before we punt the rest of it to the SEC for further study.

The way to get there can be one of two ways. We can either do it by discussions off the record outside the context of a markup, or we can have a very, very protracted markup. Because, as many of you remember in the Gramm-Leech-Bliley process, there will be a number of amendments to be debated and considered. If we don't have the opportunity to put those amendments into the process, have some discussion about them before we get to the markup, then I think this markup is going to be a lot longer than perhaps is being contemplated at this point.

So one of the things I particularly feel strongly about is that there is a very important role for private litigants to enforce rights in this context. We can't give responsibility solely to the SEC and say you have got absolute authority to do this, and if you don't do it, then nobody is going to have the authority to do it. Our whole accountability system in this country is based on the rights of individuals to hold corporations and other individuals accountable when they feel like they have been wronged. So, at a minimum, we need to put some of those provisions in the bill to provide for private litigants to protect their own rights, and that I think is a hallmark of the way our system should work.

I appreciate the gentleman bearing with me, and I will yield back the balance.

Chairman FERGUSON. The gentleman has, in fact, used the balance of his time.

The Chair recognizes the gentlelady from Illinois, Ms. Schakowsky, for an opening statement for 5 minutes.

Ms. SCHAKOWSKY. Thank you.

I want to thank the Chairman and particularly Ranking Member LaFalce for his leadership in assembling these witnesses here today that I think will make a very important contribution to the ultimate legislation, and I want to associate myself with the concern expressed by my colleague from Illinois for the Andersen employees who have, through no fault of their own, lost their jobs. For this reason, as well as many others, it is important that we do act in order to prevent those kinds of layoffs and to protect investors and pension holders from conflicts of interest and from corporate greed.

We all know that, if not for Enron's collapse, we would almost certainly not be considering these important matters today. I am concerned that some want to characterize the Enron collapse as just a case of one bad actor in the marketplace. I disagree with that interpretation, as I think do most people on this Committee, and that is why we are considering legislation. Because Enron's collapse does have systemic causes. Corporate boards of directors, Wall Street analysts and the Big Five accounting firms all have an economic incentive to provide biased analysis of large profitable companies.

Enron used its political ties to persuade the Government to carry out its business plan. Just take a look at California. President Bush, his regulators and congressional Republicans who opposed price caps for consumers, while Enron manipulated the market, causing the energy crisis. Enron had incredible access to the White House. President Bush received over $736,000 throughout his career as an elected official. Vice President Cheney had at least six meetings with Enron officials while drafting the Administration's national energy plan. Enron's economic and political power effectively muted people who were skeptical of the company's economic stability. Enron is not an isolated case, and this is not only a business scandal, but I am afraid it is also a political scandal.

The fact of the matter is we do not have the laws and procedures in place to protect common investors. If we don't take swift action, I have little doubt that corporate executives' greed and deception will victimize more people.

Simply relying on free market dogma will not suffice. Employees and pension managers must be involved in corporate decision-making. Boards that are dominated by corporate executives are inherently flawed.

Enron's collapse had a significant impact on working families. In the case of Enron, hard-working people lost their life savings, while Enron's executives gained millions. It is estimated that Illinois' State pension fund lost $25 million. That means that hard-working teachers, police officers and firefighters who worked for the public good may not be able to enjoy their hard-earned retirement, and that I don't think is what public servants deserve for their future.

Of course, I agree that we must proceed in a careful and deliberate manner, but we must proceed. That is why I am a proud cosponsor of the Comprehensive Investor Protection Act, and I look forward to making sure that, as we move to the markup, that critical provision of that bill will be included in any measure that passes out of this Committee. This legislation will help protect investors and workers in the future.

I thank Congressman LaFalce for his efforts on this legislation. We have the responsibility to enact significant reforms. I look forward to hearing the witnesses' testimony today, and I yield back. Thank you.

Chairman FERGUSON. The time of the gentlelady is expired.

The gentleman from Texas, Mr. Hinojosa, for 5 minutes for an opening statement.

Mr. HINOJOSA. Thank you, Mr. Chairman.

I want to say that I come from Texas. I have travelled throughout my district, and that is the first thing that our constituents want to know, just what are the members of the financial services going to do with regard to the losses that they have experienced, and I am looking forward to listening to the witnesses today so that, as we go through the markup, that we can make intelligent decisions and come up with a national policy that is going to protect not only the investors, but protect employees of Andersen and companies like Andersen who have lost their jobs as a result of somebody at the top who made decisions that obviously were incorrect and very damaging.

I look forward to listening to the facts that the witnesses are going to present, because I am very interested in both of the bills presented by Chairman Oxley and our Ranking Member that I think is much more comprehensive and one that is, in my opinion, going to be necessary to consider and give every opportunity to pass through this Committee so that it can go down to the whole Congress. Mr. LaFalce, I commend you for the comprehensiveness of the bill that you have given us to consider, and I yield back the balance of my time.

Chairman FERGUSON. The gentleman yields back.

The gentleman from New York, Mr. Israel, for 5 minutes for an opening statement.

Mr. ISRAEL. Thank you, Mr. Chairman.

I also spent a considerable amount of time in the last 2-and-a-half weeks travelling throughout my district and hearing from constituents who routinely asked what we are going to do to ensure the integrity of investments; and I want to commend the Ranking Member, Mr. LaFalce, for the work that he has done on his bill. I also commend our Chairman for his work.

Ultimately, it is my hope to support legislation that has a number of features: number one, that provides the strongest oversight protections; number two, that facilitates transparency; number three, that ensures accountability; and, finally, that ensures an even standard among investors and management.

I look forward to working with my colleagues on the Committee to these ends, and I yield back the balance of my time.

Chairman FERGUSON. The gentleman yields back.

The Chair sees no other Members seeking time for an opening statement.

The Committee will now hear testimony from our panel of witnesses. We thank the witnesses for their patience and for their presence here today. They are, from the Chair's left to right, the Honorable David Walker, Comptroller General of the United States, U.S. General Accounting Office; the Honorable Richard Breeden, former Chairman of the SEC, now with Richard C. Breeden and Co.; Professor Donald Langevoort from the Georgetown University Law Center; and Mr. Damon Silvers, Associate General Counsel of the AFL-CIO.

Mr. Walker, you are invited to give your testimony. You have 5 minutes. Thank you for being here.

STATEMENT OF HON. DAVID M. WALKER, COMPTROLLER GENERAL OF THE UNITED STATES, U.S. GENERAL ACCOUNTING OFFICE

Mr. WALKER. Thank you, Mr. Chairman, Members of the Committee.

With your permission, I would like the entire statement to be entered into the record.

Chairman FERGUSON. Without objection, so ordered.

Mr. WALKER. Thank you. I will now summarize that statement.

I appreciate the opportunity to share our perspectives on a range of issues emanating from the sudden and largely unexpected bankruptcy of Enron Corporation and financial-related activities relating to several other large corporations.

As the Committee knows, GAO has conducted an extensive amount of work dealing with the accounting profession and has issued a number of reports over several years. More recently, in order to assist the Congress in framing needed reforms, on February 25th, 2002, we convened a forum on corporate governance, transparency and accountability to discuss a variety of systemic issues. On March 5, 2002, we issued highlights of the forum meeting which, Mr. Chairman, we will make available for the record if you so desire.

As you requested, my comments today will primarily focus on oversight of the accounting profession and related auditor independence and corporate governance issues raised by Enron's failure.

The issues raised by Enron's failure are multi-facetted, involving many different problems and players with various roles and responsibilities. In that respect, needed changes to the Government's role should vary depending upon the specific nature and magnitude of the problem. Specifically, the Government's role can range from direct intervention to encouraging certain non-governmental and private sector entities to take certain steps designed to enhance trust and better protect the public interest.

With regard to the possibility of a new oversight body, the issues of fragmentation, ineffective communication and limitations on disciplines surrounding the accounting profession's self-regulatory system strongly suggests that the current self-regulatory system is not adequate in effectively protecting the public's interest, particularly in the auditing area. We believe these are structural weaknesses

that require congressional action. Specifically, we believe that the Congress should create an independent statutory Federal Government body to oversee financial audits of public companies.

The functions of the new independent body should include:

Establishing professional standards dealing with auditing standards, including standards for attestation and review engagements, independence standards, and quality control standards, for both public accounting firms and key members of those firms who audit public companies.

Second, inspecting public accounting firms for compliance with applicable professional records and standards;

And investigating and disciplining public accounting firms and/or individual auditors of public accounting firms who do not comply with applicable professional standards.

This new body should be independent from, but should closely coordinate with the SEC in connection with matters of mutual interest.

There are alternative models which we would be more than happy to discuss if you so desire.

In addition, we believe that the issues concerning accounting standard-setting can be addressed by the SEC working more closely with the FASB, rather than putting that function under the new body.

The new body should be created by statute as an independent Federal Government body. The new body should have resources of funding independent from the accounting profession. For accountability, we believe the new body should report annually to the Congress and the public on the full range of its activities, including setting professional standards, inspections of public accounting firms and related disciplinary activities. The Congress may wish to have GAO review and report on the performance of the new body after the first year of its operations and periodically thereafter.

We believe that the effectiveness of boards of directors and committees including their working relationship with management of public companies can be enhanced by the SEC working with the stock exchanges to enhance certain other listing requirements for public companies.

We also believe that the issues surrounding the financial reporting model can effectively be addressed by the SEC in conjunction with the FASB without statutorily changing the standard-setting process. However, we do believe that more active and ongoing interaction between the SEC and the FASB is needed in order to facilitate a mutual understanding of priorities for standard setting, realistic goals for achieving expectations and timely actions when expectations are not met.

Over the last decade, securities markets have experienced unprecedented growth and change. At the same time, the SEC has been faced with an ever-increasing workload and ongoing human capital challenges, most notably high staff turnover and numerous staff vacancies. We believe it is important for the SEC to be provided with the necessary resources to effectively discharge its current and any increased responsibilities that the Congress may wish to give it.

Finally, we believe the SEC should be directed to report annually to the Congress on certain matters that I outline in my testimony.

In closing, Mr. Chairman and Members of the Committee, the United States has the largest and most respected capital markets in the world. Our capital markets have long enjoyed a reputation of integrity that promotes investor confidence. However, this longstanding reputation is now being challenged by certain parties.

Today, I have discussed our suggestions to assist the Congress in crafting needed reforms. We strongly believe that an independent Federal Government body created by statute to regulate audits of public companies is needed in order to better protect the public's interest. However, currently we do not believe that it is necessary or appropriate for the Government to assume direct responsibility for other key areas, such as generally accepted accounting principles or corporate governance requirements. We do, however, believe that Congress should provide the SEC with direction to address certain related issues.

In the end, no matter what system exists, bad actors will do bad things with bad results. We must, however, strive to take steps to minimize the number of such situations and to hold any violators of the system fully accountable for their actions. Thank you, Mr. Chairman.

[The prepared statement of Hon. David M. Walker can be found on page 422 in the appendix.]

Chairman FERGUSON. Thank you, Mr. Walker.

I would ask the witnesses to do your best to stay within the 5-minute time constraint, something that we all up here have enough difficulty doing on our own. Thanks very much.

Mr. Breeden, 5 minutes.

STATEMENT OF HON. RICHARD C. BREEDEN, FORMER CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, RICHARD C. BREEDEN & CO.

Mr. BREEDEN. Thank you, Mr. Chairman, Ranking Member LaFalce, Members of the Committee. It is a great pleasure to have the opportunity to testify before you today at your request to discuss the provisions of H.R. 3763 and H.R. 3818, as well as to address various issues raised by the Committee arising out of the tragic and disturbing events at Enron.

I had the great privilege of serving as Chairman of the Securities and Exchange Commission back when dinosaurs roamed the earth. It was an era in which we were successful in passing several major pieces of legislation, both when I was in the White House, the savings and loan reform legislation and the Market Reform Act and Securities Enforcement Remedies Enhancement Act of 1990. And both in our legislation and the work of the Commission in that era, I had the great pleasure of working with both sides of the aisle in Congress.

It has been a great tradition in the area of financial services regulation and particularly in the areas governed by the SEC of bipartisanship, and it is a good thing to see you working together to try and address these problems. It is important that that tradition of bipartisan cooperation remain the prevailing spirit in this area.

At the outset, I would like to congratulate all the Members and the staff of the Committee for the fine work you have done in developing legislative proposals to respond to the weaknesses in our current system that this situation has brought to light. Both bills contain many sensible provisions that should enhance our extremely good system and make it more resistent to problems in the future. Both bills follow generally similar principles and demonstrate many areas of common agreement. This is particularly apparent in the provisions of both bills concerning a new approach to oversight for the accounting profession, enhancements to the quality and speed of disclosure and enhancing healthy practices in corporate governance.

While H.R. 3818 goes beyond the provisions of H.R. 3763 in a number of areas, it appears clear to me that there is good common ground in the two bills and plenty of room to craft a bill that is reasoned and measured. Certainly the President has shown leadership in this area as well, and with Presidential leadership in both Houses of Congress and both parties considering these issues, there is plenty of room to try and craft a bill that would reflect a consensus approach to these issues.

Of course, some have said the market has already fixed all of the problems of Enron, and with that I respectfully disagree. There is no question the market has reacted to the events at Enron. Boards of directors and audit committees are more sensitive and wary about conflicts and overstatements of income. Many people have learned more about SPEs than they ever thought they would learn in their life in recent weeks, and I doubt if many boards will be suspending corporate codes of conduct and conduct standards any time soon.

Hopefully, auditors at other firms realize both the importance of sharing concerns with the audit committee, rather than keeping silent about major issues and alternatives, and investors are exacting a price from companies where they perceive a higher level of accounting risk and lower levels of transparency. These are all very healthy and welcome developments.

While improvements have been made, market responses can be short-lived, and many memories can be too short. Unfortunately, companies that don't need the reforms often adopt the better practices, but companies that pose the greatest risk to investors may not change their policies at all.

There are many issues involved in the Enron-Andersen case that cannot be solved entirely by market, and there is not any reason we should be reluctant to admit where our system has weaknesses we should address.

The system for oversight and discipline of the performance of audit firms and their personnel is one area that would benefit from a legislative change. Our previous system of peer review and self-regulation of certain types of issues through the Public Oversight Board did not work. The SEC needs at least some additional resources to allow it to handle the volume of financial fraud cases it should be pursuing, as well as providing more frequent review of filings by high cap and widely held issuers.

Legal standards today for disciplining accountants and their firms for audit failures are subject to more litigation than is desir-

able. Certain enhanced types of remedies such as stronger officer and director bars and disgorgement authority to recover profits on sales of stock by insiders prior to a bankruptcy would be desirable. Standards need to be set regarding consulting services by audit firms for audit clients, and the system for developing and interpreting accounting principles through the FASB needs to be improved.

These and other modest steps can complement market disciplines and help restore balance and confidence to our system. None of these steps need involve excessive regulation or interference with healthy market developments.

In drafting the specific bill, we should not stake all on trying to do too much, and we should not allow ourselves to do too little. We have to make sure, for starters, that existing law is vigorously enforced, because much of the Enron-Andersen case involves violations of existing laws. Beyond that, you have identified a number of reasoned and careful steps that will enhance the qualities of the existing system.

My written testimony responds to a number of questions from the Committee, and I would be happy to discuss any of those questions further, and I would only like to very, very briefly summarize my views on the establishment of a new oversight body for the accounting profession.

Both bills contain provisions concerning establishment of a new oversight body. In my testimony I urge you not to create a new governmental body, but rather to reinforce the role of the SEC in dealing with such issues. Whatever body is created and whatever its exact mission, any such group should be a private sector entity with oversight by the SEC. We should not repeat now the mistake that was made when the CFTC was created that set us on a course of endless competition of jurisdiction between Government bodies with closely paralleled missions.

The SEC is there. It has the history, the culture and the tradition and the tools for dealing with these kind of problems; and it should be the body that then provides oversight to an effective self-regulatory organization, along the lines of the NASD or the New York Stock Exchange. There the organizations have strong staffs, a good record of promoting healthy ethics and law enforcement, while not creating additional Government bodies.

Again, thank you very much for having me, and I commend the strong efforts of both parties to date in seeking to build legislation that can command broad-based support. Our disclosure and accounting system has stayed viable over the years because we have not been afraid to learn from major problems and to change some of the rules of the game. In my judgment, this case demands a reasoned and measured response, but a response nonetheless. Thank you.

[The prepared statement of Hon. Richard C. Breeden can be found on page 454 in the appendix.]

Chairman FERGUSON. Thank you very much.

Professor Langevoort, you are recognized for 5 minutes for an opening statement.

STATEMENT OF PROFESSOR DONALD C. LANGEVOORT, GEORGETOWN UNIVERSITY LAW CENTER

Mr. LANGEVOORT. Thank you, Mr. Chairman, and let me try and be very brief.

The last few months have brought public attention to bear on the seriousness of a problem—that economic forces have increased the temptation and techniques many companies' executives face to be dishonest with the investing public and that these temptations and techniques have translated into an unacceptable level of corporate fraud, mismanagement and concealment.

My invitation here today is not to address all of the possible reforms that could come from this but, rather, touch on private securities litigation as one touchstone for reform; and I will try to be very, very brief by focusing my oral remarks, as opposed to my written testimony, on the two reforms that I consider most important and indeed whose merits to me are beyond doubt.

First, restoring a system in which those who aid and abet securities fraud become liable to the victims. When the Supreme Court in 1994 eliminated aiding and abetting and private rights of action, it didn't do so on policy grounds or through careful legal reasoning. Rather, it said, as a matter of statutory construction, that job is for Congress, not the courts. I urge you today to take up the court's invitation and respond accordingly.

It is very difficult to argue that somebody who provides substantial assistance to a securities fraud shouldn't have to compensate the victim. The common law has for centuries imposed that liability. Congress has recognized that aiding and abetting is a Federal crime and in 1995 gave the SEC specific authority to proceed in that direction. It is clearly wrongful. Why then wouldn't you make the aider and abetter compensate the victim? The answer, we are told, is fear of litigation abuse, that these kinds of claims can be abused.

Now, I have to confess, I am one of those people who takes litigation abuse seriously. I think Congress in 1995 acted appropriately in addressing the issues, even if I don't agree with all of the specific outcomes. But litigation abuse and its fear is no excuse for saying that somebody who provides the brains, the talent, often the motivation behind a fraud should avoid responsibility to the victims simply because their appearance is not made visible to the investing public, and sadly that is the state of the law that we have today. Those to whom the fraud is not attributed and who are not identified to the investing public have grounds to avoid liability.

It seems to me clear that we ought to change that rule in the name of common sense, without regard to debate about the statistics of whether the incidence of private securities litigation has gone up or down. It simply makes sense to impose liability on those people.

Second, the other reform I want to address in my oral testimony is redressing the rather foolish statute of limitations that we have today for private securities actions. The Supreme Court once again gave us this rule, again as a matter simply that since Congress hadn't done anything about it since 1934, who are we to impose a different standard? The result is that we have in private securities litigation a rule that was adopted in 1934 before Rule 10b-5 ex-

isted, before class actions existed, before the depth of our securities markets and its breadth could have been imagined. It is silly to assume that a rule adopted then should be the rule adopted today simply a result of history.

That rule that actions have to be brought within 1 year after notice is much too short today to develop a complex, well-grounded lawsuit. And, even worse, the rule that if somebody can hide the fraud for 3 years they get away completely simply as a result of their success is also something that makes no sense in our highly complicated, highly complex financial markets.

Now, I make no claims that these two reforms or the others that I address in my written testimony would prevent the next Enron, would change things dramatically, but they are very important first steps, very important pieces of the puzzle that we ought to take as we begin to address the problem.

Thank you.

[The prepared statement of Prof. Donald C. Langevoort can be found on page 482 in the appendix.]

Chairman FERGUSON. Thank you very much.

Mr. Silvers, 5 minutes for your testimony. Thank you for being here.

STATEMENT OF DAMON A. SILVERS, ASSOCIATE GENERAL COUNSEL, AFL-CIO

Mr. SILVERS. Thank you and good afternoon, Mr. Chairman, and Ranking Member LaFalce.

On behalf of the AFL-CIO 65 member unions and our 13 million working family members, I want to thank the Committee for the opportunity to appear here today.

The collapse of Enron and similar events at Global Crossing, Waste Management and other public companies are a window into a set of pervasive conflicts of interest that defeat the purposes of corporate governance and threaten the retirement security of America's working families.

This Committee has heard in prior hearings from those who would still have you believe what Enron used to preach in this town, that unregulated markets will solve all problems if they are just left alone. Now that may be the view from the K Street offices of the people who do the heavy lifting for the audit firms here in Washington, but it is not how things look for thousands of working families in Houston and Portland, Oregon, and Rochester, New York, and clearly in Chicago who have lost their jobs or their retirement savings and their health care because they believed what they were told by their employers, by their employers' accountants and the analysts that interpreted the accountants' numbers.

H.R. 3813, the aptly named Comprehensive Investor Protection Act of 2002, is the most comprehensive legislation introduced in this Congress in response to the conflicts of interest in the capital markets and in the boardrooms of America's public companies.

Let me briefly review the areas where Congress needs to act to protect investors, the provisions of H.R. 3818 that respond to that need, and the key differences between H.R. 3818 and H.R. 3763, which the Chairman discussed in his opening remarks.

First, public company boards need strong, independent directors, so investors need complete disclosure of all the ties that exist between the board members, the company and company management. H.R. 3818 requires just that, while 3673 has no such requirement. This higher standard of independence should be the relevant standard for measuring the independence of company auditor and compensation committees.

Furthermore, shareholders should have access to management's proxy not just for shareholder proposals on a handful of subjects, but for director candidates, independent director candidates. We urge these corporate governance provisions be added into any reform package this Committee takes up.

The second area in need of reform is the practice of public accounting. Here again H.R. 3818 takes the right approach to auditor independence by giving the SEC the authority to ban a wide range of consulting by auditors and requiring that the audit committee or the full board of directors of a company approve in advance the provision of consulting services by the company's audit firm that are still allowed by the SEC.

In contrast, H.R. 3673 bars only certain types of consulting and would allow the sorts of consulting that led to the most egregious abuses at Enron by Arthur Andersen to continue.

The next issue is auditor oversight. Former SEC Chair Arthur Levitt has outlined in testimony before the Senate Governmental Affairs Committee what we believe are the key characteristics of a much-needed auditor oversight body: members independent of the Big Five, full investigative and disciplinary powers, and independent funding. H.R. 3818 creates a public accounting regulatory board that meets these tests. H.R. 3763's provisions do not meet these tests.

Then there are the Wall Street analysts. H.R. 3818 requires the SEC to ban analyst compensation tied to investment banking performance. The Majority's bill goes no further than requiring a study.

All these reforms, though, are of little benefit if there is no enforcement. The Ranking Member's bill provides both adequate resources to fund pay parity for the SEC and to expand the Commission's oversight and enforcement activity. The Majority's bill has no such provision.

Finally I want to address the ultimate accountability measures available to shareholders: recourse to the courts. As Professor Langevoort has mentioned, the restoration of investors' right to sue those who aid and abet securities fraud is a vital and important step that must be taken immediately. I would add, in addition to the statute of limitations issue, that the restoration of joint and several liability is critical in cases where the wrongdoers start filing for bankruptcy. These provisions are included in H.R. 3818 and not in the Majority's bill.

In conclusion, H.R. 3818 gets at the heart of the problem of conflicts of interest, whereas H.R. 3763, the Majority's bill, leaves untouched the central conflicts of interest, conflicts of interest that brought us Enron and will no doubt continue to cause losses to workers' retirement savings if not addressed. At the heart of what happened at Enron are systemic problems that need systemic solu-

tions. These solutions will no doubt offend powerful interests, but they will protect America's working families. H.R. 3818 contains within it these necessary solutions and has the AFL-CIO's strong support.

The AFL-CIO is grateful for the opportunity to share our views with the Committee on these bills and welcomes the opportunity to continue to work with the Committee as you move forward in addressing these important issues. Thank you.

[The prepared statement of Damon A. Silvers can be found on page 492 in the appendix.]

Chairman FERGUSON. Thank you very much to all of our witnesses. We appreciate your presence here and lending of your insights and expertise to some of the very important matters before the Committee particularly regarding this legislation.

We are now going to be begin our question period. Each Member will be allotted 5 minutes to ask questions of the witnesses. I would like to begin the question period by yielding to the distinguished subcommittee Chairman of the Capital Market Subcommittee Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman, for that courtesy. I do appreciate it very much.

Mr. Walker, I noted in your written testimony reference to the fact that the audit clients should have clearly an understanding that he has a primary responsibility to the shareholders. I recall having read in the earlier report also another line which indicated it should be made statutorily clear that the financial statement is the property of the shareholder.

In testimony before this Committee Mr. Berardino, the former CEO of Andersen, in response to a question from me indicated that the financial statement was the property of management and the shareholder, which I thought flew in the face of Accounting 101 in that the audit committee's engagement of the audit team is to prepare an accurate and true picture of the financial condition for the shareholder. Although the financial data must be arrived at in consultation with management to understand the true operations of the business plan, management should not be involved in the alteration, manipulation or intimidation of the preparation of the numbers as the audit team sees them in light of this responsibility. Is that an accurate reflection of your understanding?

Mr. WALKER. My understanding, Mr. Baker, is that first the board of directors work for the shareholders. Second, under the current literature, management is responsible for the financial statements, but the financial statements are for shareholders and other stakeholders.

I personally believe that one of the real keys that has to be focused on here is determining who is the client and who are the parties that are representing the client. I would assert that when you are talking about an audit, when you are talking about related financial reporting associated with that audit, that the client should be the shareholders and other stakeholders who are relying upon that information. But their representatives should be the audit committee, which would be an independent body that is part of the board which should be responsible for hiring the auditors. The audit committee should assume additional responsibility above and

beyond what it has right now in order to ensure that there is a convergence of interests between the board, which is supposed to be working for the shareholders, and the independent auditors, who should be working for the shareholders, but in addition to that, should serve a broader public interest.

Mr. BAKER. If I may, let me take that as a long yes, because I have a follow-up. There is inherently a conflict between the management's interest to enhance stock performance, thereby enhancing their own remuneration, perhaps at the expense of the shareholder in unfortunate cases. To disincentivize that type of manipulative conduct in relation to the preparation of the statement, would it be advisable for us to consider making the CEO personally responsible and liable for the accurate preparation of the financial statement? I know there is clearly a responsibility, but do we need to make that more clear?

I will jump to the next one while you are rolling that one around because I would like Mr. Breeden to comment as well.

To go perhaps further, it has been represented that there are cases in which management, through collusive efforts of many, have enhanced appearances of the corporation to increase the value of stock, exercise no cost options granted as a part of their employment arrangement, and then subsequently have a restatement of earnings so that the shareholder takes the net effect of loss, and the executive remains enriched through that manipulative process. For example, in that case, should we authorize the SEC to make inquiries into matters of that sort and be given the rules and authority to take appropriate action including disgorgement, so if there is a downturn as a result of manipulative bookkeeping, that there are consequences for the corporate executive?

I make these comments in light of Chairman Greenspan's remarks and others' who have encouraged us to find ways to disincentivize short-term earnings pressures and long-term corporate asset growth. Would either of you comment, please?

Mr. WALKER. There are several things in my testimony where I talk about things that I think the SEC should be required to look into in order to provide better checks and balances, and to better protect not only the shareholders' interests or the public's interests. They include the composition of the board, the composition of the key committees on the board, and providing additional transparency and checks and balances, again the kind of actions you are talking about.

Right now management does have a responsibility to sign a management representation letter in conjunction with an audit, and they are supposed to make certain assertions that to the best of their knowledge and belief, that certain things are true and correct. I think that could be an area that you may want to have whichever body that you decide should be responsible for the auditing area for better protecting the public interest to take a look at that and determine whether or not additional steps should be necessary.

Mr. BREEDEN. Congressman, it is nice to see you. I would only add, number one, on your question of the financials themselves, financial statements have to be prepared by management. The starting point is—the only correction to what you said, the auditors are not engaged to prepare the financials. That is management's duty

and responsibility. The auditors are there then to check those financials and test them, and that check-and-balance system is at the heart of how we go about preparing financial reports.

I think absolutely CEOs should be responsible for what is in the financial statements. I think they are legally today already. The system today, however, provides also full indemnification from the company as well as insurance if they have any liabilities. So you have liabilities.

Mr. BAKER. With your due diligence, I know time has expired, I just want to emphasize that one point in the event there is an allegation against the corporate CEO for misrepresentation of material elements of the preparation of the financials, the corporate attorney defends the CEO, where the shareholder has to fund the personal litigation expense out of their pocket. My point is should there be a down side where it is defined after appropriate inquiry that the manipulation that did, in fact, occur, there was a loss incurred, should not the CEO then out of his own pocket have some liability which does not now today exist?

Mr. BREEDEN. I think your point of there being a down side is important. I think the President's messages have emphasized that. Chairman Pitt's remarks have emphasized that. My own testimony suggests that we do need to do more in the disgorgement area.

I am particularly worried about the situation where an executive may be selling, in Gary Winnick's case in Global Crossing, $750 million worth of stock on the eve of bankruptcy and whether or not you should trigger it by a restatement. I think Congress should consider whether stock sales within a certain period of time of the company going into bankruptcy, whether the profits from those sales by senior officers shouldn't be recaptured into the bankruptcy estate.

Mr. BAKER. I have much more, but I am way out of time. Thank you very much.

Mr. CANTOR. [Presiding.] The Chair now recognizes Ranking Member LaFalce.

Mr. LAFALCE. Thank you very much.

Today, I introduced a bill to give legislative teeth to a number of the recommendations that President Bush called for: Number one, with respect to disgorgement of bonuses and other incentive compensation for either false or misleading statements or other misconduct; number two, requiring the CEO and CFO to personally vouch for and certify to the veracity, fairness of their company's public disclosures, including their financial statements and certification that certain internal control procedures are in place; and third, enhancing the ability of the SEC to bring an enforcement case prohibiting a person from acting as an officer or director of a public company by lowering the standard. Right now the standard is substantial unfitness. We would simply eliminate the word "substantial."

It may be unfair to ask you to comment on a bill that you have not been asked to testify on at this juncture, but it would be fair, I think, to ask you to submit a letter to the Committee giving your views on that bill once you have had time to consider it, hopefully before markup on Thursday.

OK. Now to go on.

Mr. Walker, you have indicated, I believe, correct me if I am wrong, that a new oversight body for the auditing profession is necessary; that it should have the authority to establish professional standards for the auditors of public companies; that this new regulatory organization should be able to set independence standards; that the new regulator should be able to charge annual fees to public companies as a means of financing itself. Is that basically correct?

Mr. WALKER. That is true. Our recommendation——

Mr. LAFALCE. You find those provisions in H.R. 3818, I would assume, and not in the other bill.

Mr. WALKER. I would find——

Mr. LAFALCE. Wherever they are found, would you favor them?

Mr. WALKER. Some of the provisions are in H.R. 3818.

Mr. LAFALCE. Why do you think they are important?

Mr. WALKER. My personal view is that we should not have direct Government intervention unless we believe that it is called for. If there are other bodies which Government could encourage to take the right steps, we should first try to do that. If they fail to act, direct Government intervention should be considered.

I think the area where direct Government intervention is necessary is in the auditing area. I do not believe that you are going to achieve the objective of best protecting the public's interests without more direct Government involvement dealing with the independence setting for auditors of public companies, the quality assurance procedures associated with those auditors, the disciplinary process associated with those firms and the individual members, and certain other matters laid out in our testimony.

Mr. LAFALCE. I appreciate that. Both Mr. Oxley and I believe that we do need a new auditing body. The question is what power should it have. It certainly should have at least those powers and maybe more. It is something that Mr. Breeden suggested, subject to compromise, we can talk about. But another question is who should be on that board? And that is a very important question. And I have said that the SEC should appoint them, but from lists that were submitted from certain type of organizations such as pension plans of private employees, pension plans of public employees, and so forth. Otherwise you might have a situation where you have Mr. Pitt appointing a board that Mr. Boucher would look at and say, this is so bad I am resigning, which is exactly what happened.

So do you have any thoughts as to the type of individual that should be on that board? Do we leave it totally to the discretion of the SEC, or do we put some language in the legislation which tries to make sure that the individuals on that board will be interested first and foremost and exclusively in the protection of investors?

Mr. WALKER. My personal view is there should be some standards for the individuals who would be appointed to the board. I would note in your bill, Mr. LaFalce, there is one provision in there that I think may raise a constitutionality issue, and that is——

Mr. LAFALCE. I will take that one out, whatever it is.

Mr. WALKER. It is the one that talks about the Comptroller General being part of the appointment process. The Comptroller General can make recommendations.

Mr. LAFALCE. You don't want it, you don't get it. You are out.

Mr. Breeden, you described two concerns with the non-audit services that auditors currently provide to audit clients, one specific service that creates conflicts for the auditor, and, two, the volume of non-audit fees in relation to audit fees. Does either bill address it adequately, more adequately? Are both inadequate? Do you have a preferred approach other than the approach in either of the two bills?

Mr. BREEDEN. Congressman, I think both bills have made a very good start looking at what is—I tried to—in my usual excessively wordy way, I tried to in my testimony show that there are some real complexities in that issue. It is hard to just say no consulting at all, because things like tax services are not pure audit, but would rob the audit of its vitality if you took them away.

Mr. LAFALCE. Which I specifically say should not be done.

Mr. BREEDEN. Neither bill takes the tax services away, although some of the proposals in the marketplace have done that. I think they would do significant damage if you went that far.

Consulting on internal controls is something I used to do in the 3 years I spent at Coopers & Lybrand, and I think that it contributes to the quality of audits. So I think that we need to identify any cases where the auditors are, in essence, auditing themselves. If they have built a data system that is the system used for financial reporting, if they are doing something in the consulting side that their own auditors are supposed to go and audit, it is unreasonable to expect that they will give the same level of diligence that they would if an independent person had done that. The magnitude of all the whole shebang is too much; then you also have distortion.

Mr. CANTOR. The gentleman's time has expired.

Mr. WALKER. Real quickly, Mr. Chairman, can I?

In my testimony we recommend that the Committee consider a principles-and-safeguards-based approach that we have already promulgated for Federal entities and entities that receive Federal funds. As you know, Mr. LaFalce, the GAO actually promulgates auditing standards for Federal entities and entities that receive Federal funds. We believe that that guidance would be helpful in considering what should be done with regard to public companies. Thank you.

Mr. CANTOR. The Chair thanks the gentleman.

At this time the Chair would like to address for a moment Mr. Breeden. I take it you are familiar with Chairman Greenspan's remarks when he addressed this Committee several months ago. While he was here, he expressed a concern that Congress could go too far in overregulating the capital markets in response to the issues at hand. Can you comment on that? What do you make of those concerns?

Mr. BREEDEN. Well, I think any time you have a scandal of this kind that has touched so many people and caused such widespread losses, and between the losses to investors in Enron and the losses to Andersen employees and so on, there is an enormous amount of damage here. And so I think Chairman Greenspan was—as many others have done—noting a concern that Congress be careful in responding to events that naturally cause outrage on the part of good

people everywhere, that we not go too far in fashioning a legislative response, and I agree with that sentiment.

At the same time I also believe that there are some areas that have been exposed in this overall situation that would benefit from legislative changes, that we not do too much, but we not do too little. I think actually that Mr. Oxley's legislation together with Mr. LaFalce's legislation, both bills here attempt to—and one goes further than the other, but maybe something in between is an area where people can coalesce around. It is important not to go too far, but I think there are some areas where real change needs to be made.

Mr. CANTOR. Mr. Walker, can you respond to those concerns?

Mr. WALKER. Yes. As I said in my statement, you should only have direct Government intervention where you believe that the problem cannot be effectively addressed by other parties. In that regard, we believe the greatest need is in the auditing area, and what we are recommending is that there be a qualified, independent and adequately resourced body to be able to assume those responsibilities rather than the Congress trying to get into the details, trying to make those decisions through legislation. I think that is critical in order to make sure that you don't over react, that you have a balancing of interests.

As you know, Chairman Greenspan has also said that he believes that additional action is necessary in certain areas such as in the auditing area and has expressed some concerns about current accounting and reporting with regard to certain types of compensation arrangements.

Mr. CANTOR. Thank you.

If I could turn to Mr. Silvers for a moment. In 2000, former SEC Chair Levitt proposed auditor independence rules targeting 10 consulting services for prohibition, the final SEC rule prohibiting seven of these services. Another was dropped because it was deemed unworkable. The Oxley bill bans the other two. The LaFalce bill bans all 10. Again, seven are already prohibited under the current rules. Isn't this provision redundant?

Mr. SILVERS. I am sorry, sir, which provision do you think is redundant?

Mr. CANTOR. The Oxley bill bans the other 2, but the LaFalce comes in and bans all 10, while 7 are already prohibited by the rules as they exist now.

Mr. SILVERS. My understanding from reading the bills, Mr. Chairman, is that Mr. LaFalce's bill provides the Commission with the authority to take a look at a practice such as that which occurred at Enron where Arthur Andersen participated in structuring SPEs and then came back, and partly did so, I believe, under the rubric of tax consulting. Certainly they could have done so under the rubric of tax consulting. They structured the SPEs and came back and audited the SPEs and generated a $5 million fee for doing so.

The challenge of this problem of conflict of interest is that the Commission needs to have the authority to draw these fine lines, and the Chairman's bill simply does not give the Commission the clear authority and direction to do that. Mr. LaFalce's bill does that. The difference, frankly, is that under the Chairman's bill, if

a firm was to feel that it made sense for them economically to go and do what Arthur Andersen did at Enron, there really would be no reason per se under the Chairman's bill that they couldn't do that, whereas Mr. LaFalce's bill clearly directs the Commission to promulgate rules under that conduct. I don't believe that distinction is by any means redundant, as you would suggest.

Mr. CANTOR. Mr. Breeden, if I could turn to you in an attempt to elicit a response about the potential redundancy in one of the bills that attempts to address the rules that are already in place.

Mr. BREEDEN. Mr. Chairman, I have not looked in detail at the language of the Commission's current rules compared to the bill to see whether they are completely overlapping or whether there are gaps there. I could do so afterwards and send you a letter about it, but I really haven't done so, and so I can't tell you whether they are fully redundant or not.

Mr. CANTOR. It would be appreciated. Thank you.

Mr. LAFALCE. Would the gentleman like me to give an answer? Number one, they are not fully redundant at all because there were carve-outs within the rule. Number two, if the worst sin in redundancy is that codification into law of regulations, I will accept that sin.

Mr. CANTOR. The Chair thanks the gentleman.

The Chair now recognizes Mr. Kanjorski.

Mr. KANJORSKI. All of the testimony in the pending bills makes certain presumptions that, one, we know the full extent of the Enron disaster, and also obviously in regard to its accounting firm, Arthur Andersen, with its $25 million in auditing fees and $27 million in consulting fees. I would like to know whether these were overcharges, whether the work performed was unethical or improper, and if it was, to what extent. Are any of you aware of any studies that have analyzed what work was done, how competent the work was, and whether or not, in fact, any of it was improperly done?

Mr. WALKER. I am not aware of a study. I am also aware of the fact that Arthur Andersen at least was performing certain internal audit services that would be banned under both of these bills, which I think is noteworthy.

Mr. BREEDEN. Congressman, I am not aware of any studies, but $52 million in fees combined for auditing and consulting is an enormous fee. That would put—Enron's payments to Andersen clearly would have had to have been among the top of not only Andersen's clients, but any accounting firm's clients.

Mr. SILVERS. Mr. Kanjorski, I would make two points in response to your question. One is the conflict that was alluded to in response to the Chairman's questions is discussed on page 5 of the Powers Report and gone into in some detail later on in the report in terms of the specific conflicts that were at work here. I would add that prior to the appearance of the Powers Report, that both Andersen and Enron made some efforts to conceal from Congress in several different committees, including this one, the extent of those conflicts, but the Powers Report itself documents them quite adequately.

I could also say that although that fee is very large, it is very interesting that the multiple of the consulting fee in relationship

to the audit fee at Enron was not even close to the high end. There have been several surveys of the ratios that the SEC's recent disclosure rules have divulged to us of these ratios in other major public companies which I would be happy to provide to the Committee. I would know one sticks in my mind, which is Motorola, which had a board overlap with Enron until very recently. Motorola was 16-to-1, the ratio of consulting fees to audit fees.

Mr. KANJORSKI. The consulting fees were 16 times more than the audit?

Mr. SILVERS. Precisely.

Mr. KANJORSKI. So maybe Andersen undercharged?

Mr. SILVERS. Perhaps you could raise that with them.

Mr. KANJORSKI. The reason for that question is, obviously, that the Congress is going to act. Whenever anything happens in our society, we either pass a law or we form a commission. Obviously, we are not going to be able to form a commission to address this problem, so we are going to pass a law.

I am a little worried about the unintended consequences of what we may be passing. I am not absolutely certain that the Congress has the clarity of either the Enron problem, if it represents an endemic problem, and just how endemic that problem is, or whether or not we are in a position to move this legislation through as quickly as we seem to be. Should we take more deliberative time? Do any of you see some great risk to our economic system if we take a couple of more months in resolving this problem, or do we have to do this before Memorial Day because it fits into the political schedule?

Mr. SILVERS. I am the only person willing to take a risk on this proposition. Obviously I think the people that I represent here would like Congress very much to take action in this session. I would defer to the wisdom of the Committee as to what precise calendar that requires. It seems to me that the more important question is are you going to take the right direction or not.

I think, Mr. Kanjorski, your questions get at one issue in which I am not sure that this Committee is heading in the right direction. It would be better to take the time to get it right than to do something that won't protect America's working families against a future Enron.

Mr. KANJORSKI. I tend to agree, too. That question is structured along the idea that we have 17,000-plus public corporations. It would seem to me they do not all fall into Enron's category. Anything we do will also cause additional expenses for those corporations and to the Government in order to police the law we are enacting. I am just worried: are we going to do what sometimes we have done in other Congressional actions? We could just end up just ignoring the cost and the burden to struggling companies that have to get equity and have to get out there. They have not done anything, but they will have to comply with all these rules and regulations at great expense to the company and ultimately to the shareholders, and maybe actually put their long-term success in jeopardy.

What I am thinking, is whether or not we should put a tier operation into effect with any bill and look at only the top 1,000 or 5,000 corporations. But all 17,000 of these companies? We initially

did that with all banks when we enacted CRA. To a large extent, it was my experience that we initially put unusual burdens on small community banks to go through the legal work and expense to comply with CRA. Before we changed the law, I visited banks that were spending a sixth of their income on legal and accounting fees to prove compliance with CRA—little banks that could not exist outside of their community. So, anything they were doing, they were complying with CRA.

Yes?

Mr. CANTOR. Will Mr. Walker answer the question, then the gentleman's time has expired.

Mr. WALKER. I think in the final analysis it is better to get it right rather than do it fast, but I think there is a need for some expeditious attention to the critical area, especially in connection with the auditing area. Obviously, as you know, Mr. Kanjorski, this is the beginning of the legislative process on this side of the Hill, and the Senate has to act as well. There are a lot of things that have to happen before this will get finalized.

We do recommend in our approach that it is important to have qualified, independent and adequately resourced bodies deal with a lot of the details. The Congress may want to ask for those bodies to look at certain issues and to make sure, for example, that in the area of independence that they consider a principles-and-safeguard-based approach, that they can look at certain services in particular as to whether or not they should be allowed, and if so, under what circumstances. I think if you take that approach where you are making sure you have a qualified, independent, adequately resourced body, you are providing that body with the power to do what needs to be done, you are providing it some guidance, but not getting too detailed with regard to how much you are prescribing legislatively, that might be a reasonable balance because, after all, markets evolve over time. What you say today may not be appropriate tomorrow. So some other body has to be empowered to deal with changes over time.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. CANTOR. The Chair recognizes Mr. Rogers from Michigan.

Mr. ROGERS. Thank you, Mr. Chairman.

I am going to take maybe a bit of a different direction. One of the concerns I have is in this whole episode, we have been—we being Congress—in a hurry to find a villain, and I am not sure exactly we have identified the crime yet. I was hoping to ask Mr. Breeden, one of the things I am concerned about is that we are trying to treat this with a pill rather than laser surgery. I am not so sure that laser surgery isn't the order of the day here. We have a real possibility here to cause some real problems for lots of folks, UAW members and you name it out there, families who are investing more and more in 401K plans all across the United States. And sometimes just questioning the company's accounting practices by any official entity can be devastating to the stock of that particular company. We haven't done any investor in the United States any good if we do that maliciously or at least without good intent.

I want you to help me understand how we can make the corrective actions I think we all know we have to make here, certainly for transparency, without jeopardizing investor confidence. And

those families out there who are working very hard every day, they send their money into their mutual funds knowing that that is what they are going to retire on, and they are counting on all of us, those here in Congress as well as you, auditors, regulators and those in the business community, to make sure that there is honesty and true brokering going on out there in those companies.

Mr. BREEDEN. Congressman, I think both you and Congressman Kanjorski raise similar, in a way, concerns and good points. One of the best things we have been able to accomplish over the last couple decades is to foster a broader participation in our capital market, and as my colleague here from the AFL-CIO points out, we have working men and women through pension plans, we have investors through mutual funds and directly to the tens of millions, and that has been a wonderful accomplishment.

So we have as a Nation a great deal at stake in protecting the confidence those people have that our markets work with honesty and integrity, and they can believe the numbers they look at and that they make investment decisions on, and that this is a huge system with 17,000 public companies, and in fixing it a couple things are apparent. Number one, we have to be careful that we don't go too far, we don't fall into the law of unintended consequences when we try to fix one problem that we create another one, that we don't go too broadly and don't create excessive costs, as the Congressman is mentioning, in CRA, which is a very real risk.

We need to start with what we have, which is the world's finest system. It is not perfect. It has some flaws. No system designed by human beings and run by human beings is ever going to be perfect. But I genuinely believe, notwithstanding Enron, that the U.S. accounting and disclosure system is the best in the world. So let's not throw the baby out with the bath water. Let's start with what we have and look to see how can we build on that. If there are gaps here and there that we need to address, then let's do it.

I think that now on the question of investor confidence, I don't think there is—I am not aware of a situation where anyone has maliciously questioned people's financials, but certainly the market itself should raise questions about companies that have very aggressive accounting practices. We certainly have seen that post-Enron with aggressive selling against Tyco and other stocks that are perceived to have some accounting issues. I think those market disciplines are very healthy. In fact, I wish we had more of them, not that people should do it based on rumor or fear, but that a healthy skepticism looking hard at what numbers companies are reporting and making sure that investors do their homework to worry about the risk that they may be undertaking.

So this whole area is one in which it is extremely complex, and we have to be extremely careful that we don't get things out of balance. But at the same time I think it is clear that we can do things to speed up disclosure and make disclosure more comprehensive. For 40 percent of the assets of Enron to be hidden off the books was unacceptable. That is disclosure? That is a joke. It shouldn't have happened. The parties responsible should have known there was—whether or not it was proper accounting, it was lousy disclosure.

And so we need to look starting at the Commission, but also here at Congress, are there things we can do to make disclosure faster and make it more comprehensive? Can we have better information about executive stock sales? That is very important to individual investors across the country. They know enough to know—they may not understand an SPE, but they know if the CEO is bailing out of the stock, they don't want to be investing themselves at the very same time the top guys are getting out. So speeding up those disclosures is another healthy thing.

Making sure that auditors don't sell their integrity. We can't station an SEC enforcement agent at the shoulder of every accounting professional, but at the top trying to make sure that the system encourages quality auditing, and that the firms themselves realize how important their public trust is, and the strong efforts they themselves need to make to do a good job.

So there are a lot of things where I think we can make some improvements that are consistent with our traditions and consistent with our systems and make it a little better.

Mr. CANTOR. The Chair thanks the gentleman.

The Chair recognizes Mrs. Maloney.

Mrs. MALONEY. I thank the Chairman and the Ranking Member and all of the panelists.

I am sure all of you are aware that today Andersen announced they are laying off 7,000 of their employees and that this represents a quarter of their total employees. And furthermore, the long-term viability of the company is truly in question. And as I have said many times before, the overwhelming majority of the professionals in the industry are hard-working and honest and have a great respect for the title "certified public accountant."

I am concerned, quite frankly, about some of these employees, many of whom are my constituents. I would like to ask Mr. Breeden from what you know, do you think it is appropriate for the Justice Department to have targeted the whole of Andersen, or should we allow the Volcker plan to go forward and have it put in place and go after a limited number of employees known to have been involved in the Enron audit? Do you have feelings on this?

Mr. BREEDEN. Congresswoman, thank you. The Andersen situation is a very sad one. It is certainly one that is regrettable on many different planes, and I certainly hope that anything possible that Paul Volcker or anyone else can do to stabilize the firm and allow it to survive and then worry in the future about rebuilding, I wish it every possible success.

On the other hand, we used to have debates when I was in the White House working on financial services about whether banks were too big to fail, and I don't believe Arthur Andersen is too big to fail, and I don't believe any of the other Big Four are too big to fail. If they ever got that notion in their head that they somehow have carried their monopoly on auditing and the oligarchy that exists in competition in this world that no one could bring an action against them if they broke the law, then that would be a mistake. We went through Watergate to prove that the President of the United States is not above the law. I think that the general counsel and the CEO and other staff members of Arthur Andersen are also not above the law.

I don't take a position on whether or not the Justice Department has the—we can only know when a trial takes place and we see what evidence the Justice Department has. But in my experience working with the Department of Justice in law enforcement over many years, they don't indict people or firms capriciously. They do it on the basis of a very sober and careful calculation of whether they have the evidence of wrongdoing, and it is a responsible act.

I think some of the people worrying about the consequences for Andersen should be asking the question about isn't it sad that Andersen's management engaged in the acts that led to the permanent injunction in Waste Management; that Andersen's management tolerated massive destruction of documents on the eve of Government investigation; that chimpanzees could know that the documents at Enron were going to be subpoenaed high and low by every Government agency and private litigants all over the place, and if you destroy documents, you may be affecting the rights of the University of California to recover against Enron executives or others, and in that context destroying documents is wrong.

And so it is a tough issue, because nobody likes to see what is happening to other people at Andersen, and yet Andersen finds itself where it is largely through its own actions.

Mrs. MALONEY. You mentioned earlier, Mr. Breeden, that we should have faster and fuller disclosure, and one area that really isn't disclosed now except by consent or individual choice is the code of ethics for the board of directors or the code of ethics for firms. Do you think it would be helpful that the code of ethics was printed in the annual report, and if the board of directors took the unusual step of overriding the code of ethics of their board, that it be reported to the SEC and printed in the annual report?

As you know, in Enron, as reported in press accounts, the board of directors voted to overturn their own code of ethics to allow their CFO Mr. Fastow to head these special SPEs. So I was wondering when I called for fuller disclosure, would this be an area that you think might be helpful to the investor, to the general public?

Mr. BREEDEN. Yes, Congresswoman, I think very much so. In fact, in both testimony on the Senate side and in this testimony, I did say I believe that any time a board acts to suspend the corporate code of ethics, that not only publication in the annual report is way too slow, they should have to file an 8(k), do it within 10 days anyway, but almost immediate disclosure should be made. I think corporate codes of ethics should be at least posted on their website. It might add quite a few pages to the annual report, but I think somewhere it should be noted.

I did call for disclosure in the proxy statement or in some other vehicle for the board to set forth its policies on conflicts among senior executives. The conflicts in Enron at the CFO level were among the most dangerous possible things that a corporation could do, because the outside auditors and the audit committee and the full board all are looking at numbers provided by a CFO. So if the CFO has got a personal financial reason to give distorted numbers, it can defeat simultaneously the ability of the board, the audit committee and the outside auditors to check up on that. It is the one vital spot where—it is the hub and the spokes of the wheel. So any conflicts involving a CFO should be, in my judgment, prohibited

under State law, and there should be required to be immediate disclosure if a company goes down that road, which hopefully they will not.

Mr. CANTOR. The gentlelady's time has expired.

The Chair now recognizes Chairman Baker.

Mr. BAKER. Thank you, Mr. Chairman.

Mr. CANTOR. He was assuming the time of the Chair who was here before I was. So this is on his own time.

Mr. Chairman.

Mr. BAKER. Thank you very much for clarifying. Don't want to misrepresent my account here.

In the earlier round, Mr. Breeden, we talked about disgorgement and insider trading prohibitions, bailing out on stock the night before the bankruptcy filing. We talked about clarity in the liability for the CEO for the preparation of the financials. There are other elements that I think I would like to get your comment on. One is the subject of a cooling-off period where the auditor is the principal engaged as an outside auditor for company X; upon retirement immediately goes to work for that company as the chief financial officer. There are prohibitions which apply to Members of Congress, for example, in what we can do in post-congressional life. Do you look at that in an advisable way? Is that something we should consider?

Mr. BREEDEN. Yes, sir, I believe that you should. I remember back in my days at the Commission, we had the then infamous Lincoln Savings collapse. An awful lot of people were hurt in that. That was another case where this CFO that was in place at Lincoln Savings had come over from the outside auditor, which means the people who audit his work the very next year are all the people who used to be his subordinates at the audit firm.

So without knowing exactly how it should be done, I think cooling-off periods are healthy and is something that would probably make sense.

Mr. BAKER. As to structure on all of these, it is my thought to authorize, mandate the SEC to study and implement rules governing these points raised by the Congress as a policy matter. I think it may be difficult and take us years to get a plan that is enforceable and not disruptive to markets if we do the specifics, but at least to have a goal within 6 months, a year for the SEC and staff to determine the most appropriate manner for prohibiting whatever is an unreasonable corporate practice.

Audit committee and their ability to do their work. Provisions for independent counsel. In other words, not having to rely on internal corporate officials to do the work for the audit committee. It's difficult if you have a CFO who is conflicted, but if you are really trying to do the job on the audit committee, and you are asking the guys who are employed by the corporation, isn't that equally troubling?

Mr. BREEDEN. I serve on three audit committees, and I chair two of them. I can't imagine anybody telling us—and I don't think it is just me—I can't imagine anyone saying to an audit committee that they can't hire outside counsel. The board can do what it wants. The problem is that—it is a little bit of a chicken-and-egg situation. One of the problems in both Waste Management and

Enron was that the auditors never said boo to the audit committee. They knew there were problems and didn't bring the audit committee into the loop. So they were, in many respects, oblivious or appeared to be ignorant to many of the issues that might have caused them to go and hire outside counsel, but they have to know that they need it.

Mr. BAKER. That was my point is that rather than making it a permissible activity to do it, is that a mandatory obligation to construct your audit analysis based on outside counsel?

Mr. BREEDEN. I think we have enough make work acts for lawyers, but I wouldn't require it, but I think certainly as a matter of good corporate practice and maybe through listing standards it is something that can be encouraged. Certainly any audit committee has to have the right to speak to independent counsel and independent financial advisors if they believe they need the advice.

Mr. BAKER. Lastly, with regard to stock option plans, shouldn't that require shareholder approval?

Mr. BREEDEN. I believe so.

Mr. BAKER. And there is one other piece of work may I compliment you on. In 1992, there was a report issued by the SEC, and it also supports a statement of Chairman Pitt before the Committee just before the Easter recess relative to the reporting to the SEC by the GSEs. As I recall it, your work at that time indicated it was advisable policy for the GSEs to file as all other Fortune 500 companies do in compliance with SEC standards. Is that still your view?

Mr. BREEDEN. Congressman, I don't remember that specific report. I seem to remember getting the tar beat out of me by folks at the time over that issue. I haven't looked at it since then. So with respect, I will just stay out of that hornet's nest.

Mr. BAKER. If your bruises haven't gone away, I can assure you that the report contains that information, because I have the bruises myself.

Mr. BREEDEN. One of the great things about being in the private sector as opposed to being in Government service is you can duck a few of the fastballs that you have to go ahead and stand at the plate when you are in Government.

Mr. BAKER. I commend you for your bravery while on duty.

Mr. CANTOR. The Chair now recognizes the gentleman from North Carolina, Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman.

I want to start by applauding the testimony of Professor Langevoort. I may not be pronouncing his name right. His testimony has gone unnoticed in the question-and-answer period, but he should know that as far as I am concerned, it is among the most important testimony that has been given here today. In my opening statement I emphasized the importance of allowing individuals to hold people accountable and corporations accountable in addition to Government bodies, and your testimony seems to me to be consistent with that.

First of all, we have to reestablish the legal standard that makes other parties have legal liability to anybody, and then we have got to give individual people who are damaged by those activities the right to take up their own private litigation and enforce those

rights, and in some cases that may result in less Government bureaucracy. I keep having trouble convincing my Republican counterparts of that, but they may come around.

The problem is that—and I am certainly going to try to pursue this in the course of this markup—the problem I have already identified, however, is that the rules of germaneness in the legislative context are probably more rigorous than the rules of evidence in the evidentiary context. If we start with the Chairman's bill, I am not sure we can craft an amendment that gets that on the table for discussion and debate, so I am not going to spend a lot of time asking you questions about it. But I did want you to know that what you said did not go unnoticed by at least one Member of this Committee.

Mr. LANGEVOORT. Thank you. I was actually happy not to get all the fastballs.

Mr. WATT. Now I want to go to another issue that I am trying to resolve or reconcile, the differences between Mr. Walker and Mr. Breeden, and try to figure out which one of them I agree with more. As I understand it, Mr. Breeden—no, I am sorry, as I understand it, Mr. Walker thinks that we ought to have another Federal board of some kind in addition to FASB and the SEC. We ought to have some third agency. And as I understand Mr. Breeden's testimony, he rigorously disagrees with that. I would like for the two of you to try to reconcile, if they are reconcilable, your views on that issue. I tend, I think, to come down more on Mr. Breeden's side than Mr. Walker's side, I believe.

It is coincidental that right across the hall here where I am on the Judiciary also, as you may have gathered by my legal bent here, we are debating whether to break up the INS into about five or six different parts on the theory that if you break it up, it will all of a sudden become more efficient even if you keep the same people and the same rules and regulations and everything. It seems to me that one approach we might be using is trying to make the SEC and FASB more efficient rather than creating another institution in the process.

So let me hear from Mr. Walker first. Then I want to ask another question. I will give Mr. Breeden equal time to defend his position.

Mr. WALKER. Mr. Watt, right now you have one Federal Government entity involved, and that is the Securities and Exchange Commission. As you know, the FASB is not a Federal Government entity, it is a self-regulatory body.

Mr. WATT. But wouldn't this bill put those kind of agencies kind of under the jurisdiction, supervision of the SEC?

Mr. WALKER. What we were proposing at GAO is that the SEC has more than enough to say grace over right now. Some can debate——

Mr. WATT. One way to solve that is to add some more people.

Mr. WALKER. That is one issue. Mr. Watt, we are saying that the area of most acute need for intervention is in the auditing area. The SEC is already overtaxed as it relates to enforcing the securities laws and dealing with significant accounting and reporting issues that have to be dealt with.

There are many people on this Committee and others in Congress who believe that the CFTC ought to be merged with the SEC. So the point is there are a lot of things that the SEC has to do right now.

Our view is that you could have an independent entity within the SEC. You could have a body within the SEC that would have Presidential appointees with Senate confirmation who have the authority to make final decisions with regard to certain auditing activities, but would allow them to be able to coordinate as appropriate with the SEC on accounting issues and on securities regulation. We think that is possible to be able to do that, but one of the concerns that we have is that the auditing area is the one that we think there is the most need and there needs to be appropriate accountability to the Congress, and we don't know that you get appropriate accountability to the Congress unless you have the parties responsible and reportable to the Congress.

Furthermore, we question whether or not the commission members and their staff can effectively discharge these additional responsibilities because they are already having difficulty dealing with their current responsibilities.

Mr. CANTOR. The gentleman's time is expired. Thank you.

Mr. BREEDEN. Mr. Chairman, if I could have the liberty of responding to this, because I think it really is a pivotal issue.

Mr. CANTOR. Without objection.

Mr. BREEDEN. Thank you very much. I, of course, have boundless regard for GAO and its analytic capabilities. This is a matter that is a matter of principle and philosophy, I suppose, but I could not feel more strongly about it than I—and Mr. Watt, I appreciate your asking the question and giving me a chance to give you my side of things.

For about 68 years now, the SEC has been the Federal agency with responsibility for overseeing the accounting profession. It has a long history. It has a long culture and a long tradition of being able to put the public interest first to have an effective enforcement program. I do not think there is any wrongdoer out there, be it corporate, individual or a partnership, that the SEC and its history would not tackle. It has built up a long history there without fear or favor of any person, irrespective of party, irrespective of any other factor, and to say that, well, that is very nice, but they are awfully busy doing some other things, we should put it aside and start all over again and build a brand new agency that has no history, no culture, no existing staff, nothing. We are going to start from the beginning and build it all up, and 10 or 15 years from now it will have experience and culture and tradition, and we are going to hope at that time it is going to do a better job than the agency that for 68 years has done a great job for America's investors.

Now the Commission is starved for resources and has been underfunded since 1934, and I would appreciate the efforts of many Members of Congress to expand its staff so that we could keep pace with growth in the markets, and that is an ongoing problem today. But I really think that there is not a need for another Federal agency.

Now I agree with a great deal of what Mr. Walker has said in terms of the importance of integrity and independence and good powers, and all of those things can be in a body like the NASD that would be a subsidiary, private sector organization, out doing a lot of work, doing a lot of enforcement, bringing all those fine qualities to bear, but reporting up through the existing Government agency so we don't lose the benefit of nearly 70 years of public service.

Mr. CANTOR. Thank you.

The Chair now recognizes Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Let me thank my colleague from North Carolina, because I wanted to be the devil's advocate on that, but he is much more eloquent than I am, and I agree with his line of reasoning, and I think it is problematic.

I think, Mr. Breeden, you are right on point that what we are talking about doing now is starting over from scratch to create a new agency, and I guess—that John is correct. Redundancy is not necessarily a sin, but what I keep coming back to is does not the commission already have a tremendous amount of authority in this area? And perhaps the commission should be under some attack for not necessarily exercising that authority, and perhaps the commission can argue that they have been underfunded and haven't had the resources, but it seems to me—I have always been under the impression that the commission had this authority. You yourselves stated that, in fact, audited financials are—in fact, the financials themselves are prepared by the public company as a function under the 1934 Act, and then audited and given a blessing by the auditor, but in fact they are all compelled by securities law in the first place, and it is the commission that governs securities law. And so I think that your point is right or—your line—of reasoning is right on point.

I furthermore think that now we are talking about in the GAO—and I don't think John's bill goes this way or Mike's bill goes this way, necessarily, but the idea of registration of auditing firms with this new authority. And the next question is, which I have asked with other panels, are we going to have to have qualified opinions with an audit that is given, for each audit that is given, that it meets certain standards? And do we know exactly where we are going in setting the standards?

But let me ask—I want to move on to some other points. Everyone talks about the need of sort of a division of labor between audit and non-audit services, and I do not disagree with that, but we have a number of lists that are out there, what ought to be precluded or prohibited, and what ought not to be prohibited. Are we better off trying to write in the statute what services can be provided and what services cannot be provided, or are we better off providing the commission, if that is the route we go, or whoever the ultimate authority is—and again, I would argue that it is the commission—with the same authority that we have done in banking law, for instance, to say something that creates the appearance of a conflict and leave it up to the rulemaking bodies to determine what is appropriate and what is not appropriate? Would we be better off than providing a list? Either one or all.

Mr. BREEDEN. Congressman, I think the question of what is a permissible service is a very important one. Certainly at a minimum, if it were left to an agency, there would have to be some guidelines and standards of what should the policy be here, and I think Congress has an important role to play in trying to answer that. You know, in my mind, if Arthur Andersen had not done one penny's worth of consulting work for Enron, the exact same problem would have happened. We are in part discussing a red herring here, because the audit fee that Andersen was collecting from Enron was more than big enough to correct the behavior and create all the pressure, whether or not they were also on top of that getting consulting fees. And so let us don't kid ourselves that if we forced the people to get out of all consulting, these pressures on independence are not going to go away. In some ways they get worse, because if you have said that the entire firm is dependent on nothing but the audit fee, then the CFO who can threaten to take away the audit fee has even more leverage over the auditor than not.

So, on the other hand, we want the public to understand that audit opinions cannot be bought and the audit relationship ought to be the primary focus, and as one of the other witnesses pointed out, we have now seen some cases where companies have many multiples, the consulting fees, as the audit fee.

So what should the policy be? And if Congress sets out standards, whether it is conflict or specific types of risk, yes, then you could give the jobs of drawing the lines to an agency.

Mr. BENTSEN. My time is coming up and I want to follow up with two other points. Mr. Breeden——

Mr. LAFALCE. Mr. Walker, is——

Mr. CANTOR. The gentleman's time is expiring.

Mr. BENTSEN. Well, I do not think it is expired, because it is——

Mr. CANTOR. I said "is expiring." Yes, you are correct.

Mr. BENTSEN. I would like to hear from Mr. Walker, but I do want to ask one other thing of Mr. Breeden. An issue was raised with respect to Enron that goes back to some of the law and rule changes in the 1980s with respect to insider trading as we know it, not sales by insiders and sort of the Chinese wall that was established between underwriting and sales and trading, and some have raised the question that the unintended consequence of that was that deals that were being structured, primarily private placement deals that were being structured for Enron that had the effect of diluting stock value and taking debt off balance sheet while increasing the leverage of the company, had the brokerage side known that, they may well not have made a market in their public securities. Is that an unintended consequence, and is there a way to address that in going back to that 1980s law, or was that just something we have to live with?

Mr. BREEDEN. The whole idea of Chinese walls is to deliberately deprive certain parts of an organization of information that is possessed by other parts, and so assuming that that information is valuable, it is almost always the case, for example, that the investment banking side of a firm might know that a tender offer is going to happen or that there might be an LBO going to—something is going to happen to change the capital structure that would

cause your brokers to either recommend the stock or not recommend it and you consciously and deliberately say we cannot allow that information to be used, because only the customers of that firm would have that information. It is not out in the broad marketplace. So I think Chinese walls are not perfect, and they do have the effect that you mentioned in particular cases, but they also prevent essentially institutionalized insider trading that would happen if knowledge from the banking side can filter over into one group of brokers, but not everybody else in the rest of the marketplace.

Mr. BENTSEN. But under—and if——

Mr. CANTOR. The gentleman's time is expired.

Mr. BENTSEN. With the indulgence of the Chair. Under things such as Reg FD and others, when deals are being structured that are increasingly leveraging the company to the detriment of the public shareholders, should the underwriting side be dutybound to disclose that? And I understand the original intent, why you would put the Chinese wall in. It made perfect sense. But now you have the reverse effect occurring. Or is that just an unintended consequence we have to live with?

Mr. CANTOR. Mr. Breeden, if you can expedite your answer, as the gentleman's time is expired.

Mr. BREEDEN. Always a problem. I guess I would just say I think that is worth taking a look at, in the context of what we have seen in this case, and see if there are not ways we can mitigate those negative effects.

Mr. BENTSEN. Thank you. Thank you, Mr. Chairman.

Mr. CANTOR. The Chair now recognizes Mr. Sherman.

Mr. SHERMAN. Mr. Chairman, thank you. Let me make sure I anger virtually everyone in the room with at least a couple of quick points. First, as we praise the SEC, let us remember that that is the Government agency responsible for our capital markets, and we have just had the largest capital markets failure in history. And while we focus on an accounting industry that is about to go down from the Big Five down to the Big Four, we should remember that we could have an SEC rule that no one firm can audit more than 15 percent of the publicly reporting issuers and force the breakup of the Big Four and do something that has kind of a catchy title, the Big Eight. To us old guys, that has a catchy title. And I do not have time for oral responses, but I hope our panel would respond on whether having only 4 accounting firms auditing publicly traded companies is a good idea for our capital markets.

It has been pointed out that management prepares these financial statements and the auditor just expresses an opinion on them. We should point out that what auditors do is demand changes to those financial statements which management can implement or not implement. The reason I make this point is that there has been a lot of talk of criminalizing speech, that is to say, prohibiting the "undue influence of management on the auditors." And what worries me is that that is just a pejorative vagueness for talking, and that if we are going to criminalize some discussions between auditors and management, we ought to figure out how financial statements are going to be created or who is going to decide which talking is necessary and which is criminal.

Shifting to a question to Messers. Langevoort and Silvers, you folks have pointed out the importance of private litigation, which is the only economic incentive auditors have to do a good job and to stand up to that other economic incentive they have to do whatever Ken Lay wants them to do. The one concern I have is back in those old days, these accounting firms were general partnerships. Everybody was liable for whatever the accounting firm was liable for. All multithousands of partners and an awful lot of assets. Now they are all limited liability companies. Does it make any sense to allow lawsuits against accounting firms unless we have a requirement that they have malpractice insurance or malpractice reserves or some other capital? And should that capital requirement be set at one half a year's audit fees or at some other level?

Mr. LANGEVOORT. Certainly you need to address the question of whether there is money. I think we have yet to learn what the protective shield of limited liability partnership or limited liability company is, but you are absolutely right. If the deterrent effect is going to be there, there has to be some way of reaching the wealth generated by performing the services and capturing that.

Mr. SHERMAN. I am not so much thinking of this as a hammer that is going to take away the house of every partner of Arthur Andersen, so much as a compensation fund. If we are going to tell people they can sue because they have been harmed, they ought to be able to recover something, and I would point out that the amount being offered by Arthur Andersen now is just 6 years' fees to one client.

Mr. LANGEVOORT. I do not disagree with that, but I would keep the club and the hammer there, too.

Mr. SHERMAN. Shifting to the scope of service, there is discussion of making a laundry list, perhaps 10 items, that auditors are not allowed to do. But the main impetus for this is to say, well, maybe $25 million in fees is a necessary evil if you are going to have privately paid-for audits, but $52 million is way too much. Do we need just a laundry list of services not to be provided, or do we need a rule that says your total non-audit fee cannot exceed, say, 50 percent, 80 percent, 100 percent of your total audit fee? The ratio was commented on by, I believe, Mr. Silvers, should there be a requirement that that ratio not exceed 50 percent or 100 percent?

Mr. SILVERS. I think that the issue here really is, as you mentioned, with the laundry list, that it is possible to evade the intention, which is to end the conflict, by the change in practices within the marketplace. Our view is, is that what you need here is a—and I believe one of the witnesses—one of my co-panelists spoke to this earlier. You need a statutory mandate to the commission, right, that in general bars consulting services, allows for consulting services that are intrinsic to the audit function, all right, and gives the commission the discretion to sort out as the marketplace and practices change which are which. Right?

Mr. SHERMAN. But if, say, tax services are an integral part of the traditional accounting function or auditing function, is it acceptable to have a million dollar audit fee in a $3 million tax fee?

Mr. SILVERS. Well, I think there are two answers to that. One is, as I said earlier, there are tax services and there are tax services that are preparing the audit. Then there is structuring the

partnership designed to keep everything off the books. They are very different and that is why you need the commission to have this discretion. But to answer your question directly, the question of the ratio, it seems to me that if we have got the general rule right and the SEC is complying with the intent of Congress here, that you would never see a situation in which audit firms exceeded by multiples, right, consulting fee—audit fees exceeded by multiples consulting fees. Thus the kind of measure you are suggesting might be a—I think what Mr. LaFalce referred to as a helpful redundancy.

I think, though, that what really is critical here is, is that the Commission be given both the discretion and the clear direction.

Mr. SHERMAN. I would point out that the commission——

Mr. CANTOR. The gentleman's time has expired.

Mr. SHERMAN.——has for the last 50-plus years—I believe my time is expired.

Mr. CANTOR. Thank you, gentlemen.

The Chair now recognizes Mr. LaFalce.

Mr. LAFALCE. I thank the Chair very much.

Mr. Silvers, we have not really spent too much time considering the issue of mandatory rotation of auditors, and I might say that all of my accounting provisions or auditing provisions were discussed at great length with the former chief accountant to the SEC, Mr. Lynn Turner. As you know, in my bill, I would say that you could have an audit for a 4-year period, and it could be renewed. It could be renewed basically if you have got the Good Housekeeping Seal of Approval of the SEC for an additional 4-year period. But then that would be it. I think that might well ensure for 8 years of good audits and then another auditor could come in and say what a great job the previous auditor did or point out where there is need for improvement.

No, what are your thoughts on that concept? It seems to me that that concept is even more important, or at least equally as important, as the separation of the auditing and non-auditing functions.

Mr. SILVERS. Yes. I would very much agree with your characterization of that language. I think that—and the AFL-CIO has proposed a rulemaking petition to the SEC that the SEC put such a requirement in place by rulemaking. I think that the critical issue here again goes to what Chairman Greenwood was talking about, which is the sort of confluence of forces that are at work to compromise the audit. All right? And one of the most important is this sense of cash flows in perpetuity that come from keeping a client happy, and the way in which there is a kind of melding of the audit firm and the staff of the people they are auditing. I think that Chairman Baker made some reference to his concern about that earlier in this hearing. Both the firm rotation and the prohibition on individuals flipping over that Chairman Baker alluded to would get at that.

Mr. LAFALCE. Well, prohibition and flipping over and cooling-off period is a provision of my bill.

Mr. SILVERS. I left that to you to say.

Mr. LAFALCE. OK. And you favor that.

Mr. SILVERS. Absolutely.

Mr. LAFALCE. Let me just ask the other gentlemen. On the issue of the cooling-off period, I have a 2-year time period wherein the chief auditors of a particular company could not then be employed by that company. Would you favor that, Mr. Walker, Mr. Breeden?

Mr. WALKER. I think the issue of a cooling-off period needs to be looked at. Some changes are necessary. I think you have to recognize that there are ways to potentially get around that. While it is not appropriate for them to serve in the CFO position, some of the things that Chairman Breeden has talked about, you also can hire people as consultants, and they are not employees, and the question is, what are they doing. So I think you have to recognize and look at substance over form and make sure you are accomplishing the objective.

Mr. BREEDEN. Congressman, as I said earlier, I think the cooling off is an important principle. Without looking at the specifics of how to do it—for example, I would let a company hire someone from their audit team to come in and have another position in the company for 2 years without being CFO. I think the real risk comes when the CFO is dealing with his or her own former staff over at the audit team, and I——

Mr. LAFALCE. Let us not kid ourselves. Some accounting firms have a policy of encouraging early retirement, creating incentives for early retirement, so that you do become the CFO of the company that you have been auditing, and you cement the relationship, the tie between the firm and your former auditing firm. We have got to deal with that problem in some way.

Now we can always point out, well, this is not crossed right or that T is not dotted right, but there is a fundamental problem. And let us cure the problem. If we do it imperfectly, well, then we can correct it, but let us deal with the very imperfect problem that exists. Let me go on, though, because I have so many other questions I want to ask.

Mr. Langevoort, you have been neglected and I do not want to neglect you any more, because Mr. Watt was talking about what he considers to be so important. But that is one of the most important provisions of our bill. We specifically would give legislative sanction to aiding and abetting liability for accountants and other professionals, and we specifically alter the statute of limitations.

Now there has been some confusion. Everybody says you ought not to change the 1995 Securities Reform Act or the 1998 Securities Reform Act. Do either of those provisions change the 1995 or 1998 Securities Reform Act?

Mr. LANGEVOORT. No, and thank you for the softball question.

Mr. LAFALCE. See, everybody here is under the impression that we are undoing what is done in 1995 and 1998.

Mr. LANGEVOORT. These two changes would carry out things that predate the 1995 legislation and that the SEC has endorsed previously. They are compelling as a matter of public policy.

Mr. LAFALCE. And yet witness after witness from industry comes in and says, oh, you cannot do this, because you would be undoing the 1995 and 1998 legislation, and they really do not know that it has nothing to do with the 1995 and 1998 legislation.

Mr. CANTOR. The gentleman's time is expired. The Chair is going to yield himself time for an additional round of questions.

Mr. Breeden, I would like to ask you on the question of rotating audits, do you feel that there will be an increased quality of audit if a company is required under all circumstances to replace its auditors every 4, every 8 years? Do you really feel there will be an increase in quality of audits, given the subsequent increase and expense the company will incur?

Mr. BREEDEN. Mr. Chairman, in my testimony I said that I do not personally favor mandatory rotation because I think rotation in some cases would be a benefit, and in other cases would be a disadvantage. In a very complex company, it takes a number of years to get up to speed and really understanding where the risks in that company are, and if you rotate—and particularly if you rotate every 4 or 5 years, I think you would have periods of time, blackout periods, almost, where the auditors are getting up to speed. That could be overcome. People could spend more money to throw more people at getting up to speed faster, but in general I think that is something as a requirement that goes farther than we need.

What I would like to see us do is to move more to a system where auditors are engaged for a 3 or 4-year period, not for a 1-year period, and that at the end of that time, the audit committee has to go out for proposal and at least hear what the other firms propose and how they would structure the audit and how many hours they think should be involved, and then leave it to the audit committee to make a decision on whether that firm should be retained or whether you should rotate.

Mr. CANTOR. I would respond and ask you what value would it be for there to be an imposition and to require going out for bid again under all circumstances, because that, too, does take time, and obviously someone participating in a response to a bid will not have the knowledge of the company the way that an existing auditor will have, and is that the best way? Are we really gaining some safeguards there?

Mr. BREEDEN. I am not sure I understand the question. You are saying what value is there in going out for proposal?

Mr. CANTOR. Just for going out's sake.

Mr. BREEDEN. Well, I would not require that as a matter of legislation. But I think as a matter of audit committee good practice, that every few years you should put your periscope up above the surface of the ocean and take a look around and see what other options are out there. I think the audit committee—I wrote on this subject in the *Wall Street Journal* a week or so ago. The audit committee needs to become more active than has been traditional, and we have been moving in that direction for the last 10 or 20 years. We keep—through the exchanges they keep encouraging better literacy, higher quality membership on audit committees. They are positioned to be a check-and-balance on the CFO, but we cannot expect audit committees to attract good people, and you want them to have the responsibility, and yet put them in a straitjacket and say, well, the law itself tells you what you have to do and not do.

So I would leave some of these questions to the audit committee.

Mr. CANTOR. Thank you.

The Chair now recognizes Mr. LaFalce.

Mr. LAFALCE. Well, thank you very much. I do think that there are a number of threshold questions that are important. First of

all, we ought to not lose sight of the fact that it is more than accounting and auditing that we have to be concerned about. We had problems with corporate officers. We had problems with boards of directors. We had problems with the auditing firms. We had problems with the rating agencies. We had problems with the securities firms and their analysis. We had problems with the law firms and probably an awful lot of others, too. What I am fearful of is that—or not fearful, that we are going to overreact. Industry is too strong, too powerful, too influential. Let us not kid ourselves. It is going to be tough to get anything at all passed that is meaningful, that is more than cosmetic. Our problem is not overreacting. Our problem is underreacting, coming in with a cosmetic. And let us not kid ourselves. If we don't understand that, we do not understand the governmental process as it really works, as opposed to you know how it is supposed to work.

I want to go into some differences between the bills, and I really—it is not a question of his bill, my bill or anything like that, but I want these issues to be addressed. I would like for there to be dialogue between us. There has been no dialogue. Before we have a markup. I make a public call for an opportunity to have dialogue, private dialogue, on these issues that we can come to some compromise on them. But I would like at least a public comment on some things that are new.

To the extent that you have knowledge, and you probably do not have too much knowledge other than newspaper knowledge, but please give me your thoughts about it.

The lawsuit against Enron has been expanded to include a number of the investment banks, about 10 or so. What is the theory of liability there? It is not just lending. I think it is more than lending. It is some type of active participation. Is it more than aiding and abetting?

And then also some people think that aiding and abetting in an action brought by the SEC simply requires a show of negligence, and I think the standard is substantially higher than that. I would like some explanation on that. And then also the Attorney General of the State of New York has obtained a court order. I am not exactly sure what the order says or does, but it was against Merrill Lynch, apparently—and, again, only speaking now from what I know about it from the newspaper—for making recommendations that are contrary to opinions that were expressed by an overwhelming percentage of the analysts of the firms in their e-mail conversations. Who wants to swing at that one?

Mr. LANGEVOORT. Let me start with what I think was the first question. With respect to the pending lawsuit against a variety of participants in Enron, I have not read the 500-and-whatever-page complaint so I cannot address the specifics.

Going back to my testimony, the uphill battle plaintiffs have is in trying to trace a way in which the investor banker's involvement was more than just behind-the-scenes assistance. It tries to do that by saying the investment banks used their analyst conduits to speak directly to the market. That is more than assistance. There may have been some participation in preparation of documentation that made it into the hands of the investing public. Those are all possibilities, but I guess my bottom line concern is that is really

an unfair burden to put on the plaintiffs, if what you are really complaining about was that the bankers were the brains in some respect behind all of this.

Second, with respect to aiding and abetting——

Mr. LAFALCE. One of the difficulties I have is we have not examined that before our Committee. We have not examined what the nature of the law is that would cover and what the nature of the law should be to cover them, and that could be a large part of the problem. I do not say that it is.

Mr. SILVERS. Congressman, I am not familiar with the complaint, obviously, as it has been amended, but I am a little familiar with some of the transactions that may be part of the complaint. There have been—and because there has been litigation both in the bankruptcy court and in the Southern District of New York around some of these banking transactions, and essentially what some of that litigation seems to show—and there are traditional opinions backing up what I am about to say—is that in at least the case of JPMorgan Chase, that company engaged in what was treated as a market derivative transaction, but in effect was a loan to Enron, because it was a loan paired with two energy derivatives contracts which essentially canceled each other out, and in one case they both ran through—JPMorgan Chase subsidiaries based in the Island of Jersey off the United Kingdom, which is an offshore bank haven, and the result of that transaction was that Enron got a billion dollar loan, did not show up on Enron's balance sheet.

Mr. LAFALCE. The whole issue of derivatives and the regulation of derivatives is very important, because the industry officials that engage in derivatives have said, well, these are counterparties who are so sophisticated that there need not be any type of regulation for them at least, and yet there are innocent people who are not parties to those actions that can suffer serious consequences, and then that is an issue smack dab before the jurisdiction of our Committee which we have not looked into.

Mr. CANTOR. If the gentleman will expedite his answer. The gentleman's time has expired.

Mr. LAFALCE. Well, I want to take another round.

Mr. SILVERS. Just to conclude, that transaction, unless some particular facts have arisen, that would—Chase directly communicated that transaction to Enron investors. That transaction will not be litigable because of this aiding and abetting issue. But, nonetheless, as you point out, real people were very badly hurt here. I spent some time with some of them in Houston on Friday, and those people have no—if it is merely aiding and abetting, those people have no cause of action.

Ironically enough, Chase Manhattan Bank, though, is acting on their behalf on the creditors committee of Enron and depriving those same people their severance money, while they see if they can bob and weave out of the liability generated by these transactions. It is really scandalous, frankly.

Mr. LAFALCE. Mr. Chairman, I know my time is expired, but Mr. Langevoort did not respond, did not have the opportunity to respond to the question of the standards that have to be met in aiding and abetting liability, whether it is negligence or something considerably greater than negligence.

Mr. LANGEVOORT. Congress made absolutely clear when it restored the SEC's aiding and abetting authority that intentional misconduct was the standard, and that is clearly the law with respect to aiding and abetting generally.

Mr. LAFALCE. And, therefore, if we extend aiding and abetting liability to private litigation, we would adopt the same standard, and so you would have to prove intent.

Mr. LANGEVOORT. The bill 3813 would mirror the standard for intent in private securities.

Mr. LAFALCE. It need not, but——

Mr. LANGEVOORT. Yes. That is correct.

Mr. CANTOR. The Chair yields to himself this time for an additional question. Mr. Breeden, in your written testimony, you unequivocally state that you would not support any steps to restore joint and several liability, aiding and abetting liability and other measures. Can you speak just sort of briefly to the adequacy of the remedies available under the 1995 Act?

Mr. BREEDEN. The 1995 Act was discussed earlier. I guess the only thing I would add to the 1995 Act was this same issue of whether aiding and abetting should be—whether Central Bank should be overturned was before the Congress in the 1995 Act. The Congress in that legislation could have done so, and it did not. The absence of action rather than the actuality of action was part of what Congress ended up doing there.

My own view is that we have struck a balance in the private litigation area, and there will always be cases that will cause us to say we should give more rights of action, but there are also—that opens the door, in my opinion—and I respect the differences from others on this point, but I believe it does open the door to abusive litigation, and the costs of that are very, very real, not only to the economy and to businesses, but to shareholders, too, who pay the ultimate cost of that whole process.

Mr. LAFALCE. Mr. Chairman, if I can just follow up with the question with Mr. Breeden on that point.

Mr. CANTOR. If he can just finish his response and I will yield back to you for plenty more time.

Mr. BREEDEN. I guess my view would be twofold. One, in the context of this legislation of trying to do something positive and meaningful to respond to the Enron situation, I think if we refight the battle of litigation reform all over, as part of it I think it will make the chances of doing anything constructive here much lower and, therefore, I would not like to see that happen, because I think there are some improvements that should be made and there are a lot of good things in your bill that ought to be done.

Second, even if it were not a question of tactics and timing, I do not substantively favor the expansion of the rights as has been described.

Mr. CANTOR. Thank you very much.

The Chair now recognizes Mr. LaFalce.

Mr. LAFALCE. Mr. Breeden, I just do not know how any person, unless they have a philosophic disposition, that says individuals should not be able to go into a court of law to obtain redress for a wrong, can say that if an individual or a firm has intentionally aided and abetted in false or misleading statements, that they

should not be able to be held liable. You know, it is absolutely beyond the capacity of the SEC on its own to go after all of those instances when it is done. They have got a paltry record on this in the past. The FTC, which has the ability to go into court—and you can't go into court if you are an individual—has come into Congress and said, restore the right of an individual who has been aggrieved, because it is wildly beyond our capacity to bring lawsuits where lawsuits are necessary to be brought.

And, Mr. Breeden, I understand the philosophic mind that just wants to cut back—for example, the mind of this Administration. They want a terrorism insurance bill, but only if it is coupled with the cutback of an individual's right to go after individuals who may have participated in that terrorism and caused injury.

Well, having said that, let me just say that that is one issue where you and I have profound differences on, and I hope that the Congress, at least this Committee, will be given the opportunity to consider that as you—and not confuse it with undoing the 1995 or the 1998 legislation which simply did not address those issues. And I will not be offering the joint and several. I will be offering the aiding and abetting and I will be offering the statute of limitations and I will be offering them separately so that we can have discrete issues before us.

Now, going back to the issue of mandatory rotation, Mr. Silvers, you favor it—I do not know that you have an opinion one way or the other, Mr. Langevoort. Mr. Breeden, you have said you opposed it. Mr. Walker, you said you certainly think it should be on the table for study. Is that fair enough?

Mr. WALKER. We are saying two things. One, more things need to be done on key personnel on the engagement and that the other issue should be studied. I have some personal concerns about mandatory rotation of audit firms.

Mr. LAFALCE. Well, I brought this up with Mr. Lynn Turner, the former chief accountant, who favors rotation, and he said to me, let me tell you, he says, I used to be one of the Big Five, he says, and mandatory rotation of the chief partner just does not work. He says no partner is going to go in and replace another partner and blow the whistle on the other partner and say everything he did was wrong. He says it does not work. If you are going to get to the heart of it, you are going to have to go to mandatory rotation.

Now he may be right and he may be wrong, but my recommendation in the bill is not without significant authoritative support. But let us assume we should not do that. Now, Mr. Breeden, you have said, well, what we ought to do is have audit committees, consider hiring audit firms for maybe a 3 or 4-year period and then consider other audit firms, too. Maybe submit proposals.

Well, the only thing is, if we do not mandate that, how do we get at the bad guys rather than the good guys? Won't we have a situation where the good guys are the ones who are going to do that and the bad guys are the ones who will not do it voluntarily? And that is the problem with volunteerism.

Now you would have the SEC do it, but, look it, you have sang the praises of the SEC. The problem is the SEC has deferred almost 100 percent over the years to the SROs. They have had almost no watchdog role over the SROs, whether it is the securities

industry, and most especially the accounting industry. They have been silent.

Mr. BREEDEN. Congressman, on the issue of rotation, while I do not personally favor mandatory rotation, it is an extreme step, and I do not think we are necessarily sure that applied to 17,000 companies in this country, that it would be a good idea.

On the other hand, my idea of having a 3 or 4-year engagement could lend itself to having a statute that said that beyond, say, one initial term and two renewals, that specific standards and findings might have to be made by the audit committee in order to pick the incumbent and keep going. You could encourage and the commission itself could encourage through proxy rule its audit committee—require the audit committee to say why after a dozen years or so, but some—pick some number, why they did not consider—or did they consider rotation. If so, why did not they do it. There are ways you can put a little pressure on to make sure people do look hard at the question. Would it serve the shareholders' interest to rotate.

Mr. LAFALCE. Mr. Walker.

Mr. WALKER. As far as the interest of full and fair disclosure, I am a CPA and practiced for a number of years; and, number two, I have been with two of the Big Five firms and I know how things work; and, number three, I think if you look at the issue of rotation of the key personnel, right now the rules are not adequate. You could have an individual or a person who was serving as engagement manager, then engagement partner, then the second partner, so they can end up being on the engagement for many, many years in a row.

Mr. LAFALCE. You mean the SEC, having the power to change that since their existence, has not?

Mr. BREEDEN. Congressman, I think this is an excellent issue, though, that pointed out why the proposal of both Mr. Oxley and yourself, both bills call for a body here to be created that would begin to resolve some of these issues, and I think you have put your finger on this is one of the number of such——

Mr. LAFALCE. That is why I wanted to have this hearing, because we have not discussed this issue, and I would love to discuss it, and I would love to reach a compromise short of legislatively mandating rotation, if it is a good compromise.

Mr. CANTOR. The gentleman's time is expired, and Mr. Sherman is in wait.

Mr. WALKER. One quick thing, Mr. Chairman, please. I think one of the things you have to be concerned about is if you are looking at the public interest, I think you have to be concerned with how many firms are there that can perform the service. I think the number of firms does matter.

Mr. LAFALCE. That is an important issue, too. Now are there not a lot of auditing and accounting firms below the Big Five that really could do much more work than they presently do.

Mr. WALKER. They could do more work, except when you are dealing with highly complex and global enterprises.

Mr. LAFALCE. But an awful lot of the publicly traded companies—what are there, about 17,000?

Mr. WALKER. They do not fit this——

Mr. LAFALCE. They can do it for—we have got to be able to encourage—I had a chairman of an accounting firm in my office today saying I favor mandatory rotation. It is the only way we are going to be able to get a piece of the action.

Mr. WALKER. I understand. It depends where you sit. Number one, the number of firms that are qualified to do the work is important. Number two, we need to be concerned with firm quality and related internal quality assurance procedures. And number three, the quality of the people is key.

One of the concerns that I have about mandatory rotation is that could end up putting more pressure on price, and the last thing you want to do is create a further commoditization of the audit business, especially if you are going to end up taking a way a lot of non-audit services, because in the end you have got to have a viable economic model, and if you do not have a viable economic model, you are not going to attract and retain quality people.

Mr. LAFALCE. It is a pittance and——

Mr. CANTOR. The gentleman's time has expired and the Chair is going to recognize Mr. Sherman.

Mr. SHERMAN. Thank you, Mr. Chairman, for giving me a chance to combine my third, fourth and fifth round questions into one block.

One of the witnesses mentioned Jersey Island, and of course we have also seen a lot of Enron activity in the Cayman Islands. I commend this Committee and the Ranking Member and the Chair for having these hearings on Enron and responding, but the Ways and Means Committee is strangely silent. There are two sets of accounting games that were played by Enron. One, to cheat the shareholders; the other, to cheat the United States Government and all taxpayers.

Now, the first is a little bit more apparent, because the victims are there. The employees, everybody who held stock at Enron, and in a way every stockholder in every company in the country, because I am convinced the market would be several hundred points higher if everybody didn't have to factor into their investment decisions the fact that the company that they invest in has a number of risks, including the risk that they might be the next Enron.

The hidden cost and victims of the accounting games, the trips to Cayman Islands that had nothing to do with snorkeling, are the taxpayers, the citizens of the country, everyone who depends upon Government, our efforts to combat world terrorism, and it is not just Enron, but hundreds of companies that have each established dozens of subsidiaries in the Cayman Islands, in Jersey Island, in Barbados, in the other tax havens, and I would call upon our sister committee to be as vigorous as this committee has been. We have to defend investors. They have to defend citizens.

But shifting to our responsibility and the scope of the outside auditor, the whole problem arises, because financial reporting is the only game where the umpire is paid by one of the teams. And that means under the current system if you say no, we will not give you an unqualified opinion, you are not just giving up this year's audit fee, you are giving up this year's consulting fee. And you are not just giving up this year's auditing and consulting fee,

but those fees could continue for ten or 20 or 30 years into the future.

Now one thing that I do not think will solve the problem right away—and I used to work for one of what we call the Little Six accounting firms—as long as investors, as they have, always demanded from the big companies they buy stock in that are widely traded that a Big Five, Big Eight, Big Four firm be the auditor, I do not know a way to break that up just with rotation. I think you would end up rotating among the Big Four, which may have some advantages and disadvantages. I think if you want smaller firms, we would have to break up the firms we have got now, because I do not think Horwath is going to be able to stand up and say, we audited General Motors or we audited even Pacific Gas and Electric, and you should buy their stock, or at least rely on our financial statements to decide whether or not to buy the stock.

We then focus, though, on that financial relationship that an accounting firm has with its clients, and one thing that Mr. Silvers and I were talking about is the non-audit fee. And the question there is whether you can just list a number of different services and say, OK, from time to time we will change the list and we will prevent the client from having too much clout with the accountant because we will always have a list of prohibited services or limited services that prevent the client's total fee package from being too important to the accounting firm, and I wonder whether that is even possible without the backstop that I have suggested Mr. Silvers referred to as a perhaps useful redundancy. And I would like the members of the panel to comment. Is there any way you could list some services, but not other services and not have a situation where the client's total fees to the accountant might possibly be as large or larger than the audit fee? Can we do this by enumeration, or must we do it by ratio?

Mr. WALKER. My personal view is—and as our testimony states—you may want to have certain principles that you say that under no circumstances can the auditor violate certain principles, which are clearly articulated.

Second, you may want to have certain safeguards to make sure that people are not auditing their own work, either firms or people within the firm. You should delegate to an independent qualified authoritative body which is able to make the tough decisions on what should and should not be allowed based upon changing market conditions. I think it is difficult to establish any particular level to say that merely because non-audit fees exceed a certain number, that there is a problem per se.

Mr. SHERMAN. So if I can interrupt, let us say it was thought to be acceptable that an accounting firm also provide executive recruitment. You are not auditing your own work, except to the extent that——

Mr. CANTOR. The gentleman's time is expired. If we can expedite the answer.

Mr. SHERMAN. I didn't even get through to the question. So I would withdraw it.

Mr. CANTOR. The gentleman may proceed.

Mr. SHERMAN. If we—whatever the allowable service is, say executive recruitment, is there—if it makes sense to allow a little bit

of it, can you allow so much of it that the accounting firm is receiving more from those services than from the auditing fee?

Mr. WALKER. Under the approach that we have taken under generally accepted Government auditing standards, which is outlined in my testimony, we say there are certain things you cannot do irrespective of the comments involved. There are other things that you should be able to do, but certain safeguards must be met, and we do not propose any arbitrary dollar or percentage limit. We also think that the audit committee should end up being more actively involved in reviewing and approving certain types of services.

Mr. SHERMAN. I believe my time is expired.

Mr. CANTOR. Thank you.

Mr. LAFALCE. Yes. I just want to thank the panel very, very much. I think this has been very constructive and helpful. I just wish there were more Members from both sides of the aisle who could have listened to the issues that were discussed by both of you.

Also, Mr. Breeden, I do want to say that it was a pleasure working with you in the Bush Administration when representatives of the Administration used to talk with Democratic Members of the House. That is not the case. I used to virtually live with representatives from the Treasury Department and from the White House in those days, maybe because we were in the majority then and they used to talk with us. That is why I developed such a close working relationship, not only with you, but with the President himself and so many of his cabinet officials. That is missing in Bush 2, and it is a sad—I am sad that it is missing. Thank you.

Mr. BREEDEN. Congressman, can I only say and just respond and say it was a great pleasure working with you then and all of the Members of—some of the Members who are still on the Committee here, that I really think the savings and loan legislation was an opportunity—a great challenge faced by the country, and you played a tremendous leadership role then and it was a great pleasure. I have never forgotten working with you.

Mr. LAFALCE. Well, let me say this, that one of the difficulties—probably, in my judgment, the biggest difficulty—is that there was a cutback in examiners and in regulators for our savings and loan in the mid-1980s. I think that was the single greatest contributing factor. In the beginning of 2001, when our Committee assumed jurisdiction, I pointed out that the biggest shortcoming in Government today was the inadequacy of resources at the SEC, and I called at the beginning of 2001 for another 2 or 3 percent increase, but a 200 or 300 percent increase in the resources of the SEC. I was at least figuratively laughed at in calling for such a huge increase.

Now that Enron has happened, at least the President has called for a 6 percent increase in his budget. But that is not good enough.

Mr. CANTOR. The Chair would also like to express his thanks, and members of the panel, for your indulgence and patience. The hearing now stands adjourned.

[Whereupon, at 4:52 p.m., the hearing was adjourned.]

A P P E N D I X

March 13, 2002

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

H.R. 3763, Corporate and Auditing Accountability, Responsibility, and Transparency Act (CAARTA)
March 13, 2002

Good morning and welcome to the Committee's first legislative hearing on the Corporate and Auditor Accountability, Responsibility, and Transparency Act of 2002, or CAARTA.

This legislation makes important changes in the accounting profession, in the way public companies report their financial results, and the manner in which investors access that information.

These issues are among the most serious in our jurisdiction. They have percolated for some time. Now, the bankruptcies of Enron, Global Crossing, and others have pushed them to the forefront.

Hearings held in this Committee over the past few months have demonstrated yet again the need for modernizing our financial reporting and disclosure system. Also, it is clear that we must have stronger oversight of the accounting profession.

There should be no question that the Federal securities laws need to be updated to ensure that investors have access to the most recent, transparent, and meaningful information concerning public companies. Enhancing the public's faith in financial statements is absolutely critical. They serve as the bedrock of our capital markets.

Our legislation, CAARTA, addresses these fundamental issues by strengthening our markets in a careful way. We avoided the temptation some apparently feel to blanket market participants in a sea of red tape.

The legislation creates an entirely new oversight regime for public accountants, requiring accountants to be rigorously reviewed to ensure that they meet the highest standards of competence, independence, and ethical conduct.

CAARTA also recognizes the need for corporate leaders to act responsibly, and holds them accountable if they fail to do so.

The legislation makes important improvements in the area of corporate transparency, requiring that companies disclose to investors important company news on a "real-time" basis.

It also directs the SEC to require companies to disclose the use of off-balance sheet transactions.

CAARTA's provisions are designed to increase public confidence in the U.S. capital markets. It is important that they remain the world's most efficient means of promoting economic growth and providing retirement security.

President Bush recently announced a ten-point plan to improve corporate responsibility and protect America's shareholders.

I am pleased that the plan's core principles – providing better information to investors; making corporate officers more accountable; and developing a stronger, more independent audit system – are embodied in our legislation.

I look forward to continuing our close collaboration with the Bush Administration on this vital capital markets issue.

I would also like to mention Fed Chairman Alan Greenspan's recent testimony before this Committee.

Discussing the implications of the Enron collapse, Chairman Greenspan noted that it has already sparked a very significant shift towards more corporate transparency and more responsible corporate governance practices. While it does not, in my view, obviate the need for government action, the markets' self-correcting mechanism certainly does underscore the danger of overreacting to the Enron matter.

I am pleased that CAARTA reflects Chairman Greenspan's support for more transparent financial reporting and for strengthening the independence of the audit.

I want to thank all of the Members of this Committee for working so diligently on this important legislation.

Let me also thank all of our witnesses in advance for their participation here this morning, and I turn now to Ranking Member LaFalce for his opening statement.

###

CONGRESSWOMAN JULIA CARSON
SUBCOMMITTEE ON HOUSING AND
COMMUNITY OPPORTUNITY
COMMITTEE ON FINANCIAL SERVICES

To:	Ms. Carson	CC:	Deron, Marti
From:	Michael	Date:	Thursday, March 13, 2002

Hearing on the Community Development Block Grant (CDBG)
Time: 10:30 a.m. Room: 2220 Rayburn

Statement

I would like to thank our distinguished Panelists for appearing before the Subcommittee this morning. I have been looking forward to learning more about the President's proposals for the Community Development Block Grant, and what those proposals would mean for under-served and under-developed communities across the nation.

The Community Development Block Grant has been an outstanding catalyst for change within blighted communities all across America, including in my own District in Indianapolis. These grants, if administered properly, can become a part of a greater strategy to expand affordable housing and job opportunities for people and families in need.

Today we will have an opportunity to discuss the merits of HR 1191, the Community Development Block Grant Renewal Act, introduced by my friend Carrie Meeks. The bill will help clarify what these grants are intended to do.

The President's Budget contains two related proposals of questionable merit. It slashes funds for Public Housing and it asks more Americans to find jobs before they can qualify for federal benefits. H.R. 1191 will make the Community Development Block Grant better suited to help laid-off and unemployed Americans survive, should the Presidents budget proposals be adopted.

We know that, in the best of economic times, finding quality affordable housing can present a difficult challenge for low- and moderate-income

residents. These are not the best of economic times. We also know that by the end of 2001, nearly 2 million American jobs were lost to the faltering economy. The President is asking a lot from Americans who are still struggling to gain a piece of the American dream.

Clearly the Community Development Block Grant can play a role to help address these issues, but only if the grants are wisely distributed. I believe Congresswoman Meeks legislation, of which I am a cosponsor, will help make sure that happens.

Rep. Stephanie Tubbs Jones

Good Morning, Chairman Oxley, Ranking Member LaFalce and Members of this Committee. Mr. Chairman, I ask unanimous consent that my full statement be included in the Record.

On December 2, 2001 a multi-billion dollar U.S. company, Enron Corporation, shocked the world by suddenly filing for Chapter 11 bankruptcy leaving millions of investors holding virtually worthless stock in what was once one of the most admired companies in the world. Many of these investors made the decision to commit their hard-earned money to Enron based in large part on the financial information that was made available to them; information that was trusted to be accurately and objectively reviewed by independent auditors. The result of all of this was a loss in billions of dollars of equity of investors, thousands of jobs and countless questions as to how all of this could have happened so quickly.

Thanks in no small part to the efforts of this esteemed committee in exploring the reasons behind the Enron collapse, we now understand that Enron's corporate auditors were neither accurate nor objective in their audit of the company, and most disturbingly, that these issues reach way beyond the scope of the Enron debacle.

Mr. Chairman, we are here this morning to address these issues so that what happened with Enron will not happen again. This legislation addresses the issues of auditor independence, timely and accurate disclosure of information to investors, effective and ethical corporate governance, and corporate accountability. It is not only desirable but necessary; however we must address these issues in a manner that will be

unethical corporate governance are permanently closed.

For these reasons, I support the measure introduced by Ranking Member LaFalce through the Comprehensive Investor Protection Act or (CIPA as it is often referred to) as an alternative to H.R. 3763 introduced by Chairman Oxley. CIPA provides a clear and concise definition of independence as it pertains to corporate auditors, and creates a public auditing regulatory board. The legislations also serves to outline the roles and responsibilities of corporate boards with respect to the corporate auditing function. CIPA imposes strict restrictions for directors and other insiders with regard to company stock sales so that it is not just investors that are left accountable for the mistakes of management or the company's board.

There is still a lot of work to be done by this committee to incorporate the regulatory restrictions suggested by CIPA in such a way as to preserve the ability of the nations auditors to attract talent and remain profitable. Although we have more work to do, I applaud Chairman Oxley and especially Ranking Member LaFalce for providing a working framework from which to quickly and effectively address these issues. I look forward to the testimony today so that we may continue in our pursuit to ensure that the American people have the objective information that they need to make informed investment decisions.

Mr. Chairman, I thank you for my time.

March 16, 2002

Opening Statement for Congressman Paul E. Gillmor
Committee on Financial Services
Full Committee Legislative Hearing on HR 3763, the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002.

I would like to applaud Chairman Oxley and Subcommittee Chairman Baker for taking the initiative on this important issue and working so swiftly and diligently to introduce, HR 3763 "the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002 (CAARTA)." I was happy to become an original cosponsor of this legislation and feel it responsibly addresses the systemic problems uncovered in both the accounting industry and corporate management culture by this committee's investigation of the Enron collapse.

I always have been a firm believer in increased management responsibility and accountability to both its shareholders and the American public. I am especially interested in hearing today's witnesses' comments on the increased disclosure requirements included in CAARTA.

On February 13th, I introduced HR 3745, "the Corporate Charitable Disclosure Act of 2002 (CCDA)." The CCDA would require corporations to make publicly available, each year, the total value of contributions that they made to non-profit organizations during the previous fiscal year. As the collapse of Enron has made painfully clear, corporate disclosure rules need to be revisited and the legislation being considered today is an important first step in this process.

I would like to thank Chairman Oxley for holding this hearing today and look forward to the witnesses' constructive comments on this most important piece of legislation.

Opening Statement
Congressman Ed Royce (CA-39)
13 March 2002
CAARTA Hearing

Thank you, Mr. Chairman, for the opportunity to address the proposed improvements to the auditing process included in the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002 that are of such great importance both to our capital markets and to the American public.

As an original cosponsor of this legislation, I would like to reiterate my strong support for several of CAARTA's provisions that I think will have an immediate, strong and positive impact on the auditing profession and on public perception of the entire corporate information disclosure process. First, I strongly believe that amending the current ineffectual process of auditor oversight is long overdue. Creating a strong Public Regulatory Organization - the new type of oversight body charged with the duty of reviewing companies that audit financial statements - is a great step toward improving the current process.

These PROs - with their power to sanction and to discipline accountants that violate codes of ethics, standards of independence and competency or the securities laws - are needed to bring transparency and efficiency back to our capital markets. By ensuring that financial statements are reviewed by independent auditors who are committed to the highest standards of professionalism and objectivity, investors will be more confident about the veracity of the information they receive and less reliant upon data from potentially-biased analysts in making their investment decisions.

Second, the inclusion of new requirements for public companies to disclose important information to investors on a real-time basis is also a great step toward preventing another financial catastrophe like Global Crossing or Enron from ever happening again. Forcing corporate insiders to disclose the sale of shares in their company within 48 hours, rather than allowing them to withhold this information for up to 40 days, will help to get real-time information about the true health of a company to those investors that don't enjoy the same benefits of inside information as the executives making these trades do.

Third, this bill levels the playing field for all investors by preventing corporate insiders from buying or selling shares when company employees cannot do so because of a lockdown in a company-sponsored retirement plan. Eliminating the ability for some investors to trade these shares, even while some "second-class investors" are prevented from doing so, is necessary to restore fairness and equitability to the administration of these retirement plans.

In sum, I look forward to supporting the positive remedies included in this bill and to gleaning additional insight from the witnesses called to testify before this committee today so that at the end of the day, we can be confident that we have provided the American investing public with the best and fairest structure for governing auditing and corporate behavior.

WRITTEN STATEMENT
OF
MARC E. LACKRITZ
PRESIDENT
SECURITIES INDUSTRY ASSOCIATION

ON

THE CORPORATE AND AUDITING ACCOUNTABILITY, RESPONSIBILITY AND TRANSPARENCY ACT OF 2002 (H.R. 3763)

BEFORE THE
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

March 13, 2002

Chairman Oxley, Ranking Member LaFalce and Members of the Committee:

I am Marc E. Lackritz, President of the Securities Industry Association ("SIA"),[1] and I am pleased to testify before you today on legislation to improve the accuracy of information in the capital markets. We commend you, Mr. Chairman, and members of the Committee for your ongoing efforts to ensure that investors will continue to be well served and well protected.

[1] The Securities Industry Association brings together the shared interests of nearly 700 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of nearly 80-million investors directly and indirectly through corporate, thrift, and pension plans. In the year 2001, the industry generated $198 billion in U.S. revenue and $358 billion in global revenues. Securities firms employ approximately 750,000 individuals in the United States.

The securities industry shares your commitment to ensuring the highest level of public trust and confidence in the nation's financial markets. Indeed, we have worked closely with Congress over the last few years to achieve several major accomplishments that benefit investors. We made a seamless transition to the year 2000 and, under the watchful eye of this Committee and others, an equally smooth transition to decimal prices. Most recently, the determined and successful efforts of the exchanges, the industry, and government officials to reopen the financial markets quickly after September 11 is a vivid illustration of our mutual resolve to maintain the public's confidence. These examples illustrate the leadership and commitment of Chairman Oxley, members of this Committee, as well as your colleagues in the Senate, and underscore the cooperation and trust we have built in working with each other to ensure that investors' interests come first.

I. PUBLIC TRUST & CONFIDENCE

SIA is deeply concerned about the implosion of Enron and the corrosive effect that this event is having on the public's trust and confidence in our country's corporations and financial markets. Public trust and confidence is the bedrock of our financial system, the core asset underlying why our financial markets are the envy of the world. The securities industry relies on the public's resolute trust and confidence that the markets operate fairly with complete integrity to best perform their capital-raising function. When that trust and confidence is undermined, investors become more reluctant to provide the capital that companies need to grow and prosper, employ more workers, and provide financial returns that boost our nation's prosperity.

Although Enron's collapse appears to be a massive failure in the accuracy of information that flowed into the marketplace, the securities industry's regulatory structure remains

fundamentally strong. When Congress wrote the federal securities laws in the 1930s, it established a regulatory system that has helped to foster the most liquid, transparent, and honest capital markets in the world. We are still learning the entirety of what went wrong with Enron, and the efforts already underway by this Committee, the Securities and Exchange Commission ("SEC"), the Department of Justice, and other authorities, show that we have the means to address problems that episodes such as Enron uncover. No system is perfect, however, and we strongly support reasonable reforms to improve the quality of information in the marketplace. We look forward to working with Congress, regulators, and others to develop thoughtful, workable solutions to the issues that Enron has raised.

II. OPPORTUNITIES FOR REFORM

SIA's agenda for reform is aimed at achieving one goal: to ensure that financial information, the lifeblood of our markets, is honest, accurate, and easily accessible to investors so that they can determine how best to meet their investment goals. SIA supports several initiatives – including various pension reforms, full funding of SEC pay-parity provisions, and many of the provisions contained in H.R. 3763 – that we believe will go a long way towards achieving that goal. We note that the Administration and the SEC have advanced many of the proposals we support. Before commenting specifically on H.R. 3763, we will briefly discuss some of the other reforms we believe will improve our current system.

A. Pension Reform/Retirement

SIA welcomes the series of reforms in pension laws announced by the Administration in February. Specifically, we support prohibiting insiders from selling their securities during a blackout period, requiring prior notice to plan participants of blackout periods, and the concept

of permitting participants to sell company stock in their 401(k) plan after a reasonable period, such as three years.

We also commend the House for passage of the *"Retirement Security Advice Act"* (H.R. 2269) and we encourage the Senate to follow the House's lead in passing the bill for the President to sign. The legislation would enable retirement plan administrators to provide individual financial advice to employee participants. By allowing employers to bring in specified, regulated entities to provide investment advice to plan participants and individuals with IRAs, investors would have greater access to the information they need to make informed decisions about their retirement accounts. Importantly, the legislation includes stringent disclosure and reporting requirements to protect investors and ensure the integrity of advice provided.

B. Full Funding of SEC Pay Parity Provisions

SIA has always supported a fully funded SEC, with the staff and the tools necessary to bring wrongdoers to justice. An experienced, sophisticated staff is vital to the effective regulation of our complex industry. SIA has been profoundly troubled by the huge turnover in experienced staff that the SEC suffered in prior years. For that reason we strongly supported H.R. 1088, the "*Investor and Capital Markets Fee Relief Act*," legislation that originated in this Committee, and was then passed by Congress and signed into law by President Bush. This new law reduces SEC fees and establishes for the agency's professionals pay parity with other financial regulators. We have consistently stated that we need a "tough and effective" cop on the beat, and we believe the SEC should have the resources it needs to maintain a high standard of regulation. Congress should fund pay parity and increase the agency's funding.

C. Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002 (H.R. 3763)

SIA believes that CAARTA includes a number of important improvements to the current regulatory system. President Bush included many of these reforms in the recently unveiled 10-point plan to enhance corporate disclosure. We support many of the bill's provisions, as outlined in our comments below:

Auditor Oversight (Section 2)

H.R. 3763's provisions on auditor oversight represent a sensible and appropriate reaction to the shadow that the Enron debacle has cast on the current performance of outside auditors. Investors and all other market participants depend on high-quality, accurate information. SEC Chairman Harvey L. Pitt has correctly identified the need for "the government . . . to ensure that appropriate standards of ethics and competency are in fact established, and then rigorously implemented and enforced."[2] We agree entirely, and we also concur with Chairman Oxley and Chairman Pitt that a private-sector regulatory body, predominantly comprised of persons unaffiliated with the accounting profession, is the appropriate means of ensuring these high standards.

The bill sets up a strong statutory framework for public oversight of the independent audit function. The general structure and power of the oversight body seems to be generally modeled on the provisions of Sections 15A and 19 of the *Securities Exchange Act of 1934* under which the National Association of Securities Dealers ("NASD") was formed. This approach –

[2] Remarks at the SEC Speaks Conference by Chairman Harvey L. Pitt, U.S. Securities and Exchange Commission, February 22, 2002.

which appears to adopt established provisions of the federal securities laws – is well conceived, and we support it.

Improper Influence on Conduct of Audits (Section 3)

Section 3 of the legislation would give the SEC authority to prescribe rules making it unlawful for an officer, director or affiliated person of an issuer of a public company to willfully "influence, coerce, manipulate or mislead" an independent auditor for the purpose of making the issuer's financial statements materially misleading. Although the SEC already has strong authority to prosecute such offenders,[3] the Committee should consider granting the SEC the statutory authority to require senior executives to disgorge bonuses and other incentive-based forms of compensation in cases of accounting restatements resulting from misconduct. We note that President Bush included such a recommendation in his 10-point plan.

Real-Time Disclosure of Financial Information (Section 4)

SIA believes H.R. 3763's provisions for more timely and better disclosure of corporate information will help investors and those who advise them. The SEC has announced its intention to act in that area by proposing rules that will: (1) provide accelerated reporting by companies of transactions by company insiders including transactions with the company; (2) accelerate filing by companies of their quarterly and annual reports; (3) expand the list of significant events requiring current disclosure on Form 8-K; (4) require companies to post filings on their website

[3] See, *e.g.*, *Exchange Act* sections: 20(a) (liability for those who "directly or indirectly control a violator unless they acted in good faith); 20(b) (liability for doing through another person directly or indirectly an act that would be otherwise unlawful for such person to do himself); 20(c) (liability for officers or directors or shareholders of public companies "without just cause to hinder, delay or obstruct the making or filing of any . . . document, report, or information" required to be filed with the SEC); 20(e) (liability to SEC for aiding and abetting violations or imminent violations of the *Exchange Act*); 21B (money penalties in administrative proceedings brought by the SEC to address, among other things, acts that willfully make or cause to be made false and misleading a report required to be filed with the Commission); and, 21C (cease-and-desist proceedings to sanction, among others, anyone who "is, was or would be a cause of the violation" of an *Exchange Act* requirement).

at the same time they are filed with the SEC; and, (5) require disclosure of critical accounting policies in Management's Discussion and Analysis ("MD&A"). SIA generally supports these thoughtful reforms, and we will be making more specific comments when the SEC publishes the proposals.

It is important to avoid certain pitfalls, however, in seeking to accelerate and expand corporate disclosure. For example, expanding the list of significant events for disclosure creates a risk of market overreaction and volatility while the information is being digested. Inadvertently promoting shortsightedness among investors and market watchers would only serve to increase market instability and potentially frighten new investors. Moreover, increasing the frequency of disclosure could increase the risk that good-faith mistakes will be made by issuers seeking to provide accurate information within the accelerated time frame. This, too, could impede markets properly functioning.

The best way to ensure that investors and advisers receive good information without producing abnormal market effects is to provide the SEC with the flexibility to make the necessary judgments about the timing and content of required disclosures. The SEC could then adapt rules when necessary to respond to changed conditions or unanticipated harm to the financial markets and investors.

Insider Trades During Pension Fund Blackout Periods (Section 5)

SIA supports the purpose of Section 5, which is to prevent corporate insiders and large shareholders from selling shares while employees are barred from selling their shares. We suggest that Subsection (5)(c) provide that the Commission's authority to adopt rules may also

include the authority to prevent hardship or other unintended consequences, and that Section 5(c) is in addition to the Commission's general exemptive authority under Section 36 of the *Exchange Act*.

Improved Transparency of Corporate Disclosures (Section 6)

SIA strongly supports the goal of providing investors with improved transparency in financial statements. It is essential that users of financial statements have an accurate insight into the value of the issuer's franchise. We suggest, however, that the Committee consider certain changes to Section 6. At the outset, the SEC should not be mandated to revise its regulations in the area, but should be given the flexibility to examine and revise them only if necessary.

In addition, the disclosures that the bill would require generally overlap with an SEC statement to issuers regarding certain disclosures they may have to include in their MD&A.[4] As those disclosures have only recently been mandated, we believe it is premature to legislate in this area until investors, analysts, and regulators have had an opportunity to evaluate the quality of disclosure produced pursuant to the statement. Additionally, Special Purpose Entities ("SPEs") play a key role in a number of important financial markets, especially in the case of securitization programs. Regulatory or legislative actions that might cast a shadow over SPEs should be carefully considered in light of the significant adverse impact upon financial markets that would flow from inappropriate restrictions.

[4] SEC Release No. 33-8056 (January 22, 2002) discusses disclosures that issuers may have to include in their MD&A with respect to off-balance sheet arrangements, certain OTC contracts accounted for at fair value, and transactions with related and certain other parties, in order to ensure that they are meeting their disclosure obligations.

Moreover, since SPEs are generally bankruptcy remote, incorporating detailed financial information concerning them into the financials of an issuer could be quite misleading, either by suggesting that in the event of an insolvency of the issuer the assets of the SPE would be available to its creditors, or conversely that the liabilities of the SPE are obligations of the issuer.

We also fear that requiring disclosure rules to be adopted within 180 days after enactment of the legislation would be an insufficient time for the sort of careful and detailed analysis of the disclosure regime that we believe is necessary. The importance of getting the disclosure issues right the first time is too great to risk subjecting the SEC to an artificial deadline of such brevity.

SIA supports an analysis designed to improve the transparency and usefulness of financial statements. In that vein, we strongly urge that the Shipley Report's principles and recommendations for enhanced disclosure be reviewed by the SEC with a view to incorporating elements into the SEC's disclosure regime.[5] The Report recognized the importance of having investors exercise market discipline upon issuers, and concluded that this can be best achieved when investors have an accurate insight into the key risk-management methods and practices employed by issuers. The globally active financial firms that formed the group are currently in the process of reporting pursuant to its principles and recommendations. We believe these principles and recommendations represent the industry's "Best Disclosure Practices" and are an invaluable reference point for improving disclosure practices.[6]

---

[5] *Working Group on Public Disclosure*, January 11, 2001; Walter V. Shipley, Chairman, Letter to the Honorable Laurence H. Meyer.

[6] Importantly, the Shipley report rejected a uniform approach to making these disclosures, as firms will not all be in the same lines of business, have a uniform approach to risk management, nor share a single view of how best to monitor and manage their risks. As risk management practices continue to evolve, it is important to guard against premature codification of standards that may well become less than "state of the art" over time.

Further, we doubt that filing 10Qs and Ks somewhat sooner will greatly advance the cause of better disclosure of financial information. We believe that as part of the effort to improve disclosure, it would be beneficial to look at the earnings estimates that firms release, usually prior to the date on which their filings with the Commission are made. Those releases typically generate more interest by analysts, investors, and the media than the statements that are subsequently filed. We recommend that a private sector "Best Practices" group be formed for the purpose of developing a set of minimum standards for earnings releases. Such requirements might include a calculation of profit/loss per share; an estimate of revenues; a requirement that if a *pro forma* estimate is included that it also include a reconciliation to GAAP; etc. SIA would be pleased to work with such a group.

Reducing redundant disclosures would be an additional improvement to the disclosure system. For example, a number of virtually identical disclosures are currently required in the financials and the MD&A. An attempt to rationalize these disclosures and place them in a single location would assist readers of financial statements, and help to make them more concise and clear.

SIA believes that it would be very burdensome for issuers to explain how different accounting principles and the judgments made in applying those principles could have resulted in materially different financial statements. GAAP requires an issuer to make any number of choices with respect to accounting principles and how to apply them, many or all of which may have a "material" impact on its financials. Such a provision would seemingly require issuers to prepare their financial statements under a variety of accounting formats in order to determine

whether any one of the choices that has been made might have resulted in materially different results.[7] We think that requiring issuers to identify clearly their key accounting principles should suffice.[8]

Study of Rules Relating to Analyst Conflicts of Interest (Section 7)

Section 7 of the legislation directs the SEC to conduct a study of any final rules of the self-regulatory organizations ("SROs") regarding conflicts of interest by equity research analysts. SIA commends Chairman Oxley, as well as Representative Baker, Chairman of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Entities, for your outstanding leadership in seeking improvements in this area. SIA developed a set of best practices a year ago in a good-faith effort to address concerns that equity analysts' objectivity could be impaired by conflicts of interest posed by their firms' investment banking business, among other factors. We believe that our Best Practices for Research have been useful, but we recognize that, as a voluntary trade association, we have no ability to compel enforcement of them. We understand the concerns of those who believe that stronger enforcement measures are needed.

The NASD and NYSE have recently proposed regulations that would require new disclosures, as well as new restrictions on the internal operations of broker-dealers' investment

[7] As a simple example, firms are given a choice with respect to reporting the cost of sales, either FIFO ("first in, first out") or LIFO ("last in, first out"). Choosing one rather than the other will impact the profits reported, and all things being equal, FIFO will tend to result in lower costs and higher profits. (N.B.; The IRS doesn't permit a company to go from using one system to the other.) Thus, Acme Widget might conceivably report profits of $1.25 per share under FIFO, but profits of $1.10 if it had used LIFO. Such a difference in numbers would certainly qualify as material, but a firm couldn't know what the difference would be unless it ran its numbers under both approaches.

[8] Finally, for the sake of clarity and focusing on the central concern, we propose revising the phrase "any issuer engaged in trading non-exchange traded contracts" to "trading instruments where no dealer or exchange quotes exist" in section 6(c)(2)(C).

banking and research units. We have serious issues with some aspects of these proposals, which we will address soon in a comment letter to the SEC. However, we support the overall goal of the proposals, and we expect that the regulations will likely satisfy the legitimate concerns that have been raised by Congress, the news media, and the investing public. Most importantly, the SROs will be able to examine for compliance with the new regulations, and the regulations will be fully enforceable.

If experience shows the need to adjust the regulations, the SROs and the SEC will be able to make the necessary changes to make them more effective. For this reason, we do not believe that enacting these regulations into statutory law would serve any purpose, and could well be counterproductive. We think that the approach of Section 7, however, is very appropriate. Congress can and should be kept abreast of how well the new regulations are working.

Oversight of Financial Disclosures (Section 8)

The provision requiring the SEC to set minimum periodic review requirements for a certain segment of issuers will unnecessarily interfere with the SEC's ability to establish priorities and allocate its resources in the manner that is deems most appropriate to fulfill its investor protection mandate. No matter how large the agency's budget may grow, the Commission will still need the flexibility to respond to changed conditions and issues that may require special attention in the future. Prioritizing the allocation of the SEC's resources should not be written into stone, but should be left to the discretion of the agency and its oversight Committees.

Moreover, the unstated goal of this provision – that SEC review will somehow validate information submitted by issuers – is unrealistic. Ensuring quality filings is a burden that should fall squarely on an issuer and its auditors. Regulation can set the standard for the quality of those disclosures, and enforcement action can prevent and deter violations of those rules. But setting the SEC up to be some sort of guarantor of the accuracy of information is a false promise that will prove deceptive to the public and impossible for the agency to fulfill. A fairer and more realistic approach would be to require the SEC to report annually on the amount and type of reviews that it has conducted.

III. LITIGATION REFORM

Long-time opponents of the *Private Securities Litigation Reform Act* ("PSLRA") have argued that the act is somehow responsible for the Enron debacle. They also claim that the PSLRA has made it impossible for those victimized by Enron insiders to obtain relief. Both of these claims are simply false.

The PSLRA was enacted to address serious and well-documented abuses of the litigation system by lawyers who had no real clients. Extensive hearings over two Congresses demonstrated that a small coterie of lawyers sued companies whenever the stock price fell for *any* reason, filing boilerplate complaints alleging securities fraud, and seeking to extort settlements consisting of token payments for shareholders and enormous fees for the lawyers.

The PSLRA – enacted by a substantial bi-partisan majority of Congress over a presidential veto – contained a balanced package of reforms to address these concerns. For example, the act raises the standard for filing a complaint that alleges securities fraud; gives

judges the authority to select the plaintiff who will best represent the interests of all class members (rather than rewarding whoever races into court the fastest); restricts the ability of lawyers to engage in "fishing expedition" discovery tactics where they do not have facts to support their claims; and, requires auditors who uncover illegal acts to notify the SEC if the company does not take corrective action.

The modest nature of the PSLRA reforms is empirically borne out by the impact that the act has had on the cases brought and settled since its adoption. In each of the last four years, the number of shareholder suits filed has been equivalent to or greater than the number of cases typically brought each year prior to PSLRA's enactment. The average cost of settling has gone up rather than down post-PSLRA, and this year's cases alone include some of the largest settlements ever. This suggests that the courthouse door is very much open to securities class-action litigation.

There is also no merit to the argument that the PSLRA is having any tangible negative effect on claims being brought in the Enron case. In fact, class action litigation is proceeding apace as we speak (dozens of class actions have already been filed), and Arthur Andersen has already placed on the table a settlement offer which, if accepted, would by itself constitute one of the largest securities class-action settlements ever, even before settlements or judgments have been reached with any of the other defendants.

Clearly, Enron is proof that securities class-action litigation is still vibrant and profitable for securities trial lawyers. Why else would groups of prominent plaintiffs' lawyers have recently squared off in a very conspicuous fight to be named lead plaintiff in the litigation?

Further enriching the trial bar is not a valid basis for changing public policy. The premises of the PSLRA are still valid – the courts should continue to hear meritorious cases, while groundless cases should not be permitted to drain capital from companies and shareholders into lawyers' pockets.

IV. CONCLUSION

SIA believes our system of securities regulation and corporate disclosure is second to none. What we know about Enron's collapse so far – and we still don't have all the facts – is that our regulatory system remains fundamentally strong. It is important to resist the temptation to hastily adopt legislation or regulation that may seriously harm our capital markets. Indeed, our financial markets are envied worldwide for their efficiency and integrity, and we have the opportunity now to develop responsible reforms that will improve the markets for everyone who participates in them. Certainly, Enron has brought us a new set of challenges to address. We look forward to working with Congress, the SEC, and the Administration to developing a reasonable, measured response to those challenges.

Statement of
Barry Melancon, President and CEO
American Institute of Certified Public Accountants

Committee on Financial Services
United States House of Representatives
March 13, 2002

H.R. 3763, the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002

Chairman Oxley, Ranking Member LaFalce, Honorable Members of Congress, Ladies and Gentlemen:

I am Barry Melancon, president and CEO of the American Institute of Certified Public Accountants (AICPA). I am pleased to be here today on behalf of the 340,000 members of the AICPA – certified public accountants who work as sole practitioners and in organizations large and small, in every community across the nation, and for the almost 1,000 firms that perform audits for public registrants. I speak today for the CPAs who, day in and day out, are committed to performing their work with the expertise, diligence, and integrity that the public and this committee expect and need.

Thank you for the opportunity to discuss some of the most critical issues facing our financial markets, investors, and corporate stakeholders, as well as the accounting profession and manner in which we serve clients and the public interest. We commend Chairman Oxley, Subcommittee Chairman Baker and their staffs on their thoughtfulness and hard work in introducing H.R. 3763, the subject of today's hearing. Similarly, we appreciate the efforts of Congressman LaFalce and others on the Committee who have advanced various other proposals.

The AICPA looks forward to working with this Committee, Members of Congress, the SEC and the Administration to bring meaningful reform in the wake of the tragedy at Enron.

CPAs across this country and the Members of this Committee share a common goal: to restore faith in the financial reporting system and reassure investors that they have access to the most up-to-date, relevant and accurate financial information.

Our profession has a long history of dedication to maintaining and improving the quality of financial disclosures. We require it, investors demand it, and the strength of our financial markets depends on it. We take that responsibility very seriously.

Our profession has zero tolerance for those who break the rules. We are very serious about that as well.

I would like to be very clear: We heartily support meaningful change because thoughtful improvements are needed. But, we all should be wary of simplistic solutions that can to lead to unintended consequences.

We believe that the public interest demands that any new policy affecting the profession answer four basic questions in the affirmative. We ask that this Committee and Congress evaluate legislative proposals with any eye to this public interest test. The four basic questions we hope that all ask when evaluating a proposal are:

- Will it help investors make informed investment decisions?
- Will it enhance audit quality and the quality of financial reporting?
- Will it increase confidence in the capital markets, our financial reporting system, and the accounting profession?
- Will it be good for America's financial markets and economic growth?

Today, I would like to offer our perspective on a number of the key issues, including those embodied in H.R. 3763, keeping in mind this public interest test.

New Private Sector Regulatory Body

Self-regulation is a hallmark of the manner in which all professionals in the United States monitor themselves. For 25 years, the SEC Practice Section of the AICPA has undertaken this responsibility with regard to auditors of the public statements of public companies.

The idea of a new public regulatory organization for auditors of the financial statements of public companies is a radical change in the accounting profession's landscape, but one that we now embrace, because it meets the public interest test I have just discussed. In today's environment, a robust private sector regulatory body, independent of the accounting profession, and charged with undertaking professional discipline and quality review in this sector, will go a long way toward increasing confidence in the capital markets, our financial reporting system, and the accounting profession.

Equally important, the new private sector organization, with SEC oversight, will provide a structure through which issues related to audit quality, auditor independence, discipline, and other related matters can be addressed and resolved. This approach strikes the appropriate balance between the need for government participation and oversight, and the efficiency and flexibility inherent in the private sector. Such an organization mitigates the need for arbitrary bright line proscriptions and restrictions. The new organization should:

- Perform quality reviews of the activities of accountants who attest to financial statements filed with the SEC
- Enforce compliance by accountants with professional standards applicable to audits of such financial statements
- Discipline accountants for violations of applicable professional standards
- Establish rules deemed necessary for such review and enforcement

It is critically important that the organization have the ability to keep certain information confidential and to compel the production of documents, two tools not currently available to the AICPA. These powers would balance the need to enhance the investigative process with a guarantee of the confidentiality of materials underlying a regulatory review. The reality that materials underlying a review that are privileged may be discoverable and admissible in civil litigation because of disclosure to the AICPA worked to frustrate timely action on self-discipline. Changing that reality will greatly increase the efficacy of any regulatory review

A clear charter is also key to success. The new regulatory body should function primarily as a disciplinary and quality review board rather than as a standards setter

The AICPA's disciplinary and quality review processes have served their purposes well. However, we now accept that it is necessary to move the authority over these two functions to an independent regulatory body such as I have described, unburdened by the legal limitations imposed on the AICPA's process, and able to move quickly and definitively to determine facts and, where appropriate, take remedial and disciplinary action

Audit Quality

The historic shift from the industrial era to the information age has wrought profound change to all elements of our economy, but perhaps none more fundamental than in our capital markets.

New financial instruments, for example, in the area of derivatives, emerge on an ongoing basis. Many of the instruments have become so complicated that understanding and measuring their effect on a business is difficult, and explaining them to a lay investor can be an even greater challenge. Likewise, the vibrancy of our markets is increasingly dependent on the creation of innovative and very flexible business models based on customer and supply chain relationships, operating in shorter and shorter business cycles. Understanding and measuring the impact of such rapid evolution is an equal challenge. New business risks are being created as a consequence, and capturing these risks is even more critical right now as these new models push the boundaries of traditional control.

Simply put, the business and investing environment is more complicated than ever before. The competencies and experience needed to conduct today's audit are vastly broader than they were even a few years ago. And those requirements will be even more far-reaching in years to come.

We ask that you recognize that the SEC disclosure requirements that have fed much of the debate about scope of services features a very narrow definition of audit services, a definition that has not changed since the 1930s, and clearly one that has not kept up with the times. Under the requirement, all services outside of the audit itself – even many of the services that auditors have traditionally performed such as accounting, tax, and assurance services – are put into the "non-audit" service category. Yet, a number of these services are a necessary part of a modern audit. Others "evolved from requests by audit clients for additional services that their auditors seemed best suited or capable of providing," according to a report issued by the POB-appointed Panel on Audit Effectiveness.

This categorization, rooted in the past, does not provide any enlightenment about what both companies and investors need today. We ask that you keep this in mind as you evaluate various proposals built upon these disclosure requirements.

In fact, after more than a year of intensive research, the Panel on Audit Effectiveness found that, in a quarter of the instances where a firm provided both audit and other services to a client, the insight gained from providing so-called non-audit services actually improved audit quality. Significantly, in no instance did the Panel find that the provision of non-audit services reduced audit quality. A very recent study conducted by investigators at the University of Southern California and Texas A&M International University indicates that concerns that non-audit services impair auditor independence are unfounded.

New rules that would narrow the experience brought to the audit are an invitation to disaster. Applying our public interest test, such action would impede audit quality and the quality of financial reporting.

Equally important, audit quality is highly dependent on auditor quality. We must be absolutely sure that we can attract the most competent professionals into our firms – individuals with the knowledge, education, and intellectual capacity to meet the challenges of this complex business environment. The excitement and dynamism of information age companies exert an enormous pull on young people entering the job market. Accounting school enrollments has decreased from 192,000 in 1995-1996, to 143,000 in 1999-2000. And accounting school graduates has decreased from 60,000 to 45,000 over the same period. Like newly minted lawyers and MBAs, young professionals in finance and accounting want to go where the action is. New rules that reinforce an outdated regulatory model and restrict

career opportunities in accounting firms are more likely to strangle the auditing profession than nurture it.

Interfering with the marketplace by walling off auditors will have other unfortunate unintended consequences.

- Prohibitions on services would be particularly onerous to smaller companies that may not be able to pay different firms for auditing and other related services.

- It is a very real possibility that restrictions applicable to the activities of auditors of public registrants would be adopted by other government agencies, such as the GAO for Yellow Book audits, federal regulators for their regulated entities, state boards of accountancy, and state regulators. The ripple effect of such action would be very significant, affecting accounting firms of all size in all communities, and potentially driving up costs to government and businesses at every level.

- Such statutory restrictions will substitute informed and reasoned decision-making by companies and their audit committees with government fiat. This is not good for our financial markets or our country's economic growth.

Nevertheless, the profession recognizes that public concern about two particular services – financial system design and implementation, and internal audit outsourcing – has become intense, with a corrosive effect on public confidence. With our public interest test in mind, the profession has concluded that it will not oppose prohibitions on auditors of public companies from providing these two services to audit clients. In the wake of Enron, such prohibitions will help restore public confidence in the profession and the financial reporting system, without posing a significant threat of unintended consequences.

Risk of Creating Audit-Only Accounting Firms

One of the chief concerns from an investor and financial market perspective is the risk that proposals, whether intended or not, could lead to audit-only firms. While at first glance some may find this an appealing prospect, an audit-only firm would create significant economic viability and audit quality concerns.

The biggest threat is the risk to audit quality. We believe any proposal that results in the creation of audit-only firms will inevitably prevent the audit from keeping pace with changes in business models, market dynamics, and the overall economy. The skills and expertise of audit-only accountants will quickly be outpaced by rapid changes in business practices and financial transactions. Lower paid, less skilled accountants may staff

audit-only firms, harming the ability of lead audit partners to go toe-to-toe with the modern corporate financial executive. And equally important, auditors cannot prevent the implementation of proposed improper transactions if their role is limited to an annual examination of historical financial statements.

Even though there are no federal proposals to mandate today's accounting firms to restructure themselves into the untested business model of an audit-only firm, some proposals on the table would force us there. For example, if a broad range of non-audit services is prohibited – or if the market is driven to the same conclusion -- there is no economic reason for talented experts offering non-audit services to remain connected to accounting firms. This loss of necessary expertise would be a critical blow to audit quality.

Take, for example, the case of the tax expert on derivatives, whose know-how is needed by the audit team, but who would be walled off from offering services to audit clients. Yet, that individual continues to bear the very significant liability risk associated with the audit function. Under such a scenario, sheer economics would force that individual to break away from the accounting firm. And he or she would not be alone. Faced with the huge liability risks associated with the firm's audit work, but unable to participate fully in the firm's activity, others in similar positions would leave en masse.

Equally important, there are real economic viability questions attached to an audit-only firm. With decreased business opportunities and a much smaller, relatively stagnant economic base over which liability, technology and training costs would be spread, an audit-only firm may very likely find it hard to continue to perform quality audits on an ongoing basis – a very real threat to the future of private sector auditing.

Corporate Governance

The financial reporting process is a complex system of checks and balances featuring:

- The company's board of directors and its audit committee, which hires independent auditors and oversees the creation of a company's financial statements

- Company management, including internal accountants, who work year round to maintain the company's financial information and, in doing so, prepare the financial statements

- Independent auditors, who perform an audit of the company's financial statements to test management's assertions regarding the fairness of the reported financial statements.

The financial reporting process also includes many others such as FASB, attorneys, securities analysts, etc.

The SEC has required the board's audit committee to publicly report that it has reviewed and discussed the audited financial statements with management, received disclosures regarding the auditor's independence, and discussed certain key issues with the auditors. The public report must also state that the audit committee has recommended to the board that it include the audited financial statements in the annual report, that the board has adopted a charter for the audit committee, and whether members of the audit committee are independent.

Audit committees should have the sole authority to approve the company's financial statements and required business disclosures in the annual report and other public documents. And the audit committee should be responsible for the hiring and firing of the company's auditor.

Audit committees have recently taken on new obligations to consider non-audit services provided by a company's auditor, and the potential impact on auditor independence. Under ISB No. 1, issued by the Independence Standards Board, the audit committee and the auditor must examine, at least annually, all relationships between the auditor and the company, including the provision of non-audit services that could bear on the independence on the auditor. Additionally, the proxy disclosure requirements resulting from the recent SEC independence rule require annual disclosures about the audit committee's consideration of any allowed non-audit services being compatible with maintaining the accounting firm's independence. We believe these recent measures, in effect for less than a year, appropriately enhance the role of audit committee oversight and should be given a chance to work.

We hope that Members of this Committee, Congress and others recognize that it would be harmful to cast a dark cloud over all services outside the statutory audit by establishing the negative presumption that an auditor cannot be independent if any such services are provided to an audit client -- even if that presumption was overridden by an audit committee's affirmative action.

Equally important, audit committees should be composed of outside directors with auditing, accounting or financial experience. It is imperative that individuals making these decisions be independent of management and knowledgeable enough to make educated decisions.

Mandated Audit Firm Rotation

Many independent studies – including those by the Public Oversight Board, the Commission on Auditors' Responsibilities, and the National Commission on Fraudulent Financial Reporting – have looked at the idea of mandatory

rotation of audit firms and found that the benefits are clearly outweighed by the associated costs. These studies show that audit failures are three times more likely in the first two years of a client/auditor relationship, and that there is a positive relationship between audit firm tenure and auditor competence.

Adverse effects are caused by a number of factors. The audit firm needs to be familiar with the client's accounting, operations, and internal control systems. A replacement audit firm loses the knowledge, experience, and expertise developed through successive audits over time. As Senator Dodd noted in comments last week, the major accounting firms also often possess industry-specific expertise within firms, with one firm perhaps more dominant in the health care or financial services industry, for example.

The diversion of resources necessary for a registrant to find, retain, and educate a new auditor may also adversely affect the quality of the company's financial reporting and other business activities in the early years. And the audit may suffer from mismatches between characteristics needed by the client and those offered by the new auditor. These mismatches take time to become apparent.

Requiring that companies take on such risks would not pass our public interest test.

Moreover, mandatory audit firm rotation creates an unwarranted restriction on the freedom of companies to choose their own auditors. The determination of the best audit firm for a particular client should rest with the audit committee, which is in the best position to make that decision. To remove this very basic corporate governance role is to send a message to investors that the board and management of public companies is not competent to exercise its governance responsibility.

As a practical matter, with more than 17,000 public company audits, a mandatory rotation would create a significant annual proposal frenzy affecting thousands of audits and creating an unnecessary distraction for corporate leadership. An unintended consequence would be the added difficulty of ensuring timely reporting because audit firms would need to meet a very short learning curve to perform a rigorous audit. We note that the SEC recently announced a proposal to shorten the filing deadline to 60 days.

Member firms of the SEC Practice Section of the AICPA – all firms that conduct audits for publicly traded companies – already are required to take the lead engagement partners off engagements after seven years, for a period of two years, thus prohibiting long-term personal relationships between auditor and client contact.

Finally, I must mention that at one time Greece, Spain and Italy all required mandatory auditor rotation. Greece and Spain dropped the requirement after determining that the concept did not achieve public policy goals. Canada also put in place an audit firm rotation requirement applied to financial institution audits. It, too, dropped the requirement. In short, given the known risks, why follow these failed experiments?

Turning Back Reforms in the Private Securities Litigation Reform Act

In passing the Private Securities Litigation Reform Act (PSLRA), Congress found that the private securities litigation system was too important to the integrity of the capital markets to allow it to be undermined by abusive and meritless lawsuits. Private securities litigation is an indispensable tool for investors to use to recover their losses without having to rely on government action. These lawsuits promote public confidence in our capital markets and deter wrongdoing. Congress enacted the PSLRA because it found significant evidence of abuse in private securities lawsuits, and it felt it was necessary to enact the PSLRA reforms to protect investors and maintain confidence in our capital markets.

Preliminary empirical evidence gathered by the SEC and the Stanford Law School Securities Litigation Clearinghouse indicates that the race to the courthouse, in which lawyers try to seize control of a case by being the first to file suit, appears to have slowed. The complaints filed by plaintiffs now have more factual detail and appear to have more substance. This is demonstrated in several studies that have found that the average settlement value of post-PSLRA claims is up substantially. From 1995 to 1999, the average settlement went from $8.2 million to $47.9 million.

In light of this, it is ludicrous to suggest that the PSLRA has let accountants off the hook. One simply has to read the newspaper to see that simply is not true. The past few years have seen record numbers of lawsuits and record settlements from accounting firms. The number of securities class action suits has increased from 188 in 1995 to 209 in 1999.

The PSLRA is working to protect investors today, and we believe that turning back the meaningful reforms within it will hurt, not help, the public. The PSLRA is working as it was intended.

But perhaps most important, this law has nothing to do with the Enron debacle. Many of its original opponents are simply using current events as an opportunity to revisit old – and unproven – arguments. We ask that you look at the facts to see that the law works well and should be upheld.

Corporate Truthfulness

The AICPA supports legislation that would make it unlawful to improperly influence the audit or mislead auditors. If auditors are not provided with

complete, relevant and accurate information, no system of regulation can protect investors and ensure proper financial disclosure.

Employment Restrictions

Some recent proposals would place additional restrictions on individuals in a company's audit firm from accepting certain senior positions at the client company. Currently, The Independence Standards Board's Independence Standard No. 3 (July 2000) provides that if the engagement partner joins the client within 1 year of disassociating from the audit firm, the audit must be reviewed separately by a professional in the firm who previously was not involved in the audit in order to make sure the audit team exercised the appropriate skepticism. Additional prohibitions will severely limit the number of firms qualified to perform a company's audit because most major companies today employ financial executives who were previously affiliated with various audit firms. Equally troubling, the proposals would effectively dry up the pool of competent individuals that companies could recruit for senior positions and limit career opportunities for all accountants.

Thinking back to our four essential public policy questions, such restrictions on auditor choice and the pool of competent corporate talent might boost confidence in the short run, but will hurt, not enhance financial reporting in the longer term. Such changes are not in the public interest.

Financial Reporting Reforms

The financial reporting system in the United States established almost 70 years ago to stabilize our markets and protect investors is no longer adequate, or even very relevant. The sweeping changes in our economy and the technologies that drive and support it require an equally sweeping overhaul of our financial reporting system to ensure that investors get the information they need – when they need it – to make informed investment decisions.

Financial reporting reforms such as the following are needed:

- Improved disclosures and more timely reporting to investors in "plain English"
- A requirement for registrants to report on internal controls with independent assurance
- Increased resources for the SEC to effectively oversee financial reporting disclosures.

We also strongly encourage Congress to consider the need for additional assurances on other non-financial information for investors, and a modernization of the current business reporting model.

Today there is a mismatch between the needs of financial statement users and the information they receive, a mismatch that disserves both investors and our capital markets. Efforts to modernize business reporting must be accelerated, including changes that address:

- Unreported intangibles
- Off balance sheet activity
- Non-financial performance indicators
- Forward-looking information
- Enterprise opportunity and risk
- Timely reporting

From a broader perspective, we need to focus on:

- A broader "bandwith" of information for investors, a recommendation long advocated by the profession
- New distribution channels that recognize the ubiquity of the Internet as a communications tool
- Increased financial reporting frequency, and ultimately online, real-time reporting.

The AICPA hopes to work with the members of this committee, Congress, the SEC and the Administration to explore thoroughly and thoughtfully the challenges the current environment poses to protecting the public investor. We support meaningful change that meets the public interest test identified at the outset of this testimony: help investors make informed decisions, enhance the quality of audits and financial reporting, restore confidence in the profession and the reporting system, and spur U.S. economic growth.

We will not support simplistic solutions, and we should all be wary of easy solutions that can lead to unintended consequences. With the public interest in mind, when we see such potential, we will not by shy about pointing it out.

On behalf of CPAs around the country, I thank you for the opportunity to present our views today and commend the committee for what we trust will be a thoughtful approach to these important and complex issues.

How to Protect Investors Against Another Enron

James K. Glassman

Resident Fellow, American Enterprise Institute

And

Host, www.TechCentralStation.com

Testimony before a hearing on H.R. 3763, "The Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002"

Committee on Financial Services
U.S. House of Representatives
The Honorable Michael G. Oxley, chairman

March 13, 2002

American Enterprise Institute
1150 17th Street, N.W.
Washington, D.C. 20036
202/862-7198
jglassman@aei.org

Good morning, Mr. Chairman and members of the Committee. Thank you for inviting me to testify today.

My name is James K. Glassman. I am a resident fellow at the American Enterprise Institute for Public Policy Research in Washington, where I concentrate on economics and financial markets. I am also host of the website TechCentralStation.com, which focuses on matters at the intersection of technology, finance and public policy.

Since 1993, I have written regularly on investing for a broad audience. I am currently a weekly syndicated financial columnist for the Washington Post, and my column appears as well in The New York Daily News, the International Herald Tribune and newspapers around the country. My second book "The Secret Code of the Superior Investor," a guide mainly aimed at novices, was published in January and was called the best new investing book of the year by Business Week.

I believe my usefulness to this committee lies in my understanding of the needs, desires and fears of small investors and of the consequences of public-policy measures on the economy and financial markets.

Protection Against Deception:

Investors Apply the Best Discipline

The Enron scandal is primarily a story of executives and auditors deceiving investors about the true state of a business. The question that the legislation before you addresses is how to protect investors against such deception.

"The Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002" (H.R. 3763) makes several changes in current law: mainly, to increase oversight over auditors, to ensure the independence of auditors by barring activities that pose conflicts of interest, and to increase transparency of transactions. In the current overheated atmosphere, the bill is admirably level-headed and restrained, especially in comparison with the "Comprehensive Investor Protection Act" (CIPA). Still, some of H.R. 3763's provisions are troubling. Rather than protecting investors, these provisions may harm them.

In fact, investors do a remarkable job protecting themselves, mainly through a simple system of rewards and punishments. Investors reward good corporate citizens with higher stock prices, and they punish miscreants with lower. Investors have their own unwritten set of rules, and when companies violate them, the retribution is swift and often extreme. Those rules center on trust – essential for the operations of all capital markets. Investors do not tolerate lying in any form. In Enron's case, as soon as it became clear that the firm had deceived them, investors entered a verdict of guilty and applied capital punishment. They didn't wait for a trial; they didn't wait for an SEC investigation. If you lie to us, investors said, then you're dead. They dumped Enron's stock, and a company with a market capitalization of $60 billion in early 2001 and $30 billion as recently as the fall of 2001 became practically worthless by the end of the year.

This is precisely the response we should want from investors: brutality. Similarly, clients of Arthur Andersen, Enron's accounting firm, did not wait for an indictment or a government report. Delta Air Lines, Merck & Co. and Freddie Mac, among others, fired Andersen as their auditor. On March 11, the Wall Street Journal reported that employees

were leaving a sinking ship and that another firm was trying to buy Andersen. While Andersen has had problems in the past, it is safe to say that the Enron episode alone stands a good chance of destroying the 88-year-old firm entirely. That's discipline.

Enron and Andersen executives face possible criminal penalties as well. But even if they did everything by the letter of the law – and GAAP accounting – investors and clients would have exacted severe punishment.

In the face of such a ferocious reaction, one wonders why Congress is considering, in 10 committees and at least 32 bills, new laws. Congress has played an important role in exposing the details of the scandal to the public and in calling the participants to account publicly. This committee deserves particular praise. Voltaire once said, "In this country it is a good thing to kill an admiral from time to time to encourage the others." That is, to encourage the others to behave. The Enron case has definitely encouraged better behavior. Many companies have reacted quickly with more disclosure than the law now requires, the most recent example being General Electric. Firms foolish enough to believe that they could deceive investors and get away with it are now on notice. Firms with questionable balance sheets and income statements have suffered sharp price declines since the Enron scandal broke. If investors and analysts had been dozing before, they are wide awake now.

The market incentives for responsible corporate governance and accurate accounting are powerful. With more than 8,000 publicly traded companies from which to choose, why should investors buy shares in those that aren't forthcoming? A recent study by Paul Gompers, Joy Ishii and Andrew Merrick, published by the National Bureau of

Economic Research,[1] found that "a portfolio strategy based on purchasing shares in companies with the strongest investor protections and selling short those firms with the greatest management power earned an abnormal return of [that is, beat the broad market by] 8.5 percent a year."

In addition, short sellers have an enormous incentive to expose corporate wrongdoing. If they are right, they can make millions of dollars. Bethany McLean of Fortune broke the story of Enron's deception after she was tipped off by James Chanos, who heads Kynikos, an investment firm that specializes in selling stocks short – that is, betting that they will fall.

After the Enron scandal entered full public consciousness in December, the media carried stories claiming that, as a result, investors were losing faith in the stock market in general. Instead, while investors have become more vigilant, they have not responded by dumping shares across the board. In fact, in January 2002, according to the Investment Company Institute, investors added $19.6 billion more than they took out – the largest such net gain in many months.

Investors have done the right thing. They have continued to buy stocks, but they have exacted terrible retribution against Enron and against other firms suspected of deceiving them. Now, Congress wants to enter the picture with additional remedies….

[1] "Corporate Governance and Equity Prices" (NBER Working Paper No. 8449). Summary at National Bureau of Economic Research website: http://www.nber.org/digest/dec01/w8449.html

What Should Not Be Done

Auditor Independence. H.R. 3763 would bar accounting firms from providing the same publicly traded corporate client with both external audit services and either financial-information system design or implementation services or internal audit services. The CIPA, introduced by the ranking member of this committee also forbids a long list of activities, including appraisal or valuation, "expert services" and just about anything else.

But the enthusiasm for these "independence" rules is misguided.

The Securities and Exchange Commission failed to achieve enactment of such regulations in 2000 "primarily because of a lack of evidence demonstrating that providing non-audit services does, in fact, compromise auditor independence," write Zoe-Vonna Palmrose, professor of auditing at the University of Southern California, and Ralph S. Saul, a former director of the SEC's division of trading and markets, president of the American Stock Exchange and chairman of CIGNA Corp, in an extensive article in Regulation.[2] The SEC began examining this issue in the late 1950s, and, since then, "the question of whether non-audit services compromise audit firm independence or cloud the appearance of independence has been studied and investigated by numerous government and self-regulatory commissions and committees. None of the studies recommended the separation of auditing from consulting."[3] The SEC, in its latest attempt, "produced no empirical evidence of abuse."[4] Indeed, one study found that in 25 percent of cases, the

[2] "The Push for Auditor Independence," Regulation, Winter 2001, pp. 18-23.
[3] Ibid, p. 19.
[4] Ibid, p. 20.

provision of both audit and non-audit services "had a positive impact on the effectiveness of the audits."[5]

But the Commission was apparently not so worried about empirical evidence. The SEC's response in a June 2000 statement was that "studies cannot always confirm what common sense makes clear."[6]

Nor has clear evidence established yet of a link between auditor independence question and the deception practiced at Enron. On the contrary. The theory put forth by advocates of "independence" rules is that companies use the high fees involved in contracts for non-audit services in order to bribe accounting firms to produce deceptive audits that favor the company. The average company among the 30 Dow Jones Industrials paid its auditor three times as much for non-audit as for audit work. Enron, however, paid Andersen $25 million for audit work and $27 million for non-audit. The audit payments were exceeded by only one Dow company (Citigroup) while the non-audit payments were exceeded by thirteen. The ratio of non-audit to audit work for Enron was lower than that of all but three of the 30 Dow companies.[7]

It is true that investors should be concerned about the audit-bias problem. After all, the company that pays the auditors wants to put the best face on its financial results, while the auditing firm is supposed to be presenting the material fairly. That's a real-life conflict, and reducing it is the reason audit committees were invented and the reason that investors take financial statements so seriously. But why should forbidding non-audit work solve the problem? After all, it is just as easy to bribe accountants directly: just

[5] Ibid., p. 21.
[6] Ibid.
[7] "Blue-Chip Companies, Blue-Chip Fees," sidebar, Wall Street Journal, March 7, 2002, p. C1

pump up the fees for audit work. Instead of $10 million for a typical large-company audit, why not slip the accountants an extra $5 million?

While evildoers lurk in the corporate world as well outside it, the main reason that such respected companies as McDonald's, General Motors, DuPont and ExxonMobil use the same firms for both audit and non-audit work is not that this combination provides some kind of nefarious leverage but because a technology revolution has occurred in the infrastructure of American businesses – one that has greatly benefited the economy, as Federal Reserve Chairman Alan Greenspan noted in his testimony before this committee on Feb. 27.[8] A thorough audit requires a thorough knowledge of the information-technology systems of a complex global corporation, and often the auditing firm is in the best position to provide such non-auditing services. Clearly, having one firm do both jobs lowers overall costs, and forcing companies to divide the job is economically inefficient. It will add expenses, lower profits and, inevitably, lower stock prices. That hurts investors; it doesn't help them.

But will auditor independence increase investor confidence, lowering risk aversion and boosting stock values in the long run? That's a dubious proposition. If the conflict is so threatening to investors, then why, at least before Enron, did companies that separate the functions not advertise to shareholders and potential shareholders that they were free of conflicts?

The Congress and the SEC should not substitute their judgment of who should provide accounting services for the judgment of the companies that actually buy those services. Similarly, as Palmrose and Saul note, "There is not just one model for

[8] See http://www.federalreserve.gov/boarddocs/hh/2002/February/Testimony.htm

organizing accounting firms, and…each firm, not the SEC, should be able to define the particular model for that firm."[9]

Auditor Oversight. The legislation proposes a public regulatory organization (PRO) to oversee the accounting profession. As I stated earlier, the discipline provided by investors, clients and suppliers, as well as current criminal and civil laws and SEC regulations, offer adequate protections currently. The constitution of a particular board is not the problem. Why should the accounting profession be subject to a PRO when the professions of the law, journalism and politics are not? Misbehavior by professionals in these arenas can be at least as destructive as misbehavior by accountants.

But if an oversight board is created, the guidelines offered in H.R. 3763 are far superior to those in CIPA, which says, in effect, that the SEC and the General Accounting Office (which, I don't have to remind you, is a congressional agency) should run the accounting industry.

Increasing the Complexity of Accounting Rules. Government officials need to understand that the complex nature of American corporations means that every loophole cannot be plugged, every possible deception and distortion cannot be remedied with a new rule. In this regard, the Europeans, believe it or not, have a better approach than do the Americans. In a recent interview in the Financial Times, Frits Bolkestein, the European Commision's commissioner for internal markets, stated, "Having rules is a good thing, but having rigid rules is perhaps not the best thing. You must give an

[9] Regulation, p. 19.

accountant a certain latitude to use his judgment. It's not merely a question of ticking boxes."[10]

The Economist recently put it well: "There are two main approaches to rule-setting. One is to define precisely how to deal with each and any situation. The other is to spell out rough principles and let auditors decide how to apply them. America has typically gone for precise rules rather than broad principles.... If the rule says that above 10 percent an item should be shown, then those with something to hide go for 9.9 percent."[11]

Harvey Pitt, the SEC commissioner, has said that "the current system of disclosure is designed to avoid liability, not to inform anybody."[12] I read 10-K and 10-Q statements all the time. I understand this stuff, but I yearn for a plain-English explanation of what is going on within a company. The answer is not more numbers and legalese but more leeway for auditors and corporate executives to explain the true health of a company. That requires two things: 1) a loosening of current rules, and 2) strict accountability by companies and auditors. I strongly agree with President Bush's call to make CEOs personally responsible for the financial statements of their companies. Another point in the President's plan "to improve corporate responsibility and protect America's shareholders" was, "The authors of accounting standards must be responsive to the needs of investors."[13] Absolutely. But this means giving them more flexibility, not less. Andersen should been able to tell shareholders, "The books of Enron are consistent

[10] "Bolkestein: a breath of fresh air or maverick who shoots from the hip?" Financial Times, Feb. 21, 2002, p. 4.
[11] "When the numbers don't add up," The Economist, Feb. 9, 2002, p. 58.
[12] Ibid, p. 60.
[13] See http://www.whitehouse.gov/news/releases/2002/03/20020307.html.

with GAAP, but shareholders should be aware of the hundreds of off-balance-sheet entities that carry heavy liabilities."

What Should Be Done

Real-Time Disclosure. I strongly agree with Section 4 of H.R. 3763, which requires that officers and directors disclose sales of company stock to the SEC before the end of the business day after the transaction and made available to the public by the SEC on the day after that. I would go further, requiring contemporaneous information (that is, within an hour) to be released directly to the public on both sales and purchases. News of such sales and purchases is important information that could signal the true state of corporate health. Investors need to know it in minutes, not in 40 days.

Improper Influence on Conduct of Audits. Section 3 of H.R. 3763 correctly states that it should be unlawful for corporate officers to "improperly influence" accountants into "rendering...financial statements materially misleading.

Blackout Periods and Restrictions on Selling Company Stock. Section 5 states that, if participants in a 401(k) are prohibited during a transition period from selling their company stock, then officers and directors who own company stock outside the plan should be prohibited from selling as well. This is a fair, confidence-building measure. In addition, I favor a ban on any restriction on the transfer of company stock by employees

within a 401(k) plan. Enron employees, for example, could not transfer company stock (given to them by Enron) until age 50. A simple rule should be that every asset in a 401(k) plan must be a marketable security or mutual fund. No lettered or restricted stock, period.

End Double-Taxation of Dividends. Cash dividends are the clearest, most transparent evidence of corporate profits. An investor who sees dividends increasing every year can, properly, have confidence in a company. But dividends are taxed twice – both at the corporate and the personal level – and, mainly as a result, fewer public companies now pay dividends than ever in history and dividends represent a smaller and smaller proportion of total earnings. Ending double taxation of dividends would increase payouts and vastly increase investor confidence. I realize that this matter goes beyond the committee's jurisdiction, but it is probably the single most important legislative step that can be taken to protect shareholders.

Treat Options as Expenses. Currently, accounting rules do not treat as immediate expenses most options granted to employees. Therefore, companies have an incentive to pay executives with options, even if such compensation does not make economic sense. Options often provide the wrong incentives for executive behavior, pushing them to boost profits in the short run, by whatever means. But, more important, options are a real expense – they are things of value given as compensation by the shareholders – and they should be treated that way.

Peripheral Issues

Analyst Conflicts of Interest. H.R. 3763 calls for a study of "matters involving equity research analyst conflicts of interest." The CIPA goes much farther, requiring, for example, that "analyst compensation not be based on investment banking revenue" and that criteria be established to ensure that "analyst compensation be principally based on the quality of the equity analyst's research."

In my testimony last year before this committee's subcommittee on capital market, insurance and government-sponsored enterprises, I stated, "There is little doubt that conflicts of interest pervade the securities industry." In fact, they pervade life – even journalism. For example, a study by the Roper Center of 139 Washington bureau chiefs in 1992 found that 89 percent said that they voted for Bill Clinton and just 7 percent for George Bush. Yet I doubt that a single one of these journalists would admit to bias in reporting – and most would probably be correct. Analysts are torn by conflicts, just as politicians and journalists and mothers and fathers are, but ultimately their judgments about companies are out there for the public to assess. An analyst who recommends bad stocks in an effort to sell investment banking services will be an analyst who will ultimately lose his job.

A study of 360,000 recommendations by 4,340 analysts over a 10-year period by Brad Barber of the University of California at Davis and other economists, published in the April 2001 issue of The Journal of Finance, found that analysts' top stock selections

beat the market benchmark by a remarkable 4.1 percentage points annually and their lowest-ranked selections trailed the market by 4.9 percentage points.[14]

A further public airing and more studies of this issue would not be fruitless, but blaming the stock-market decline or the collapse of Enron on stock analysts is inaccurate and misleading. It wasn't just analysts who were wrong on Enron. Large institutions, with skilled research staffs, including Fidelity and Janus, the giant mutual fund houses, had invested heavily in Enron stock as well.

Repealing Litigation Reform. On Dec. 22, 1995, the Senate joined the House in overriding President Clinton's veto of the Private Securities Litigation Reform Act of 1995. The vote in the House was 319-100; in the Senate, 68-30. The bill scaled back the excesses involved in often-frivolous securities fraud cases brought by a small group of politically generous plaintiffs lawyers. "California's high-tech industries, in particular, have suffered from lawsuits aimed more at squeezing out settlements than righting wrongs," said the Fresno Bee in an editorial at the time.[15] The law took such steps as barring "professional plaintiffs" from being named in more than five class-action lawsuits in a three-year period and requiring plaintiffs to cite the concrete facts of each allegation of fraudulent behavior. Lawsuits to recover damages for securities fraud have continued since 1996, but the law redressed a severe imbalance and it undoubtedly helped high technology prosper and the U.S. economy expand.

Now, some in Congress have decided that these moderate reforms were responsible for the Enron excesses. If only plaintiffs' attorneys could have sued Enron, it

[14] The Barber study and quotations are from my testimony, "The Analyst Paradox: If They're So Plagued With Conflicts, Why Do They Do Such a Good Job?" June 14, 2001. See www.aei.org.
[15] Fresno Bee, "Curbing stock swindles," editorial, Dec. 13, 1995, p. B6.

would have brought the company back to the straight and narrow. In fact, of course, attorneys could have sued Enron earlier, and they are certainly suing Enron and its auditor, Arthur Andersen today. Repealing this reform would not protect shareholders; it would hurt them by forcing their companies to make payments of tribute and distracting executives who should be focusing on managing their firms.

Conclusion

In times of scandal, emotions run high, and the urge to rush in with legislative remedies is understandable. But it should be resisted. Parts of H.R. 3763 are admirable, but the bill goes too far in trying to substitute the economic judgment of regulators for that of investors, clients and managers. Ultimately, legislation of this sort diminishes earnings and depletes corporate value – a loss not just to executives but, in a nation in which half of all households own stock, to small investors as well.

Market discipline and current criminal and civil laws provide powerful remedies and protections against another Enron already.

As a financial columnist, what bothers me most about this legislation – and, far more, what bothers me about CIPA -- is that it sends the wrong signal to investors. When stocks decline, the underlying logic of this legislation goes, someone must be doing something illegal or immoral. Analysts and accountants are the current targets. This is absolutely the wrong message to send investors. They need to understand that the stock market is a risky place and that they themselves are responsible, in the end, for their own

investments. Yes, the market provides the threat of punishment, but bad things still happen to the best of investors, and he only protection is diversification.[16]

For that reason, my focus as a remedy would not be to change accounting rules but to educate investors. We don't want to scare them out of the market – and so far they have not been scared. We want instead to get more of them into the market. The best way to do that is to inform them of the true risks and rewards of investing.

Thank you.

[16] See my op-ed piece, "Diversify, Diversify, Diversify," Wall Street Journal, Jan. 18, 2002.

TESTIMONY OF TED WHITE

DIRECTOR OF CORPORATE GOVERNANCE

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

Before the U.S. House of Representatives

Committee on Financial Services

March 13, 2002

Chairman Oxley, Ranking Member LaFalce and distinguished members of the committee, my name is Ted White and I am the director of corporate governance for the California Public Employees' Retirement System (CalPERS). On behalf of CalPERS' Board and myself, I thank you for the opportunity to testify before the committee today to discuss issues that are so important to our capital markets.

CalPERS is the largest public pension system in the world, with an investment portfolio of more than $155 billion. These assets are all held in trust for the benefit of over 1.2 million current and retired public servants from our state, and their families. CalPERS' assets are allocated among fixed income instruments, real estate, equities and other investments. Our investments in the US stock market alone are currently valued at some $67 billion.

CalPERS has long been a vocal and leading advocate of effective corporate governance. We strongly believe that, as owners of the corporations in which we invest, shareholders have both the right and a duty to hold corporate boards and managers accountable for their performance. Concepts of accountability and transparency are widely recognized as being the cornerstone of a successful corporate

governance model, and as being the foundation of this country's financial markets. Unfortunately, the events of these past months have also demonstrated that basic ethics – something that we all may have presumed was built into our business cultures – must also be a concern for today's investors.

With this background, I would like to focus on two key legislative issues and several other regulatory matters. The two legislative issues concern auditor independence and oversight of the accounting industry.

CalPERS was pleased to see that both Chairman Oxley's bill and Ranking Member LaFalce's bill include provisions on these important topics. Thank you, both, for recognizing the need for Congress to address these issues. We look forward to working with the committee as these proposals are debated in the weeks ahead.

AUDITOR INDEPENDENCE

On the issue of auditor independence, CalPERS believes that there is currently a crisis of confidence with the accounting industry. The independence of accounting firms that audit the financial statements of public companies must be beyond reproach. Investors, large and small alike, must be able to trust that when an auditor says a company's books are accurate, then they are accurate. The Enron-Andersen situation has prompted this erosion of investor confidence, due in large part, to the obvious conflict of interest created when an external auditor is simultaneously receiving fees from the company for non-audit work – fees which in most cases dwarf the firm's audit revenues. How can we trust that the auditor's sign off on the company's financial statements – in its exercise of the discretion that is inherent in evaluating the

aggressiveness of management's numbers – is not at least unconsciously influenced by a desire to keep a well-paying client happy?

We understand that there has been, and will continue to be, much debate over where to draw the line between "audit" and "non-audit" services. As one investor, CalPERS believes the line should be drawn so as to place a bright line ban on external auditors simultaneously providing consulting or internal audit services to a client. A firm should be an auditor or a consultant; not both to the same client.

Of course, by eliminating lucrative consulting fees, auditors may become even more reliant on audit fees. For this reason, CalPERS believes there should be a system of mandatory rotation of a company's external auditors. CalPERS has suggested a five- to seven-year limit. Although we recognize that there is a cost to the inherent training curve for a newly-retained auditor, we believe this cost is more than outweighed by the benefits of both "fresh eyes" and renewed investor confidence. In this context let me note that, under California state law, CalPERS is required to change its external auditor every five years. This is not easy for a financial institution of our size and complexity, but we do it.

OVERSIGHT OF THE ACCOUNTING INDUSTRY

Turning to the supervision of the accounting industry, we again applaud the efforts of this committee, SEC Chairman Pitt and President Bush for identifying the need to strengthen the oversight of auditors and accountants.

The Public Oversight Board has done a fine job since its creation in 1977, but our capital markets and corporate finance structure have changed dramatically in the last 25

years. It is now time to update the accounting industry's oversight to reflect these changes.

In principle, CalPERS believes that a public accounting regulator must represent the interests of end-users—that is, investors and those whom investors rely upon (for example, Wall Street analysts). This representation is best assured through the composition of the entity's governing body. The new entity must also have the power to effectively investigate, adjudicate and discipline the industry, and it must have a stable funding source that is independent of both the corporate community and the accounting industry. We also believe that, while the SEC should oversee this new entity and will clearly need to adopt regulations to assist it in its work, the creation of the new entity, its charter and scope of authority, at a minimum, must be established by Congress.

OTHER CORPORATE GOVERNANCE ISSUES

CalPERS also believes that, in addition to the principles of corporate governance that we adopted in 1998 (attached to my written testimony), additional issues have arisen in these initial post-Enron, post-Global Crossing days. These include:

- Strengthening the competency of a corporation's audit committee. This requires providing market guidance as to what it means to be "financially literate;" requiring that more than simply one committee member possess these skills; and requiring minimum training standards for all members of audit committees.
- Strengthening the independence of outside directors by requiring greater disclosure of potential conflicts of interest;

- Scrutinizing the roles of investment banks, Wall Street analysts, rating agencies, lending institutions, liability insurance carriers, outside attorneys and other consultants; and
- Reforming accounting standards so that they more accurately reflect the current complexities of financial structures (including addressing Special Purpose Entities or Vehicles), and are capable of changing to adapt to rapid market developments.

Allow me to expand on this last point for a moment.

We think these revisions can and should be made by the Financial Accounting Standards Board (FASB). CalPERS believes that FASB serves a vital role in our system of financial reporting. However, because of a myriad of budgetary and political reasons, it is slow to produce new, comprehensive rules. I recently heard that it's been working on developing a rule for SPEs for nearly 20 years. No offense, but even Congress acts quicker than that.

We think FASB should also have a stable, independent funding source so that it may have the resources necessary to more effectively and efficiently address such matters. In addition, we believe the SEC should hold FASB's feet to the fire on producing needed rules in a more timely manner.

Finally, CalPERS was pleased to support HR 1088, the Investor and Capital Markets Fee Relief Act, because of both the SEC fee reduction and pay parity aspects. In fact, CalPERS CEO Jim Burton testified in support of its sister bill in the Senate last year. However, thus far only the fee reduction component has been implemented and

we would like to express our strong desire that pay parity for the SEC staff be fully funded by Congress this year.

CONCLUSION

In conclusion, CalPERS is pleased that the members of this committee are taking such a thoughtful and constructive approach to addressing the financial reporting issues stemming from the Enron collapse. We believe Congress must play an important role in helping to restore investor confidence by improving auditor independence, enhancing accounting oversight, providing regulators with the power and resources to effectively regulate these industries and encouraging interested market participants to assist them where practical.

Thank you again for the opportunity to testify today and I would be pleased to answer any questions you may have.

THE CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

CORPORATE GOVERNANCE CORE PRINCIPLES & GUIDELINES
April 13, 1998

The United States

"Everywhere shareholders are re-examining their relationships with company bosses – what is known as their system of 'corporate governance.' Every country has its own, distinct brand of corporate governance, reflecting its legal, regulatory and tax regimes... The problem of how to make bosses accountable has been around ever since the public limited company was invented in the 19th century, for the first time separating the owners of firms from the managers who run them...."

"Corporate Governance: Watching the Boss," THE ECONOMIST 3 (Jan. 29, 1994).

California Public Employees' Retirement System
Lincoln Plaza - 400 P Street - Sacramento, CA 95814

I. INTRODUCTION

CalPERS' Corporate Governance[1] Program is a product of the evolution that only experience and maturity can bring. In its infancy in 1984-87, corporate governance at CalPERS was solely reactionary: reacting to the anti-takeover actions of corporate managers that struck a dissonant chord with one's sense – as the **owners**[2] of the corporate entity – of accountability and fair play. The late 1980s and early 1990s represent a period in which CalPERS learned a great deal about the "rules of the game" – how to influence corporate managers, what issues are likely to elicit fellow shareowner support, and where the traditional modes of shareowner/corporation communication were at odds with current reality.

Beginning in 1993, CalPERS turned its focus toward companies considered, by virtually every measure, to be "poor" financial performers. By centering its attention and resources in this way, CalPERS could demonstrate to those who questioned the value of corporate governance very specific and tangible economic results.[3]

What have we learned during these past dozen years? We have learned that (a) company managers want to perform well, in both an absolute sense and as compared to their peers; (b) company managers want to adopt long-term strategies and visions, but often do not feel that their shareowners are patient enough; and (c) all companies – whether governed under a structure of full accountability or not – will inevitably experience both ascents and descents along the path of profitability. We have also learned, and firmly embrace the belief that good corporate governance – that is, *accountable governance* – means the difference between wallowing for long (and perhaps fatal) periods in the depths of the performance cycle, and responding quickly to correct the corporate course. As one commentator noted:

---

[1] "Corporate Governance," at CalPERS, means the "relationship among various participants in determining the direction and performance of corporations. The primary participants are (1) shareowners, (2) management (led by the chief executive officer), and (3) the board of directors." (Robert A.G. Monks and Nell Minow, CORPORATE GOVERNANCE 1 (1995).)

[2] Throughout this document, CalPERS has chosen to adopt the term "shareowner" rather than "shareholder." This is to reflect our view that equity ownership carries with it active responsibilities and is not merely passively "holding" shares.

[3] See Steven L. Nesbitt, "Long-Term Rewards From Shareholder Activism: A Study of the 'CalPERS Effect'," J. OF APP. CORP. FIN. 75 (Winter 1994) [concluding that CalPERS' program generates approximately $150 million, per year, in added returns].

> *"Darwin learned that in a competitive environment an organism's chance of survival and reproduction is not simply a matter of chance. If one organism has even a tiny edge over the others, the advantage becomes amplified over time. In 'The Origin of the Species,' Darwin noted, `A grain in the balance will determine which individual shall live and which shall die.' I suggest that an independent, attentive board is the grain in the balance that leads to a corporate advantage. A performing board is most likely to respond effectively to a world where the pace of change is accelerating. An inert board is more likely to produce leadership that circles the wagons."*

Ira M. Millstein, New York Times, April 6, 1997, Money & Business Section, at p. 10.

Now, with the benefit of its experience, CalPERS is embarking on its next evolutionary step. With the Corporate Governance Core Principles and Guidelines that follow, CalPERS speaks not only to today's underperformers, but also to tomorrow's.

II. PURPOSE

The document that follows is separated into two components: **Core Principles** and **Governance Guidelines**. CalPERS believes the criteria contained in **both** the Principles and the Guidelines are important **considerations** for all companies within the U.S. market. However, CalPERS does not expect nor seek that each company will adopt or embrace every aspect of either the Principles or Guidelines. CalPERS recognizes that some of these may not be appropriate for every company, due to differing developmental stages, ownership structure, competitive environment, or a myriad of other distinctions. CalPERS also recognizes that other approaches may equally – or perhaps even better – achieve the desired goal of a fully accountable governance structure. CalPERS has adopted these Principles and Guidelines to advance the corporate governance dialogue by presenting the views of one shareowner, but not to attempt to permanently enshrine those views. As one shareowner, CalPERS believes that the **Core Principles** represent the **foundation** for accountability between a corporation's management and its owners. The **Guidelines** represent, in CalPERS' view, additional features that may further advance this relationship of accountability.

III. CORE PRINCIPLES

A. Board Independence & Leadership

Independence is the cornerstone of accountability. It is now widely recognized throughout the U.S. that independent boards are essential to a sound governance structure.[4] Therefore, CalPERS suggests:

1. **A *substantial majority* of the board consists of directors who are independent.[5]**

2. **Independent directors meet periodically (at least once a year) alone, without the CEO or other non-independent directors.[6]**

But the independence of a majority of the board is not enough. The ***leadership*** of the board must embrace independence, and it must ultimately change the way in which directors interact with management.

> *"In the past, the CEO was clearly more powerful than the board. In the future, both will share influence. In a sense, directors and the CEO will act as peers. Significant change must occur in the future if boards are to be effective monitors and stimulators of strategic change. Directors and their CEOs must develop a new kind of relationship, which is more complex than has existed in the past. . . ."*

Jay W. Lorsch, "The Board as A Change Agent," THE CORPORATE BOARD 1 (July/Aug, 1996).

---

[4] The National Association of Corporate Directors' (NACD's) Blue Ribbon Commission on Director Professionalism released its report in November 1996. (Hereafter "NACD Report".) The NACD Report calls for a "substantial majority" of a board's directors to be independent. This report also suggests that independence "may be compromised by" reciprocal directorships ("director interlocks"); existing significant consulting or employment relationships between the director and the company; existing substantial commercial relationships between the director's organization and the board's company; and new business relationships that develop through board membership. (NACD Report, at p. 9-10.) The Business Roundtable's Statement on Corporate Governance (September 1997, hereafter "BRT Statement") is in general accord that a "substantial majority" of directors should be "outside (non-management)." (BRT Statement, at p. 10.) The BRT, however, believes that financial relationships between directors and the company should be evaluated on a case-by-case basis "rather than through the application of rigid criteria." (BRT Statement, at p. 11.)

[5] The definition of "independence" is discussed in part IV, Governance Guidelines, below.

[6] BRT Statement, at p. 17.

To instill independent ***leadership***, CalPERS suggests:

3. When the chair of the board also serves as the company's chief executive officer, the board designates – formally or informally – an independent director who acts in a *lead capacity*[7] to coordinate the other independent directors.

4. Certain board committees consist *entirely* of independent directors. These include the committees who perform the following functions:

Audit
Director Nomination
Board Evaluation & Governance
CEO Evaluation and Management Compensation[8]
Compliance and Ethics[9]

Lastly, independence also requires a lack of conflict between the director's personal, financial, or professional interests, and the interests of shareowners.

> *"A director's greatest virtue is the independence which allows him or her to challenge management decisions and evaluate corporate performance from a completely free and objective perspective. A director should not be beholden to management in any way. If an outside director performs paid consulting work, he becomes a player in the management decisions which he oversees as a representative of the shareholder...."*

Robert H. Rock, Chairman NACD, DIRECTORS & BOARDS 5 (Summer 1996).

---

[7] The potential duties of a "lead independent director" are illustrated in Appendix A. See also NACD Report, at p. 4 ["Boards should consider formally designating a non-executive chairman or other independent board leader. If they do not make such a designation, they should designate, regardless of title, independent members to lead the board in its most critical functions . . . ."]. "The BRT also believes that it is desirable for directors to have an understanding as to how non-executive leadership of the board would be provided, whether on an ongoing basis or on a rotational basis if and whether the need arose." (BRT Statement, at p. 13.) A recommended definition of "independent director" is provided in Appendix B-1. Appendix B-2 contains a matrix of some of the differing definitions of this term that currently exist.

[8] See NACD Report, at p. 5.

[9] See Harvey L. Pitt, Karl A. Groskaufmanis, and Vasiliki B. Tsaganos, "Talking the Talk and Walking the Walk: Director Duties to Uncover and Respond to Management Misconduct," CLIENT LETTER FROM FRIED, FRANK, HARRIS, SHRIVER & JACOBSON, Feb. 21, 1997, at p. 5.

Accordingly, CalPERS recommends that:

5.	**No director may also serve as a consultant or service provider to the company.**[10]
6.	***Director compensation* is a combination of *cash and stock* in the company. The stock component is a significant portion of the total compensation.**[11]

B. Board Processes & Evaluation

No board can truly perform its overriding functions of establishing a company's strategic direction and then monitoring management's success without a system of evaluating itself.

CalPERS views this self-evaluation to have several elements, including:

1.	**The board has adopted a written statement of its own *governance principles*[12], and regularly re-evaluates them.**
2.	**With each director nomination recommendation, the board considers the *mix of director characteristics, experiences, diverse perspectives and skills* that is most appropriate for the company.**[13]

[10] "A firm's board of directors owes its fiduciary responsibilities to the common stockholders of the firm. If the directors also serve as consultants to the firm's management, then their willingness to confront management when they think they have done something wrong is limited -- for to confront management is to risk the loss of those management consulting fees. Even if directors are not swayed by the prospect of losing their consulting fees, academic studies indicate that investors appear to view the prospect that they might as sufficient reason to discount the firm's shares." (John D. Martin and Robert Parrino, "Using Directors as Consultants," DIRECTORS & BOARDS 32, 35 (Summer 1996).)

[11] See NACD Report at p. 5, referring to 1995 Report of the NACD Blue Ribbon Commission on Director Compensation. See also GM BOARD OF DIRECTORS CORPORATE GOVERNANCE GUIDELINES ON SIGNIFICANT CORPORATE GOVERNANCE ISSUES (Adopted January 1994; Revised August 1995; hereafter "GM Guidelines"); Guideline No. 13.

[12] General Motors is perhaps the most well known company to have formally adopted governance principles. However, as of May 1995, nearly 70% of the largest 300 U.S. companies had also adopted written governance principles.

[13] CalPERS does not believe that each director must possess all of the core competencies. Rather, following the conclusion of the NACD Report, we believe that *each* director should contribute some knowledge, experience or skill in at least *one* domain that is critical to the company. (See NACD Report, at p. 8-9.) In addition, CalPERS believes that consideration of the appropriate director skill mix should also include consideration of obtaining a diversity of experiences and perspectives within the board. (See BRT Statement, at p. 7.)

3. The board establishes *performance criteria* for itself., and periodically reviews board performance against those criteria.[14]

4. The independent directors establish *performance criteria and compensation incentives for the CEO, and regularly reviews the CEO's performance against those criteria.*[15] The independent directors have access to *advisers* on this subject, who are independent of management. Minimally, the criteria ensure that the CEO's interests are aligned with the long-term interests of shareowners, that the CEO is evaluated against comparable peer groups, and that a significant portion of the CEO's total compensation is at risk.

C. Individual Director Characteristics

In CalPERS' view, each director should add something unique and valuable to the board as a whole. Each director should fit within the skill sets identified by the board (see B.2, above). No director, however, can fulfill his or her potential as an effective board member without a personal dedication of time and energy and an ability to bring new and different perspectives to the board.

1. The board has adopted guidelines that address the *competing time commitments* that are faced when director candidates serve on multiple boards. These guidelines are published annually in the company's proxy statement.[16]

IV. GOVERNANCE GUIDELINES

[14] See NACD Report, at p. 16-17. See also BRT Statement, at p. 9.

[15] See BRT Statement , at p. 5.

[16] See NACD Report, at p. 10-12 [recommending that candidates who are CEOs or senior executives of public corporations be "preferred" if they hold no more than 1-2 public company directorships; other candidates who hold full-time positions be preferred if they hold no more than 3-4 public company directorships; and all other candidates be preferred if they hold no more than 5-6 other public company directorships.] See also BRT Statement, at p. 8. However, surveys indicate that directors spend an average of 190 hours per year preparing for and attending each organization's board and committee meetings. (Jeremy Bacon, CORPORATE BOARDS AND CORPORATE GOVERNANCE, 22-24 (New York, The Conference Board, 1993.) With this level of time commitment, CalPERS believes that limitations greater than recommended by the NACD may be appropriate. "The job of being the CEO of a major corporation is one of the most challenging in the world today. Only extraordinary people are capable of performing it adequately; a small portion of these will appropriately be able to commit some energy to directorship of one other enterprise. No CEO has time for more than that." (Robert A.G. Monks, "Shareholders and Director Section", DIRECTORS & BOARDS (Spring 1995), as quoted in Autumn 1996 volume at p. 158.)

Section III (above), containing the Core Principles, represents CalPERS' view of elements of corporate governance that form the foundation of accountability between a corporation's managers and its owners. During its decade-long experience in examining governance structures, however, CalPERS has found that there are many additional features that are important considerations in the continuing evolution of "corporate governance." The importance of these issues often varies from company to company, depending upon the unique composition of each board, and the special challenges that each company faces. CalPERS offers the following Governing Guidelines as additional topics for discussion in the governance dialogue.

A. Board Independence & Leadership

1. **Corporate directors, managers and shareowners should come together to agree upon a uniform definition of "independence." Until this uniformity is achieved, each corporation should publish in their proxy statement the definition adopted or relied upon by its board.**

2. **With each director nomination recommendation, the board should consider the issue of continuing director tenure and take steps as may be appropriate to ensure that the board maintains an openness to new ideas and a willingness to critically re-examine the status quo.**

Nearly all corporate governance commentators agree that boards should be comprised of at least a majority of "independent directors" (with a growing trend toward a "substantial majority, see III.A.1 above). There is, however, no current agreement as to what constitutes "independence."[17] Despite these varying opinions, CalPERS believes an opportunity now exists for those involved in this debate to come together to craft a definition that generally meets the needs of all. Toward this end, CalPERS offers the definition attached as **Appendix B-1**.

[17] Many definitions exist, in statutes affecting certain purposes (e.g., section 16(m) of the Internal Revenue Code, section 16 of the Securities Exchange Act of 1934), in national exchange listing standards, and as endorsed by different governance participants. Appendix B-2 contains a matrix of some of the existing variations on this concept.

3. When selecting a new chief executive officer, boards should re-examine the traditional combination of the "chief executive" and "chairman" positions.

There has been much debate concerning the wisdom, and feasibility, of an "independent chair" structure in American corporate culture. Although this structure is more common in European corporations[18], it remains the exception in the United States. CalPERS believes, however, that *true* board independence may ultimately – within the next decade – require a serious re-examination of this historic combination of powers.[19]

CalPERS also believes that much of the current debate in the U.S. is the result of uncertainty, and a lack of a clear definition of the role of an independent chair. Many commentators are concerned that such a position would undermine the CEO, confuse accountability, and disrupt daily company operations. CalPERS agrees that an independent chair should not effectively equate to a "co-CEO" role; rather, CalPERS sees the role as – although vital – quite narrow. To promote further dialogue of this issue, CalPERS offers in **Appendix C** a possible "Independent Chair Duty Statement."

[18] In a recent study of the impact within the United Kingdom market of separating, or combining, the roles of CEO and chair, the author found a "significant positive market reaction . . . followed the separation of the responsibilities of chairman and CEO." Also, companies that announced a separation subsequently performed better than their counterparts based on several accounting measures. Conversely, companies that announced combination of the positions resulted in "the largest negative market response the day after the announcement." (J. Dahya et al., "The Case for Separating the Roles of Chairman and CEO: An Analysis of Stock Market and Accounting Data," 4 CORP. GOVERNANCE 71, 76 (1996).)

[19] "The function of the chairman is to run board meetings and oversee the process of hiring, firing, evaluating, and compensating the CEO . . . . Without the direction of an independent leader, it is much more difficult for the board to perform its critical function." (Michael C. Jensen, "Presidential Address: The Modern Revolution, Exit and the Failure of Internal Control Systems," 48 J. OF FIN. 831, 866 (1993).) "Wearing both hats is like grading your own paper." (Anne Hansen, deputy director of the Council of Institutional Investors, as quoted in "A Walk on the Corporate Side," TRUSTEE 9, 10 (Nov/Dec. 1996).) See also, Constance E. Bagley and Richard H. Koppes, "Leader of the Pack: A Proposal for Disclosure of Board Leadership Structure," 34 SAN DIEGO L. REV. 149, 157-158.

B. Board Processes & Evaluation

In addition to the processes described in the Core Principles, above, CalPERS recommends that boards consider the following:

1. **The board should have in place an *effective CEO succession plan*, and receive periodic reports from management on the development of other members of senior management.**

2. **All directors should have *access to senior management*. However, the CEO, chair, or independent lead director may be designated as liaison between management and directors to ensure that the role between board oversight and management operations is respected.**[20]

3. **The board should periodically review its own size, and determine the size that is most effective toward future operations.**[21]

C. Individual Director Characteristics

Many of the Core Principles and Guidelines in this document would not be necessary if corporate boards had an effective means of evaluating ***individual director performance***. It is this seeming inability to promptly replace directors who are not fully contributing toward overall board success that has led shareowners to question many concepts that would, under a true delegation of management responsibility to boards, otherwise be unnecessary. With this in mind, CalPERS recommends that:

1. **Each board should establish *performance criteria*, not only for itself (acting as a collective body) but also *individual behavioral expectations* for its directors. Minimally, these criteria should address the level of director: attendance, preparedness, participation, and candor.**[22]

2. **To be re-nominated, directors must satisfactorily perform based on the established criteria. Re-nomination on any other basis should neither be expected nor guaranteed.**

---

[20] See GM Guidelines, No. 12. See also BRT Statement, at p. 18.

[21] See NACD Report, at p. 4, 5.

[22] See NACD Report, at p. 16-17.

3. **Generally, a company's retiring CEO should not continue to serve as a director on the board.**[23]

4. **The board should establish and make available to shareowners the skill sets which it seeks from director candidates. Minimally, these *core competencies* should address: accounting or finance, international markets, business or management experience, industry knowledge, customer-base experience or perspective, crisis response, or leadership or strategic planning.**

D. Shareowner Rights

Shareowner rights – or those structural devices that define the formal relationship between shareowners and the directors to whom they delegate corporate control – are not typically featured in the governance principles adopted by corporate boards. CalPERS generally believes that, if the Principles and Guidelines described above are internalized and become part of the way in which American corporations operate, then shareowners should trust that independent boards will make the decisions that promote long-term shareowner interests – whether those decisions concern shareowner rights or other issues. But, we are not yet at that point. Therefore, to help build tomorrow's corporate governance structure, CalPERS offers today's corporate boards the following views on issues affecting shareowner rights:

1. A majority of shareowners should be able to amend the company's bylaws by shareowner proposal.

2. A majority of shareowners should be able to call special meetings.

3. A majority of shareowners should be able to act by written consent.

4. Every company should prohibit greenmail.

5. No board should enact nor amend a poison pill except with shareowner approval.

6. Every director should be elected annually.

7. Proxies should be kept confidential from the company, except at the express request of shareowners.

8. Broker non-votes should be counted for quorum purposes only.

---

[23] "What about losing the accumulated experience of the retiring CEO? That is easily solved. If the new CEO wants to tap the perceived wisdom and experience of the retired CEO, a telephone call or a quiet meeting does not require a board seat." (Former Citicorp Chairman Walter Wriston, "Resist the Desire to Stay On," DIRECTORS & BOARDS (Spring 1993) 35.)

9. Any shareowner proposal that is approved by a majority of proxies cast should either be implement by the board, or the next annual proxy statement should contain a detailed explanation of the board's reasons for not implementing.

10. Shareowners should have effective access to the director nomination process.

V. CONCLUSION

In adopting these Core Principles and Governance Guidelines, CalPERS' goal is to stimulate healthy debate. To the extent this document evokes disagreements, may these disagreements be used to promote greater clarity of thought. With continued experience and communication between corporate managers and owners, the issue of accountability can become – if not resolved – more clear.

> *"As conflict – difference – is here in the world, as we cannot avoid it, we should, I think, use it. Instead of condemning it, we should set it to work for us… So in business, we have to know when to … try to capitalize [on conflict], when to see what we can make it do…. [In that light] it is possible to conceive of conflict as not necessarily a wasteful outbreak of incompatibilities but a normal process by which socially valuable differences register themselves for the enrichment of all concerned…. Conflict at the moment of the appearing and focusing of difference may be a sign of health, a prophecy of progress."*

THE PRICE WATERHOUSE CHANGE INTEGRATION TEAM, THE PARADOX PRINCIPLES 275 (quoting Mary Parker Follett) (1996).

APPENDIX A

LEAD INDEPENDENT DIRECTOR POSITION DUTY STATEMENT

- The chief executive officer is the senior executive of the Company. The CEO is responsible for:
  - providing management of the day-to-day operations of the Company;
  - recommending policy and strategic direction of the Company, for ultimate approval by the Board of Directors; and
  - acting as the spokesperson of the Company.
- In contrast, the Lead Independent Director is responsible for coordinating the activities of the independent directors. In addition to the duties of all Board members as set forth in the Company's [Governance Guidelines], the specific responsibilities of the Lead Independent Director are as follows:
  - advise the Chair as to an appropriate schedule of Board meetings, seeking to ensure that the independent directors can perform their duties responsibly while not interfering with the flow of Company operations;
  - provide the Chair with input as to the preparation of the agendas for the Board and Committee meetings;
  - advise the Chair as to the quality, quantity and timeliness of the flow of information from Company management that is necessary for the independent directors to effectively and responsibly perform their duties; although Company management is responsible for the preparation of materials for the Board, the Lead Independent Director may specifically request the inclusion of certain material;
  - recommend to the Chair the retention of consultants who report directly to the Board;
  - interview, along with the chair of the [nominating committee], all Board candidates, and make recommendations to the [nominating committee] and the Board;

- assist the Board and Company officers in assuring compliance with and implementation of the Company's [Governance Guidelines]; principally responsible for recommending revisions to the [Governance Guidelines];

- coordinate, develop the agenda for and moderate executive sessions of the Board's independent directors; act as principal liaison between the independent directors and the Chair on sensitive issues;

- evaluate, along with the members of the [compensation committee/full board], the CEO's performance; meet with the CEO to discuss the Board's evaluation; and

- recommend to the Chair the membership of the various Board Committees, as well as selection of the Committee chairs.

APPENDIX B-1

DEFINITION OF INDEPENDENT DIRECTOR

"Independent director" means a director who:

- has not been employed by the Company in an executive capacity within the last five years;
- is not, and is not affiliated with a company that is, an adviser or consultant to the Company or a member of the Company's senior management;
- is not affiliated with a significant customer or supplier of the Company;
- has no personal services contract(s) with the Company, or a member of the Company's senior management;
- is not affiliated with a not-for-profit entity that receives significant contributions from the Company;
- within the last five years, has not had any business relationship with the Company (other than service as a director) for which the Company has been required to make disclosure under Regulation S-K of the Securities and Exchange Commission;
- is not employed by a public company at which an executive officer of the Company serves as a director;
- has not had any of the relationships described above with any affiliate of the Company; and
- is not a member of the immediate family of any person described above.

APPENDIX B-2

VARIATIONS ON A THEME – "INDEPENDENT DIRECTOR"

Source	Citation	Applicability	Standard	Definition
Investment Company Act of 1940	15 USC sec. 80a-10(a); 15 USC sec. 80a-2(a)(18)	Registered investment company boards	No more than 60% of the directors may be "interested persons"	"Interested person" means: • affiliated to the company • a member of the immediate family of one who is affiliated to the company • affiliated (directly or through familial relationships) with an investment advisor or principal underwriter to the company • legal counsel to the company within the prior two fiscal years (including all partners and employees of such counsel) • all brokers and dealers, including persons affiliated to brokers or dealers • any person so deemed by order of the SEC, by virtue of having had, within the prior two years, a material or professional relationship with the company or its CEO, or with any investment company having the same investment adviser or principal underwriter, or with the CEO of such investment company
Securities Exchange Act of 1934	17 CFR sec. 240.16b-3 (interpreting 15 USC sec. 78p, concerning certain insider transactions)	Companies whose securities are registered for sale under the 1934 Act	A grant, award or other acquisition of a security, from a company to an officer or director, is exempt from the Act's insider trading restrictions if, among other alternatives, the transaction is approved by the company's board or by a committee of the board composed solely of two or more "non-employee directors"	"Non-employee director" means: • is not currently employed by the company (or a parent or subsidiary of the company) • does not receive compensation, directly or indirectly, from the company or a parent or subsidiary, in an amount which is significant enough to be disclosed under Regulation S-K, excluding directors' fees • has no interest in any significant transactions or business relationships with the company, such that they would have to be disclosed under Regulation S-K

Source	Citation	Applicability	Standard	Definition
Internal Revenue Code	26 CFR sec. 1.162-27 (interpreting 26 USC sec. 162, concerning the deductibility of certain executive pay)	Publicly held corporations	Generally, executive compensation over $1 million is not deductible. Among the many exceptions to this rule is compensation that is "performance based" and is determined by a compensation committee that is comprised solely of two or more "outside directors"	"Outside director" means: • is not currently employed by the company • is not a former employee who received compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year • has not been an officer of the company • does not receive compensation (defined to be more than *de minimus*, which is also a specifically defined term) for goods or services performed, excluding directors fees
FDIC	12 CFR pt. 363 Appendix A	Insured depository institutions	All audit committee members must be "independent of management of the institution"	"Independent of management" is generally a determination each institution may make. This term absolutely excludes a director who: • is, or has been within the preceding year, an officer or employee of the institution or its affiliates • owns or controls, or has owned or controlled within the preceding year, assets representing 10% or more of any outstanding class of the institution's voting securities. Beyond this, the institution should consider whether the director: • has been, prior to the preceding year, an officer or employee of the institution or its affiliates • serves as a consultant, advisor, promoter, underwriter, legal counsel or trustee of or to the institution or its affiliates • is a relative of an officer or other employee of the institution or its affiliates • hold or controls, or has held or controlled, a direct or indirect financial interest in the institution or its affiliates • has outstanding extensions of credit from the institution or its affiliates.

Source	Citation	Applicability	Standard	Definition
American Law Institute	ALI, *Principles of Corporate Governance* sec. 3A-01	Recommended for large publicly held corporations (2,000 or more record holders and $100 million or more in total assets)	A majority of the directors should be "free of any significant relationship" with the company or its senior executives	"Significant relationship" means: • is, or was within the preceding two years, employed by the company • a member of the immediate family of such a current or former employee • received from the company during either of the two preceding years over $200,000 • owns an equity interest (with the power to vote) in a business that received compensation from the company, such that the director's equity share was over $200,000 • is the principal manager of a business that received from, or paid to the company, during either of the two preceding years, 5% of the business' consolidated gross revenues, or $200,000, whichever is more • is professionally affiliated with the corporation's primary outside legal firm Notwithstanding the above, a director may still be considered not to have a "significant relationship," if "on the basis of countervailing or other special circumstances, it could not reasonably be believed that the judgment of a person in the director's position would be affected by his relationship."
National Association of Corporate Directors	NACD's Blue Ribbon Commission on Director Professionalism (1996), at p. 9-10	n/a	A substantial majority of directors should be independent	"Although potentially valuable benefits may accrue from business relationships, these benefits can impair the director's independence. It is important to make the distinction between directors and service providers. . . If the director's primary value to the company is as a consultant or advisor, the individual should be brought on as such and paid as such, not brought on as a director and paid as a consultant.." • Boards should define and disclose to shareholders a definition of "independent director."

Source	Citation	Applicability	Standard	Definition
				• Boards should require that director candidates disclose all existing business relationships between them or their employer and the board's company. • Boards should then evaluate the extent to which, if any, a candidate's other activities may impinge on his or her independence as a board member, and determine when relationships are such that a candidate can no longer be considered independent."
Business Roundtable	Business Roundtable's Statement on Corporate Governance (Sept., 1997), at p. 11-12	n/a	A substantial majority of directors should be independent	"The degree of independence of an outside director may be affected by many factors, including the personal stature of the director and any business relationship . . . with the corporation or any business or personal relationship . . . with management. . . Depending on their significance to the director and to the corporation, such relationships may affect a director's actual or perceived independence. The [BRT] believes that, where such relationships exist, boards should be mindful of them and make a judgment about a director's independence based on . . . individual circumstances rather than through the mechanical application of rigid criteria. . . . For certain functions, such as membership on an audit or compensation committee, more specific standards of independence should be used."
National Association of Securities Dealers	NASD By-Laws, Subdivision D, Schedule D, Part II	Corporations quoted on NASDAQ	Boards must maintain a minimum of two independent directors; audit committees must be comprised of a majority of independent directors	"Independent director" means a person other than an officer or employee of the company or its subsidiaries, or any other individual having a relationship which, in the opinion of the board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

Source	Citation	Applicability	Standard	Definition
New York Stock Exchange	NYSE Listed Company Manual, sec. 303.00	US companies listed on the exchange	Audit Committees must be maintained and comprised entirely of independent directors	"Independent director" means a person who is independent of management and free from any relationship that, in the opinion of the board, would interfere with the exercise of independent judgment as an audit committee member. However, no officer or employee of the company or its subsidiaries is qualified as an "independent director."
Council of Institutional Investors	CII Core Policies, at p. 1, 7-10	n/a	At least a majority (proposed to be increased to 2/3) of the directors should be independent	A director is deemed independent if his or her only non-trivial professional, familial, or financial connection to the corporation or its CEO is his or her directorship. (Explanatory notes provide additional general guidance.)

APPENDIX C

INDEPENDENT CHAIR
POSITION DUTY STATEMENT

- The chief executive officer is the senior executive of the Company. The CEO is responsible for:
  - providing management of the day-to-day operations of the Company;
  - recommending policy and strategic direction of the Company, for ultimate approval by the Board of Directors; and
  - acting as the spokesperson of the Company.
- In contrast, the Independent Chair is responsible for coordinating the activities of the Board of Directors. In addition to the duties of all Board members as set forth in the Company's [Governance Guidelines], the specific responsibilities of the Independent Chair are as follows:
  - conduct all meetings of the Board and the meetings of shareowners;
  - serve as an ex-officio member of each of the committees of the Board of which the Independent Chair is not a member;
  - schedule Board meetings in a manner that enables the Board and its Committees to perform their duties responsibly while not interfering with the flow of Company operations;
  - prepare, in consultation with the CEO and other directors and Committee chairs, the agendas for the Board and Committee meetings;
  - define the quality, quantity and timeliness of the flow of information between Company management and the Board; although Company management is responsible for the preparation of materials for the Board, the Independent Chair may specifically request the inclusion of certain material;
  - approve, in consultation with other directors, the retention of consultants who report directly to the Board;

- interview, along with the chair of the [nominating committee], all Board candidates, and make recommendations to the [nominating committee] and the Board;
- assist the Board and Company officers in assuring compliance with and implementation of the Company's [Governance Guidelines]; principally responsible for recommending revisions to the [Governance Guidelines];
- develop the agenda for and moderate executive sessions of the Board's independent directors; act as principal liaison between the independent directors and the CEO on sensitive issues;
- evaluate, along with the members of the [compensation committee/full board], the CEO's performance; meet with the CEO to discuss the Board's evaluation; and
- recommend to the full Board the membership of the various Board Committees, as well as selection of the Committee chairs.

STATEMENT

OF

THE HONORABLE RODERICK M. HILLS

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES

HOUSE OF REPRESENTATIVES

March 13, 2002

STATEMENT

We need only to recount the accounting embarrassments of Enron, Global Crossing, and Waste Management in the past few years to know that the regulatory system that has evolved over the past 69 years to protect the investing public has serious deficiencies that need attention. At the same time, we should appreciate the fact that the vast majority of the more than 14,000 publicly traded companies in the United States produce reliable financial statements year after year. We have a good system. No other country comes close to providing the degree of investor protection as does the United States. It deserves the respect it has had for so many years.

As we consider how to strengthen that system, it is useful to remember that its last major strengthening occurred in the middle 1970s in reaction to the fact that some 400 companies were compelled to disclose that they had bribed or made questionable payments to foreign officials. At that time, the SEC stimulated the New York Stock Exchange to compel independent audit committees, substantially increased the responsibilities of auditors and required that publicly traded companies have effective internal financial controls.

Since leaving the SEC in 1977, I have served, at one time or another, on 14 boards of directors, as chairman of 8 audit committees and as an audit committee member of all 14 boards. Six times we wrote off more than $100 million of improperly taken income. Eight times we terminated the Chief Executive Officer (See Appendix A). From those experiences and from my time at the SEC, I suggest substantial weaknesses remain in our system:

- First, the overall system, now reaching the age of 70 years, needs a complete overhaul. The Financial Accounting Standards Board ("FASB") and the American Institute of Certified Accountants ("AICPA") are not tailored to be responsive to the type of accounting issues raised by the Enron, Waste Management and Global Crossing incidents;

- Second, it is increasingly clear that some number of audit partners are not able ***consistently*** to resist management pressures to permit incomplete or misleading financial statements; and

- Finally, the audit committees of too many boards are not exercising the authority given to them or the responsibility expected of them.

H.R. 3763 has the prospect of making substantial improvements in all three areas.

The System

Criticism of the regulatory system that protects the investing public has two principle aspects.

First, whether fair or not, the almost universal view is that peer review of accounting firms is not providing sufficient quality control. Discipline comes primarily from class action and shareholder derivative litigation. The SEC does bring actions against accounting firms and individual accountants, but such actions almost always come after the fact of an accounting failure. The SEC does little preventative work.

The Public Regulatory Organization (a "PRO"), that H.R. 3763 would create, appears to have the authority and responsibility to investigate and assess the quality of an accounting firm before damage is done. Also, a PRO appears to be able to discipline accountants and accounting firms without compromising the primacy of the SEC.

Second, the audit today has become a commodity that does not test the judgment of the auditor to a sufficient degree. Chief Executive Officers see no added value in them and the accounting firms, therefore, compete for the work with price not with quality. There are so many rules with so much precision that there is an implication that whatever is not prohibited is permitted. The auditor is too often reduced to a rule checker looking only for compliance.

The auditor's opinion invariably includes this phrase:

"In our opinion, the financial statements [prepared by management] fairly present, in all material respects, the financial position of the company."

In fact auditors are not exercising the judgment that such an opinion suggests. Instead the above statement usually means only:

"We have found no material violation of applicable rules."

Section 6 of H.R. 3763 would cause both management and auditors to exercise considerable judgment in deciding what key accounting principles are most affecting the apparent financial position of reporting companies. By requiring management to explain how different accounting principles would produce materially different results, the bill would necessarily cause auditors to review such explanations. As I understand Section 6, it provides a legislative endorsement for the SEC's December 12, 2001: Release Nos. 33-8040; 34-45149; FR-60.

In short, H.R. 3763 will require more judgment by the auditor and, thus, should make management more concerned about the quality of the audit staff.

Paul Brown of the Accounting Department of New York University has recently summed up our system:

"It's an old adage of an FASB rule. It takes four years to write. It takes four minutes for an astute investment banker to get around it."

H.R. 3763 does not deal specifically with the deficiencies in the FASB process. Professor Weil of the Chicago School of Business describes what needs to change:

"I want accountants to use fundamental concepts in choosing methods and estimates. I want accountants not to hide behind the absence of a specific rule."

This Committee may wish in Section 9 of H.R. 3763 to ask the SEC to review the FASB process.

The Profession

In addition to its other troubles, the accounting profession is not attracting the same talent that came to the profession 20 years ago. Far more people were then entering the profession. Then, significant numbers of them were graduates of our leading business schools but few come from that source now. Yet, the Big 5 accounting firms are now attempting to hire far more CPA's than 20 years ago.

This difficulty of finding top-notch personnel, the difficulty of finding a precise rule to deal with ingenious corporate structures and especially the ***pressing financial***

need to keep clients too often causes audit partner's to allow questionable accounting policies to slip by.

Section 3 of H.R. 3763 will provide some deterrent to zealous management officials, but real protection for the auditors can only come from a vigilant audit committee: an issue that is discussed below.

Also, Section 2 of H.R. 3763 will restrict the ability of auditors to provide services, other than the audit, to audit clients. The proscription against providing "financial information system design" is constructive. However, the absolute prohibition against providing any internal audit service is both unwise and impractical.

It is unwise because a significant number of publicly traded companies maintain their own internal audit function. In any given year that internal audit force may need to be supplemented for any number of unanticipated and unique reasons. It would be enormously expensive and inefficient to force management to hire a different accounting firm for such sporadic assistance.

Such a rule would be impractical because there is no bright line between the external audit and internal audit tasks. In my experience as chairman or as a member of audit committees that line varies from year to year. Each year, the audit committees on which I sit or have sat oversee a practical allocation of audit tasks between the external and the internal audit staffs. The SEC's rules now permit the external auditor to perform

as much as 40% of the internal audit. So long as there is a separate and effective internal auditor, the SEC's approach is preferable to an absolute ban.

The Committee may wish to consider the fact that the SEC does not specifically require an internal audit. An amendment to Section 9 of H.R. 3763 could ask the President's Working Group to consider this matter.

The Audit Committee

The primary task of the audit committee should be to protect the auditor from the all too common pressure from management to allow a questionable accounting policy to slip by. However:

- Board members are too often chosen by the CEO who also decides who will sit on the audit committee and who will chair it;
- The audit committee members seldom ask the auditor if there is a fairer way to present the company's financial position;
- They seldom play a significant role in selecting a new audit firm; and
- They seldom establish themselves as the party in charge of the audit ***and in charge of retaining the auditor.***

Section 9 of H.R. 3763 asks the President's Working Group to determine "whether the duties and responsibilities of audit committees should be established by the Commission." While this inquiry is appropriate, the Committee may wish to be more forceful in establishing the authority of the audit committee.

As noted above, the mandatory audit committee came into existence just over 25 years ago. It would be timely for the audit committee to have a more formal legal status.

That status would be obtained if the SEC would simply state that the failure to maintain an independent and competent audit committee constitutes a material weakness in a company's internal controls. Such a statement would require the auditors to determine whether such a committee is present and thus ask such questions of board members as:

- How did you get to the Board and on the audit committee, and who selected the Chairperson of the committee?

- What percentage of your annual income is derived from your service on this board or other boards?

- What experience or education have you had that is relevant to the responsibilities of an audit committee?

It should rapidly become apparent that an independent audit committee requires that there be an independent nominating committee.

And, the SEC can make it quite clear that the audit committee's most important task is to make the auditor believe that its retention depends ***solely*** on the decision of the audit committee.

If such steps are taken an accounting firm should not take any engagement unless it is certain of the audit committee's support. With such support, the firms should have the resolve to qualify their opinion when they believe that the financial presentation is deficient notwithstanding the fact that all rules are satisfied.

The Committee may wish to amend Section 9 of H.R. 3763 to ask the President's Working Group to consider these more specific audit committee issues.

Miscellaneous Comments

I have two further suggestions with respect to H.R. 3763.

Section 2 of the bill provides that a PRO be self-funded. I suggest that this may be inappropriate. A body with the regulatory authority of a PRO should not need to "pass the hat." There are few if any large publicly traded companies that could not be affected

by a PRO's regulations. On the one hand, these companies might be tempted to imply that they would withhold support to influence a PRO decision. On the other hand a PRO's authority could intimidate many companies.

It would be preferable for Congress to establish a permanent funding mechanism. A surcharge on all audit fees would be one possibility. Alternatively, Congress could mandate the creation of an endowment sufficient for a PRO's activities and could provide for that endowment in whole or in part. The Congressional grant could be supplemented by contributions from private sources.

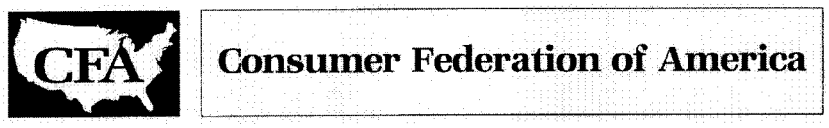
Section 8 of H.R. 3763 requires the SEC to periodically review the financial statement of all issuers "with the most actively traded or widely held securities, or the largest market capitalization."

I suggest that a preferable approach would be to give the SEC sufficient funds to create an information system that would identify those companies that are most likely to have an accounting problem. Each of the Big 5 accounting firms have a system that identifies those of their audit clients that are most likely to have such a problem. The SEC, using similar methodology, can identify the same companies and thus better allocate their resources.

Conclusion

The Enron debacle is emblematic of weaknesses in our regulatory system. Andersen is in the headlines, but all accounting firms have had the same kind of troubles. Andersen and the other firms are not blameless, but they do not deserve all the blame. The profession has real problems because of the system that they cannot change by themselves.

The accounting profession is of enormous importance to the United States and to the increasingly global economy in which we exist. As we identify the deficiencies of the accounting profession, we should also acknowledge the responsibility we have to assist it to reform itself.



Testimony of
Barbara Roper, Director of Investor Protection
Consumer Federation of America

before the
Financial Services Committee
of the U.S. House of Representatives

Regarding H.R. 3763
"The Corporate and Auditing Accountability, Responsibility and Transparency Act"

March 13, 2002

I am Barbara Roper, director of investor protection for the Consumer Federation of America. CFA is a non-profit association of more than 290 pro-consumer organizations founded in 1968 to advance the consumer interest through advocacy and education. Ensuring adequate protections for the growing number of Americans who rely on financial markets to save for retirement and other life goals is a top CFA priority.

I would like to thank Chairman Oxley and Ranking Member LaFalce for the opportunity to appear here today to discuss H.R. 3763, "The Corporate and Auditing Accountability, Responsibility and Transparency Act." I also want to thank you and your staffs for seeking out our views as legislation was being drafted. CFA shares your obvious conviction that, in the wake of Enron's sudden, surprise collapse last year and in response to a rising tide of earnings restatements, congressional action is needed to restore investor confidence in the reliability of corporate disclosures.

This legislation recognizes that a variety of factors contributed to the massive investor losses resulting from the Enron collapse, and that none is more important than the failure of the auditors to ensure complete and accurate disclosures. CFA shares that view, which we outlined in a white paper on audit-related issues exposed by the Enron collapse. I have attached that report as an appendix to this testimony. As we note in that report, CFA believes the growing lack of independence in the independent audit is the single most important issue for Congress to deal with to restore investor confidence. Lack of effective auditor oversight is also a pressing problem that must be addressed as part of any comprehensive solution.

Because this legislation fails to deal adequately with central issue of auditor independence, and because it does not do enough to ensure the independence and effectiveness of the auditor oversight mechanism it creates, we believe H.R. 3763 falls short of the comprehensive, strong reforms that the current crisis demands. With strengthening amendments, however, the bill could offer significant progress toward meaningful reform.

Auditor Oversight

The heart of this bill is its proposal to create a professional regulatory body to which all accountants who audit publicly traded companies must belong. CFA strongly agrees that regulatory oversight of auditors must be improved. The current system provides neither a thorough, objective review of audit practices and audit quality, nor a credible threat of timely, forceful punishment for those who fail to fulfill their professional responsibilities. As such, it does not serve as an effective deterrent to shoddy practices, or worse.

CFA believes an independent regulatory body, subject to SEC oversight, can provide effective oversight. To do so, however, it must be completely independent of the accounting industry, be adequately funded, have extensive rule-making and standard-setting authority, and be endowed with strong investigative and enforcement powers. In short, the accounting firms it oversees must not be able to unduly influence its funding, its regulatory agenda, its investigations, or the scope of its authority.

The bill takes important steps in this direction. It specifies, for example, that the professional regulatory organization (PRO) it creates would have the ability to deny firms and individuals the right to audit public companies. That is a meaningful sanction that should help to deter wrong-doing. It also includes provisions designed to provide independent oversight and funding. Unfortunately, much of the language in H.R. 3763 is simply too vague to ensure that these essential standards for effective oversight will be met.

It specifies, for example, that the PRO not be "solely dependent upon members of the accounting profession for [its] funding and operations." But this still leaves a great deal of room for the accounting firms to dominate PRO funding, and to threaten that funding when they object to PRO actions. The legislation should be amended to specify a funding mechanism that is immune from accounting industry domination.

The bill is somewhat stronger on the issue of independent governance. It requires that two-thirds of board members be public members who are not members of the accounting profession. It also requires that the PRO have procedures to minimize, deter, and resolve conflicts of interest involving public members. We support these provisions, but believe the legislation should do more to define tough independence standards for public board members. This is necessary to ensure that these standards are not watered down in the same way that independence standards for corporate board members have been.

We are also concerned that the bill does not clearly specify that the PRO will have authority to set audit standards. As Mr. Turner, who testified here earlier, has stated previously, the current audit standards adopted by AICPA are "so general that, as a practical matter, it's difficult to hold anyone accountable for not following them." We believe that audit standards must be improved, and that this is a job for an independent regulator, not the auditing industry.

The bill also leaves open the possibility of multiple PROs for accountants. Because of the legislation's relatively vague language on key topics, these organizations could set significantly different standards both for their members and for the PRO's own independence and oversight functions. Because they would likely be financially dependent, at least in part, on attracting members, there is a very real danger that multiple PROs would compete for members by lowering their standards. Such an approach gives the industry an unacceptable degree of potential influence over its regulator. We strongly urge, therefore, that the legislation be rewritten to create a single independent regulatory to which all auditors of publicly traded companies must belong.

If these changes are adopted -- a funding mechanism that is immune to industry influence, tighter independence standards for public board members, clarification of the board's responsibility for setting audit standards, and designation of a single PRO -- this legislation could provide the effective oversight of the accounting profession that is badly needed and long overdue.

Auditor Independence

On the central issue of auditor independence, the legislation is much weaker. It simply directs the SEC by rule to prohibit auditors from providing internal audit and financial information system design or implementation services to their audit clients. In doing so, it codifies steps the major firms have said they would take voluntarily to enhance their independence. There is certainly a benefit to having those prohibitions written into the rule book, as that will prevent backsliding once attention has turned elsewhere. It also represents real progress over where we were in late 2000, when the AICPA and several of the major firms fought vehemently to prevent these same restrictions from being imposed by the SEC.

Again, however, more is needed. The SEC auditor independence rule proposals that form the basis of this provision were crafted at a time when, as many opponents pointed out, we did not have evidence of a significant audit failure resulting from a lack of auditor independence. Now we have that evidence. And what the evidence looks like is thousands of workers out of jobs, with their retirement savings evaporated, and billions of dollars in shareholder money lost.

Furthermore, the original SEC proposal was put forward at a time when there was little concrete evidence regarding the extent of non-audit services provided to audit clients. Members of the industry argued that the magnitude of such services had been exaggerated. But the disclosures that followed passage of the SEC rule have shown that nearly all major companies also hire their auditors for non-audit services, and that they typically pay between two and three times as much for these services as they do for the audit. In some cases, the disparity is far greater. At least one company paid 30 times as much for non-audit services in 2000 as it did for its audit. What reasonable investor would trust that auditor's independence?

Given what we now know about the devastating harm that a failed audit can cause and the pervasiveness of significant consulting-related conflicts, Congress should be looking to address the auditor independence issue more comprehensively than the original SEC proposal attempted to do. Instead, this bill falls short of restoring the protections that were included in the original proposal. First, it fails to restore the stronger language in the original rule proposal on the whole range of non-audit services prohibited under that rule. Second, it does not include the four principles for determining auditor independence that were removed from the final rule.

Furthermore, the supporting materials for the original rule proposal made a strong case for a total ban on all non-audit services. As the proposal noted, this is the only approach that attacks, not just the particular conflicts associated with certain practices, but also the substantial conflicts that arise when other fees start to eclipse revenue from the audit itself. Some services will inevitably fall between the cracks of even the best drafted list of prohibited services. Auditors, who have shown a deep unwillingness to shoulder their responsibility to maintain their independence, will likely conclude that anything that isn't specifically banned is permissible. Finally, a total ban is essential to maintaining the auditor's independence of management. If an accounting firm has, or is seeking, a lucrative consulting contract from company managers, the auditors may come under enormous pressure within their own firm to please those company managers by signing off on questionable accounting practices.

For these reasons, CFA believes a ban on the provision of non-audit services to audit clients is essential. Certain services could be exempt, on a case-by-case basis, if it is shown that these services are closely related to the audit, directly enhance the quality of the audit, benefit investors, and create negligible conflicts of interest for the audit firm. At an absolute minimum, if auditors are allowed to continue to provide certain non-audit services, all such services should have to be directly and independently approved by the audit committee of the board.

In addition, Congress should look beyond the conflicts of interest associated with offering consulting services to clients in crafting real reforms to enhance auditor independence. The lack of independence in the independent audit starts with the fact that auditors are hired, paid, and fired by the audited company. Several proposals have been floated to reduce or eliminate this conflict. CFA has endorsed Rep. Kucinich's bill (H.R. 3795) to create an independent federal auditing bureau within the SEC. Others have suggested that the exchanges could be made responsible for hiring accounting firms to audit the companies that trade there. The idea is that such an approach would minimize the company's financial leverage on the auditor, and that auditors would as a result be more likely to perceive themselves as working for investors, rather than for the audited company. This is an intriguing suggestion, which we believe deserves further exploration.

A less radical notion that has gained some high-powered backers is the idea of requiring periodic mandatory rotation of auditors. When auditors expect to retain an audit client for 20, 30, even 50 years, it is that much harder for them to challenge management aggressively and risk losing that client. After all, they risk losing, not just that year's audit fee, but also a seemingly endless stream of future audit fees. On the other hand, an auditor who knows they are retained for a limited term has significantly less to lose by challenging management. Because we believe mandatory rotation would significantly reduce audit clients' ability to tame their auditors, CFA strongly urges that a mandatory rotation requirement be added to this bill's auditor independence provisions.

Another problem that clearly needs to be addressed is the revolving door that all too often exists between auditors and their audit clients. This was true at Enron, it was true at Waste Management, and it is a common feature in many failed audits. A constant flow of personnel from the auditor to the audit client helps to create an environment in which external auditors are viewed as just another part of the corporate family. Such intimacy is not conducive to true independence. To counteract this problem, auditors should be subject to a cooling off period during which members of the audit team would be prohibited from seeking employment with an audit client. We urge that such a provision be added to the bill.

CFA believes an approach that combines a broad ban on non-audit services, mandatory rotation of auditors, and a cooling off period for auditors would dramatically enhance auditor independence. While Rep. LaFalce's bill, H.R. 3818, does not include a total ban on non-audit services, it contains most of what we believe is necessary to restore a reasonable level of independence to the independent audit.

Furthermore, we believe such dramatic improvements are not just warranted, they are essential to justify restored investor confidence in the reliability of corporate disclosures. After all, the whole point of requiring public companies to obtain an independent audit is to ensure that outside experts have reviewed the company books and determined that they not only comply with the letter of accounting rules but also present a fair and accurate picture of the company's finances. Unless the auditor is free of bias, brings an appropriate level of professional skepticism to the task, and feels free to challenge management decisions, the audit has no more value than if the company were allowed to certify its own books. Any legislation that fails to address this issue comprehensively will have failed to restore real value to the independent audit.

Improved Disclosure

While poor disclosure rules cannot be made a scapegoat for what was clearly a company that was intent on deceiving investors and an auditor that was willing to let them, inadequate disclosure rules clearly contributed to the problem. H.R. 3763 includes a number of provisions to improve the frequency and clarity of corporate disclosures. It requires the SEC to move forward with rules to promote real-time disclosure of key information. It requires the SEC to improve disclosure on some of the key issues that helped bring down Enron -- off-balance sheet transactions and relationships with unconsolidated entities and deals with company insiders on terms other than those that would be likely to be negotiated with third parties. And it requires the SEC to study whether additional changes are needed to make financial statements more useful to investors.

CFA has been supportive of SEC Chairman Harvey Pitt's calls for more timely disclosure of material information. We share his concern that our current system of periodic disclosure often reduces investors to relying on stale information. It seems obvious, but it bears repeating: for a system of disclosure to be useful to investors, it must provide the information they need, in a form they can understand, at a time when it is useful to them. By combining a requirement for more timely disclosure with a requirement for broad dissemination of that information, this legislation will help to improve the value of corporate disclosures to investors. CFA supports this provision of the bill.

CFA also supports requiring better disclosure in the area of off-balance-sheet transactions and relationships with unconsolidated entities. Regardless of whether those improvements are made by the SEC or by FASB, they are clearly badly needed. It was the surprise revelation of Enron's massive indebtedness, and the sudden revelation that there was less to Enron than met the eye, that ultimately sent its stock price plummeting. While such entities apparently often serve legitimate business purposes, companies should not be able to use complex partnership structures and other accounting gimmicks to hide their level of indebtedness from the investing public. Better disclosure rules, enforced by a thorough, independent audit, could have helped to prevent this catastrophe.

CFA also agrees that it would be beneficial to require better disclosure of insider deals. Forced into the light of day, these practices, which have the potential to create massive conflicts

of interest between corporate managers and shareholders, are likely to be strictly curtailed, and their most abusive provisions are likely to be eliminated.

Finally, we agree that, beyond these two specific issues that clearly need to be addressed, the SEC should study ways to make financial statements not just more reliable, but also more readable, more complete, and more transparent. Chairman Pitt has expressed a similar concern, even before the Enron case made the issue more pressing. This legislation should help to advance that goal by providing sound guidance on issues for the Commission to pursue.

Enhanced SEC Oversight of Financial Disclosures

CFA believes financial and other disclosures by all issuers should be subject to periodic, thorough reviews by the SEC. We are very encouraged that members of this committee have supported significant increases in SEC funding that are essential if the agency is to fulfill that and other important priorities. We also agree that certain issuers, where the risk to the public is greatest, should be subject to more frequent reviews. Size of market capitalization, level of trading activity, and the number of investors holding a particular security are all factors that should be taken into account in developing a review schedule. However, there may be additional factors that would also be relevant, such as a past history at the company of accounting abuses or membership in an industry that has been particularly prone to aggressive accounting. We believe the legislation should give the SEC more leeway to add factors that would be used in setting an appropriate and realistic review schedule.

Prohibition on Insider Trades During Pension Fund Blackout Periods

No aspect of the Enron disaster has struck more of a chord with the general public than the image of Enron executives profiting handsomely on their stock sales while employees watched their retirement savings evaporate. Prohibiting company executives from selling stock during periods when employees are subject to blackouts should help to ensure that executives don't intentionally time disclosure of bad news when they know a significant block of stock will be blocked from sale. CFA therefore supports this provision of the legislation.

Additional Studies

In addition to specifying the reforms discussed above, the bill calls for additional studies on rules relating to analyst conflicts of interest, corporate governance practices, enforcement actions, and credit rating agencies. CFA believes additional information would be valuable in all these areas to help determine whether additional protections are needed and, if so, what the most effective reforms are likely to be.

This committee, and the Capital Markets Subcommittee, played an extremely valuable role in exposing the conflicts of interest that can bias securities analyst research. Without the high profile attention this committee brought to that issue, it is unlikely we would have seen the strong rule proposals that were recently announced to minimize those conflicts. CFA expects to comment on those rules as they move through the rulemaking process. While we believe the

rules represent real progress on this issue, conflicts of this magnitude are difficult to combat. Thus, we agree that it is a good idea to have the SEC review the rules' effectiveness.

We also believe it would be extremely valuable to have this committee conduct the same kind of oversight hearings on credit ratings agencies as it conducted on securities analysts. Having the SEC undertake a study on the issue could provide a good launching point for such hearings. Given the increasingly complex issues that govern determinations of credit-worthiness, the failure of credit rating agencies to provide a timely warning of problems at Enron (and in numerous previous examples), and the growing concentration in the industry, a thorough study is warranted and could be extremely valuable.

The Enron collapse brought to light certain types of accounting practices that result in less than transparent disclosures, and the legislation deals with several of those directly. It also directs the SEC to review and analyze all Commission enforcement actions from the last five years involving violations of reporting requirements and restatements of earnings. The goal of that study is to identify areas of reporting that are most susceptible to fraud, manipulation, or inappropriate earnings management. We believe this is a very useful exercise for the Commission to undertake. It should produce valuable information on types of accounting practices that merit special SEC review as well as accounting rules that may need revision.

Finally, the apparent gross violations of ethical conduct that occurred among Enron managers and the failure of the corporate board to adequately supervise these activities raises serious questions about the adequacy of current corporate governance practices. CFA has concluded, for example, that independence standards for board members should be strengthened and that all audit committee members should have to be independent board members. However, a more comprehensive review of corporate governance practices could reveal numerous additional areas in need of reform. We support both the requirement for a study in this area and the scope of the study proposed in the legislation.

Conclusion

The Enron collapse has understandably shaken investor confidence in the reliability of corporate disclosures and the safeguards our financial system provides to keep company management honest. Only a comprehensive package of reforms, with strong auditor independence and oversight at its heart, will restore that shaken confidence. Though it falls short in several areas, H.R. 3763 could provide the framework for real audit reform. Most of the changes that are needed to strengthen the legislation can be found in H.R. 3818, which was recently introduced by Ranking Member LaFalce and his Democratic colleagues. We urge the Committee members to work together and with the Senate to produce the strongest possible legislation to restore investor confidence and, with it, market stability.

Once again, I want to thank you for inviting me to appear before you today. I will be happy to take any questions.

THE COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

WRITTEN STATEMENT BY LYNN TURNER

MARCH 13, 2002

Chairman Oxley, Congressman LaFalce, Members of the Committee. Thank you for the opportunity to provide comments on H.R. 3763 that addresses issues of vital importance to the U.S. capital markets. My comments draw upon past experience as a certified public accountant and auditor, a business executive, a regulator and an educator.

After receiving degrees from both Colorado State University and the University of Nebraska, I started with the widely respected international accounting firm of Coopers & Lybrand (now PricewaterhouseCoopers) in 1976. I served in various capacities with this firm including as the business unit leader of the high technology audit practice, as an SEC partner responsible for reviewing filings with the Securities and Exchange Commission (SEC), and as an audit engagement partner.

In 1996, I left the firm to take a position as Chief Financial Officer (CFO) and Vice President with Symbios, Inc., a large international manufacturer of semiconductors and storage systems that was a client of the firm. I was appointed as the Chief Accountant of the U.S. Securities and Exchange Commission (SEC) in July of 1998 and served until August of 2001. Now I have the privilege of shaping the minds of students who are the future of the accounting profession, as a professor in the College of Business at Colorado State University (CSU).

In addition to teaching today, I also do limited consulting in the accounting industry and business community.

Why Reliable Numbers are Critical to the Success of the U.S. Capital Markets

Financial numbers are used to report to investors, lenders, regulators and other users of the financial statements, the economic performance of a company. The numbers in the financial statements, just like a score on a college student's test, tell investors how a company has performed in comparison to expectations of management, the markets and competitors. Without these historical numbers, it is difficult, if not impossible, to gauge the future prospects of a company. Without accurate numbers, investors and management are likely to be misled into making make wrong decisions. In essence, those who prepare or aid in the preparation of false and misleading financial statements take away from investors their ability to make their own informed choice as to whether they would invest in a company. When this occurs with increasing frequency, as we have seen in recent months and years, investors question whether they can invest with confidence.

Critical elements must be present in our financial disclosure system if capital markets are to maintain their integrity and the confidence of investors. First, management must prepare financial statements and disclosures that fairly reflect the underlying economics of the business on a consistent, timely basis. Second, the corporate board, principally through the audit committee must oversee the integrity of the financial reporting process. Remember, that financial fraud typically starts with management, and when we look for culpability, we should begin there as well[1]. Third, the independent auditor must perform

[1] Fraudulent Financial Reporting: 1987-1997,*An Analysis of U.S. Public Companies*, 1999, Committee of Sponsoring Organizations of the Treadway Commission (COSO). This study of SEC enforcement actions from January 1987 through December 1997 studied nearly 300 companies involved in alleged financial

a robust, impartial and unbiased audit, designed to ensure the numbers are fairly presented and accurate. Investors rely on an auditor as an independent umpire who calls the numbers as the auditor sees them, not as management desires. Fourth, analysts who play an integral and important role in our financial markets must use the financial information and disclosures to perform their independent analysis of the figures, and arrive at recommendations that investors can read and understand.

I commend the Chairman for his efforts, initiated before Enron became a household word; to bring about badly needed reform to the system of conflicts that exist with analysts, underwriters and Wall Street. As you have so aptly stated Mr. Chairman, we need independent analysis, fueled by a desire to provide investors financial information based on reality, not hype and the potential for underwriting fees, and with plain English stock recommendations that do not require deciphering.

I also commend Congressmen LaFalce and Kanjorski for their foresight when raising a red flag with respect to leaks in our system. Well before Enron investors were left afloat when the once invincible ship Enron hit the Iceberg, these Congressmen met with representatives of the SEC, the Financial Accounting Standards Board (FASB) and the Public Oversight Board (POB) to push for greater resources for the SEC and necessary reforms. I greatly appreciated that support while I was at the SEC.

H.R. 3763, the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002.

H.R. 3763 has positive elements that will enhance the current financial disclosure system. Furthermore it presents opportunities for additional recommendations to better protect and serve investors.

Reforms set forth in the proposed legislation and in the following testimony will be even more critical if the "Big Five" turn into the "Final Four." The Big Five are some of the world's largest private businesses. They audit approximately 80 percent of all public companies resulting in a significant concentration of business and power within the industry[2]. Further concentration will only result in greater potential for independence conflicts, fewer choices of a firm for a public company and its investors.

It is unquestionably in the best interest of the profession if Andersen continues as a separate firm. I strongly believe that the problems facing the industry today are profession-wide, not just an Andersen issue. This was also the position stated by the Independent Oversight Board of Arthur Andersen LLP on March 11, 2002[3]. In fact I

---

fraud. Its findings include that in 83 percent of the cases, the SEC action named the CEO or CFO or both as being associated with the financial fraud.

[2] Data from the Public Accounting Report's Annual Survey of National Accounting Firms – 2001notes the average number of SEC audit clients for a Big Five Accounting firm is 2,574 with a range from 1,802 to 2,975.

[3] Report of the Independent Oversight Board of Arthur Andersen LLP dated March 11, 2002. The members of the Independent Oversight Board include Former Federal Reserve Chairman Paul Volcker,

applaud Andersen for the changes they, or their oversight board chaired by Former Federal Reserve Chairman Paul Volcker have already announced including:

1. Splitting of the auditing and consulting business.

2. Creation of a new Office of Audit quality comprised of senior specialists with the sole mission of driving audit quality.

3. Creating a new independent Office of Ethics and compliance to investigate any concerns of Arthur Andersen partners, employees or individuals from outside the firm relating to issues of audit or auditor quality, integrity, independence and compliance.

4. Committing to report to audit committees more comprehensively than currently required and to include quality of results, industry comparisons and performance indicators.

These reforms clearly set a new benchmark all large accounting firms in the profession should be held to by each and every audit committee, and federal and state regulators. They constitute what I would call a "best practice" that more than just Andersen should strive to achieve. However, until the other firms agree to measure up to these new practices, it is likely that Andersen will ironically, provide the highest quality audits.

I also believe we should strive to find ways to encourage Wall Street to quit requesting that audits of companies undertaking an initial public offering be performed by Big Five accounting firms as opposed to other very well qualified firms such as BDO Seidman LLP, Grant Thornton LLP and McGladrey & Pullen, LLP.[4] As we are currently seeing, "deep pockets" are meaningless when an audit does not meet public expectations.

Positive Elements

With respect to H.R. 3763, there are very positive elements of the bill including:

---

former U.S. Comptroller General of the United States Charles Bowsher and retired chairman and chief executive of Merck & Co., Inc., Dr. P. Roy Vagelos.

The report states:

"In making its decisions, the Board has given great weight to the need, in conducting audits, to avoiding the reality or appearance of conflicts of interest that might otherwise arise in firms offering a variety of services. It also recognizes that effective auditing of financial statements requires strong professional discipline, effective training in the complexities of modern finance, and clear recognition of the need for timely, accurate and comprehensive reports to the investing community.

There have been lapses in achieving these goals in this country and elsewhere. The difficulties are not confined to Andersen, or to auditing firms, alone."

[4] A survey by SEC staff of proxies filed by 563 Fortune 1000 companies through April 30, 2001 noted only 6 of the companies were audited by a non-Big Five accounting firm.

- The establishment of a public regulatory oversight board (PRO) for the accounting profession under the oversight of the SEC.

- Section 3, Improper Influence On conduct of Audits, making it unlawful for company executives or directors to willfully and improperly influence, coerce, manipulate or mislead the auditor.

- Requiring more timely disclosure of financial information provided all investors receive such information consistent with the current requirements of Regulation FD.

- Electronic disclosure of insider and affiliate transactions including disclosure on the corporate website.

- A prohibition on insider trades during pension fund blackout periods.

- Section 6(C)((2) regarding Alternatives to Be Considered.

- A requirement for the SEC to undertake a study of enforcement actions, which appears to be similar to the study performed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).[5]

- A requirement for the SEC to study rating agencies.

As a partner at a major international accounting firm, I have witnessed company's who attempted and in some cases, succeeded in "brow beating" their auditor. I also recall during my tenure as SEC Chief Accountant, receiving a transcript of a company's call with their analysts.' During the call, a company executive commented about how the audit partner had been prodded and pressured into a larger write-off that later resulted in a restatement. Time and time again we saw such behavior in enforcement actions. In light of Enron and my experience with similar situations, enactment of Section 3 is long overdue. I would urge the committee to ensure the SEC has adequate remedies with respect to enforcement of this provision.

I also support more timely disclosure of financial information that will provide analysts and investors with key indicators of a company's performance, value and trends. Disclosure of key performance indicators or KPI's will go a long way in achieving this goal. The report of the Garten Committee last summer encouraged the SEC to issue a concept release on this subject. We had started work on that project before I left the Commission and I hope the SEC will continue to move forward in this direction.

I do have concerns with respect to more timely disclosures beginning with foreign issuers who now comprise about 10 percent of all issuers. Currently many foreign companies are not required to file quarterly financial statements. The SEC has been more than

[5] Ibid Footnote1.

accommodating to foreign filers in order to attract them to our capital markets. But it is time these foreign companies be required to file their annual and quarterly financial information consistent with the same requirements for U.S. companies. I would encourage the committee to state that the timely disclosure section applies to all filers with the SEC.

Another concern with timely disclosures involves *when* it is appropriate to make a disclosure. As a CFO, I could make the professional judgment as to whether a matter was material or not. It was my job as an executive to understand how significant issues were. But there were also times when I was not sure if initial information was indicative of a trend that should be disclosed. For example, in the semi-conductor industry one can see swings in the bookings of new business and resultant backlog. These swings often do not happen overnight but rather may develop over time. Likewise, a business does not usually see the value of its assets such as inventory or plant and equipment increase or decrease overnight. A key question that must be addressed is at what point in that timeline is it that management should make that disclosure. If bookings start to go up over a two or three week period, but then drop back down, would it have been proper to have told investors backlog and sales were likely to be going up sometime during the three week period? Financial information is not always black and white.

Timely disclosures may also act to increase the focus of investors, especially institutional investors, on short-term results. Too much focus on short-term results rather than long-term value creation already exists today and is not healthy for companies or the markets. There is too much pressure being exerted on business executives to make their numbers each quarter, and that is contributing to problems we are discussing here today. Perhaps this is an issue the SEC should address in a concept release.

I agree with additional disclosures that are suggested in Section 6(C)(2) and which appear to be modeled after proposals put forward by the SEC. I would note that in particular, with respect to Section 6(C)(2)(C), in 2000, the SEC staff requested the accounting profession undertake a project to provide enhanced guidance on valuation of financial instruments.[6] The American Institute of Certified Public Account have not yet taken up the request of the SEC staff but have been working on useful guidance for valuation of stock options since 1997.

Improving H.R. 3763

I also believe that certain improvements to the Bill would provide for greater protection of the investing public. These improvements will become especially crucial if there are only four major international accounting firms. In that situation any further "Enron" experiences could call into question the ability of the private sector to continue to perform the independent public audit function. These improvements include:

[6] See letter from the Chief Accountant to Ms. Arleen Thomas, Vice President of the American Institute of Certified Public Accountants, dated November 17, 2000 at http://www.sec.gov/info/accountants/staffletters/valuguid.htm.

- Providing that the PRO be:
    - Drawn solely from members of the public, albeit certified public accountants who have not had any financial ties to an accounting firm for some period of time may comprise some minority of the board;
    - Provided with powers to compel testimony and document production on a timely basis;
    - Allowed to conduct its hearings into unprofessional conduct in public as the SEC has done since the late 1980's with its Rule 102(e) proceedings and take timely disciplinary actions;
    - Given the ability to levy civil monetary penalties, in addition to a bar from practice or registration of either the firm or individual involved or both;
    - Provided the authority to issue not only quality control standards, but also auditing standards against which the performance of audits is measured; and
    - Allowed to share documents and information gathered in its investigative process with appropriate state regulators during the course of the investigation so as to streamline the investigative and disciplinary process.
- Enhancing Section 2(C) addressing auditor's independence by including:
    - All of the original provisions of the SEC's rule proposal rather than just those the accounting firms have already agreed to;[7]
    - A requirement for the audit committee to select, retain and when necessary to fire the auditor;
    - A requirement, consistent with the findings of the Panel on Audit Effectiveness and the original SEC rule proposal that the audit committee pre-approve non-audit services;[8] and

[7] Revision of the Commission's Auditor Independence Requirements, Proposed Rule, June 30, 2000. The rule proposal provided for greater prohibitions than those included in H.R. 3763 such as all legal and expert services. It also required disclosure of whether the audit committee had pre-approved non-audit services. The final rule placed certain restrictions on internal audit outsourcing and set forth certain criteria that must be met before either internal audit outsourcing or information systems consulting services could be provided after the effective date in August 2002 of these provisions of the rule. These are likely to have a significant effect of whether companies would retain their auditor after the effective date to provide such services. Some public companies have already publicly announced they would not retain their auditor for such services.

[8] The Panel on Audit Effectiveness, August 31, 2000, page 117; see recommendation 5.30. This recommendation states: "The Panel recommends that audit committees pre-approve non-audit services that exceed a threshold determined by the committee. This recommendation is consistent with the

- A provision for mandatory rotation of auditors, which may also be combined with a requirement for mandatory retention of auditors unless the PRO approves a change.

- Modifying Section 6, Improved Transparency of Corporate Disclosures, to require the SEC to modify its rules, provided these improvements to transparency of corporate disclosures are not completed within a specified timeframe by the FASB.[9]

- Adding a statutory requirement that Chief Executive Officers and CFO's should be required to provide a statement to their shareholders vouching for the full and fair disclosure of the company's public disclosure including that the financial statements fairly present the financial condition and operation of the business. Consistent with Section 36 of the Federal Deposit Insurance Corporation Improvement Act of 1991, I would also encourage this statement encompass the requirements for reporting of management's responsibility for internal controls and laws and regulations, the effectiveness of those controls and be accompanied by a reporting requirement for independent public accountants.

- Modify Section 8, Oversight of Financial Disclosures, to provide the necessary appropriations for SEC, including provision for adequate staffing and technology resources to undertake the mandated review requirements.

- With respect to *each* of the studies being mandated, consider requiring each study to include as a part of the study, an evaluation of a sample of actual problem situations. This is consistent with the requirements set forth in Section 10, Study of Enforcement Actions, which are very good.[10]

Let me expand on some of the above comments.

Independent Governance of the Profession

The quality and reliability of financial statements and disclosures provided to investors are ultimately determined by whether there is compliance with the applicable accounting rules. You can write all the accounting rules you want to; you can require sufficient disclosures to fill up a phone book; but unless someone assures investors the established rules are being followed, they are meaningless. That is why we have independent audits.

---

recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees regarding auditors' services."

[9] Previous testimony before the Senate Governmental Affairs Committee notes that if Enron had complied with existing Generally Accepted Accounting Principles the Enron financial statements would have included more transparent related party disclosures and certain off-balance sheet transactions would have been included as liabilities on the balance sheet.

[10] It should be noted that Senator Sarbanes, Chairman of the Senate Committee on Banking, Housing, and Urban Affairs in a letter dated January 7, 2002 requested the Comptroller General of the U.S. General Accounting Office perform a study of enforcement cases involving accounting irregularities.

Independent audits provide investors with confidence that the numbers are accurate and reliable.

Since the financial frauds and failures arising from the 1972-73 bear market, including cases such as Penn Central and Equity Funding, the profession has attempted to ensure audit quality through a self-governance process. While some argue that 99.9% of the audits each year are okay, remember that Enron was once one of those 99.9%. The fact is we really don't know how many more audits are like the iceberg below the water level, unseen until it is too late.

What we do know today, is the increasing number of earnings restatements, the number of massive financial frauds, the tens and hundreds in billions of losses to investors and now Enron, accompanied by the almost daily parade of financial reporting issues, highlight a serious question in the minds of investors with respect to the quality of audits.[11] They also strike at the very heart of the credibility of my once esteemed and proud profession. Yet the multitude of organizations often referred to in the press these days as "alphabet soup" do not yield an efficient or effective quality control process.

It is well past time to establish a legislative based, SEC supervised PRO in light of:

- Recent disclosures that the accounting industry has thwarted attempts of the POB to complete in a timely fashion the public reports regarding the Involuntary Look-Back Program previously established in 2000 by the SEC as discussed in its 2000 Annual Report To Congress.
- The American Institute of Certified Public Accountants (AICPA) and profession having cut-off the funding for the POB in spring of 2000 when it attempted to fulfill its mandate to the public and carry out an investigation of the lack of compliance with independence rules.
- The AICPA having a weak, if not totally ineffective self-disciplinary group called the Professional Ethics Executive Committee or PEEC. A group that conducts its meetings behind closed doors, that often defers taking action on cases for years at a time, that has no subpoena powers, and that has failed to take action in a number of instances after the SEC has. The AICPA and firms had stated to the SEC and public in press releases towards the end of 2000 that they would work towards increasing the public membership of this organization from the current three out of twenty members. Andersen publicly said it would support an increase in public membership to half of the committee's total membership. Unfortunately, this has become a broken promise.
- The AICPA creating a for-profit portal and web of business relationships called CPA2Biz, and along with a failed attempt at establishing a business consulting credential. It is difficult to understand how a not-for-profit organization can enter

[11] Study of Restatement Matters – An Analysis of the Industries and Accounting Issues Underlying Public Company Restatements For the Four Years Ended December 31, 2000, Arthur Andersen , 2001. The study notes 116f restatements of financial statements in 1997, 158 restatements in 1998, 216 restatements in 1999 and 233 restatements in 2000.

into this web of for-profit relationships and not create conflicts with the notion of being a public interest self-regulatory organization.

- The POB itself has no disciplinary powers.
- The POB has limited capabilities to ensure auditing standards are written based on meeting the needs of the public for effective audits, as opposed to being written by, and for, the general legal counsels of the firms.
- The Quality Control Inquiry Committee or QCIC that is often trumpeted as investigating alleged audit failures in fact has no subpoena powers. It only has members from the profession, often retired partners from the Big Five "club", lacks members from the public and only looks at documents that are already publicly available. It has recommended cases to the PEEC or Auditing Standards Board (ASB) for further action. Action that too often fails to materialize.

I have heard some say that unless practicing accountants serve on the PRO it will not have the necessary expertise. Yet in the United Kingdom the accounting profession itself recommended a new framework for the independent regulation of the profession that has an independent oversight board, called the "Foundation," without any practicing accountants among its members. I believe you can get many well-qualified public servants who understand audits and will protect investors by drawing from the ranks of former auditors.

I have also heard some say we should consider using one of the existing self-regulatory structures that exist today. However these may well involve organizations where the members themselves have a vested interest in the outcome of accounting and auditing standards. For example members of a stock exchange have a vested interest in the numbers they must report, the disclosures they must make, and the outcome of their audits. This creates a conflict that will not ease investor's fears about the current lack of independence.

One reason for creating a PRO is the need for an active inspection program that can discipline auditors when substandard work is identified. An inspection requires very experienced personnel who are typically partners and managers and who have significant practical experience. These people would be no lower than a GM-15 or Senior Executive Service in the government personnel scale. For a typical accounting firm office, it may take on average of ten reviewers working seven to ten days to perform an inspection. Large offices like those located in major metropolitan areas will take significantly more staff. Given the large accounting firms today have a hundred offices in just the U.S., one can quickly see where it will take significant manpower to perform timely and effective inspections. Being able to attract, competitively compensation and retain such staff will be a challenge for the PRO. However given today's budgetary pressures, this is probably easier accomplished in the PRO as opposed to the SEC.

Improving Audit Quality

The PRO will enhance audit quality through effective independent inspections. Performance of annual on-going independent inspections of the large accounting firms, with perhaps no less than tri-annual inspections of smaller firms who tend to audit fewer public issuers, should overcome the current system of "backslapping" peer reviews. It is interesting to note that today it is perhaps the smaller firms that face the most rigorous reviews. The system of firm on firm reviews by the large firms reminds one of grade school where the rule was "I won't tell on you so long as you don't tell on me." A system that time and time again I questioned the credibility of the reviews being performed. A process that did not examine audits such as Enron or Global Crossings where investors had alleged a failure occurred, and did not mandate that all audits in which a restatement had occurred to be inspected

And when the SEC staff raised questions with the peer reviewers, meaningful and satisfactory responses were generally not forthcoming. The responses we did receive continually sounded like a rationalization of whatever had been done. Yet the public continued to be provided with the blue ribbon seal of approval by the very profession under scrutiny. Eventually this led to the SEC removing the "endorsement" of the peer review process from its Annual Report to Congress in 1999.

Further recommendations continue to need to be implemented to improve audit quality. They include:

- The 200 plus recommendations the Panel on Audit Effectiveness made to the profession and accounting standard setters in August 2000 need to be adopted as proposed, without being watered down. This includes a substantial rewrite of many of the auditing standards to require certain forensic audit procedures be incorporated into each audit, and to put sufficient detail into the standards to ensure they can be enforced. The POB was charged with overseeing the implementation of the Panel's recommendations. I would encourage the GAO undertake that charge, as the POB will soon cease to exist.

- Auditing standards need to be established by an independent standard setting body. No doubt some will argue that you need to have a knowledgeable body of auditors to set auditing standards if you are going to be effective. But keep in mind that for the past twenty plus years, the ASB has been drawn almost exclusively from "knowledgeable" auditors with the major accounting firms. And yet the Board's Statements on Auditing Standards:

    - Result in an audit report to investors that fails to provide an adequate explanation of an audit, such as the fact the auditor may not even have tested internal accounting controls, or while generally accounting rules are followed, aggressive accounting practices have been employed by the company to meet earnings expectations.

    - Today still don't *require* auditors to look at large unusual adjusting journal entries that are a common characteristic of many financial frauds.

- Do not provide guidance to auditors on factors an auditor would need to consider in assessing materiality until after the SEC staff issued guidance on this subject in August 1999.
- Still have not provided an auditing standard with authoritative guidance on auditing "cookie jar" reserves despite the request of the SEC staff over two years ago to provide such guidance to help reduce the incidence of improper earnings management.[12]
- Still permit auditors to consult on the design and structuring of transactions which reduce, rather than improve the transparency of disclosures, despite two previous requests from the SEC as well a renewed request in recent weeks to address this abusive practice.
- Have recently adopted a new standard that will set the requirements for auditors documenting their work that still does not require sufficient documentation to permit an independent third party to validate the work auditors have performed.

Simply put, auditing standards today, which are often reviewed and edited by the legal counsels of the firms, are written to protect the interests of the firms, not ensure quality audits that will protect investors. Perhaps the greatest chief accountant of all times, Sandy Burton was way ahead of his time in 1978 when he testified before Congress stating that the current system of setting auditing standards would not serve investor protection.

I do give the current chairman of the ASB credit for trying to improve recently the quality of the auditing standards. Guidance has been forthcoming on topics such as auditing revenues in selected industries as well as financial instruments many companies have invested in. However it has been the age-old story of too little, too late. We need to change the process to one that will develop standards for auditors and provide them with timely guidance before they and investors hit the iceberg. Again I point out that in the new system in the United Kingdom, the establishment of auditing standards has been lifted from the profession itself and been given to a new organization under the auspices of the new independent oversight board.

Auditor's Independence

Auditor's independence has long been a hotly contested issue to the profession and the SEC. But after cases such as Waste Management and Enron, no longer are people asking, "where is the smoking gun." Disclosures of consulting fees that run into tens of millions of dollars and multiples of the audit fees are generating an outcry for action.[13]

---

[12] Letter from the Chief Accountant to Ms. Debbie Lambert, Chairman of the Auditing Standards Board dated December 9, 1999.

[13] A study by the SEC staff of proxy disclosures by 563 of the Fortune 500 companies in 2001 found that on average, for every dollar of audit fee, companies paid their auditor $2.69 in fees for non-audit services. The range of non-audit fees paid to a company's auditors was from $0 to $32.33 per dollar of audit fees.

Once and for all, we need to adopt rules that will truly protect the independence and integrity of the audit, and gain the public's confidence that the auditor's are working for them, not management. Rules that will ensure investors that with the auditor's seal of approval, they can trust the numbers. To accomplish that, in addition to the changes I already suggested to H.R. 3763, we need to:

- Close the revolving door between the audit firm, its partners and employees, and the company being audited.
- Adopt a rule that allows auditors to provide only audit services to an audit client, unless the audit committee makes a determination and discloses that the services provided by the audit firm are (1) in the best interest of the shareholders, and (2) will improve the quality of the company's financial reporting. This is sometimes referred to as the exclusionary ban approach to auditor's independence.
- Prohibit an independent auditor from assisting a company design and structure transactions, then provide their accounting or tax opinion on what the appropriate accounting is for the transaction, and then audit the accounting for that transaction. This was discussed in the original SEC rule proposal. However, companies and their auditors should be permitted to consult on the proper accounting for a non-hypothetical transaction that the auditor has not designed and structured, as that is a normal and important process in any audit.

Some will argue that a ban on the ability of an auditing firm to provide non-audit services to its audit clients will have a negative impact on the quality of audits or the financial strength of an accounting firm. Others argue that tax services are an integral part of performing an audit. To that I respond that if the service is integral to the audit, then no one should be better situated to make that assessment on behalf of investors than the audit committee. Under the proposed recommendation the audit committee will have the option of agreeing to those services that are in the best interests of the investors.

Trying to make an across the board cut on which of these services will or will not impair an auditor's independence, in a quickly changing business environment, is not a long term solution. As soon as a new statute or rule is adopted, new services will be developed and the issue will reappear.

I also am reminded that during the intense debate on the SEC's proposed rules on auditors independence, the opposition often argued that their inability to provide IT consulting services to their clients would impair their ability to provide a quality audit. But the proxy disclosures have shown that the vast majority of audit clients do not currently engage their auditor for such services. Yet I have not heard a single firm say the audits of these company's are substandard. Why?

The fact that auditors are paid by the management of the companies they audit has also been brought up time and time again in recent months. Some argue that the auditor would never risk their reputation for the fees from a single audit. Yet at the Commission we saw situations, some of which are now public, where the auditors identified the problems with the numbers in the financial statements discussed them and still issued their unqualified

reports. In fact, it is not the magnitude of the fee to the firm that matters as much as it is the magnitude of the audit and consulting fees to the profitability of the office or the engagement partner's portfolio of business.

Ellen Seidman, then Director of the Office of Thrift Supervision or OTS, testified before the Senate Committee on Banking, Housing, and urban Affairs on September 11th, 2001 regarding the audit of the failed Superior Bank. In her opening statement the Director stated "Congress or the FBA's [Federal Banking Agencies] could also encourage the AICPA and SEC to establish an 'external auditor rotation requirement'...its adoption would result in a 'fresh look' at the institution from an audit perspective, to the benefit of investors and regulators."

But others will argue that there is greater risk in the first year of an audit, as the auditor has to get an understanding of the business to ensure the proper issues are identified and dealt with.[14] I don't dispute the fact the auditor has a higher learning curve on the first year of an audit. But in all my years in public accounting, I never once heard my former firm or any other firm for that matter, say they did not do what they needed to do, to get the necessary background to perform a proper audit. Perhaps the real fact is, that in some cases, auditors propose a lower fee in the first year of an audit relationship in order to gain the account, and this has a negative impact on the quality of the first year audit.

Another argument made is that with five major accounting firms there is already too great a concentration and audit specialization amongst the firms resulting in businesses being limited in their ability to chose a qualified audit firm. Certainly permitting the industry concentration to fall to just four firms will exacerbate this issue. However to-date, approximately 30 firms have chosen to switch from Andersen to another Big Five accounting firm and there has not been a single case that I am aware of where another firm was not ready, willing and able to provide the audit services. In fact, today it appears as if the ambulance is out chasing the injured uninhibited by limited numbers.

Also remember that investors have suffered their largest losses on audits of companies that did not involve an initial audit, but rather an ongoing relationship. Examples include:

- Enron
- Microstrategy
- Cendant
- Rite Aid
- Livent

[14] Ibid Note 1. The COSO study noted that just over 25 percent of the companies involved in the SEC enforcement actions studied changed auditors during the time frame beginning with the last clean financial statement period and ending with the last fraud financial statement period. The average fraud lasted 23.7 months. A majority of the auditor changes occurred during the fraud period and as a result, two auditors were associated with the fraud period.

- Informix
- WR Grace
- Sunbeam
- Lernout and Hauspie
- Xerox
- Lucent
- Oxford Healthcare
- Superior Bank
- HBO McKesson
- Waste Management.

One final argument you will hear against the rotation of audit firms is that they already do an internal rotation of audit partners on the companies they audit. That will probably also be true for some of the above companies. But once a firm has issued a report on the financial statements of a company, there is an inherent conflict in later concluding that the financial statements were wrong. This is especially true if the company has accessed the capital markets using those financial statements and as a result, the accounting firm has significant exposure to litigation in the event of a restatement of the financial statements. By bringing in a new firm every seven years, you get an independent set of eyes looking at the quality of the financial reporting that have no "skin in the game" with respect to the previous accounting.

Engaging Audit Committees

It was in 1940, after the discovery of a large fraud at McKesson Robbins that the Commission first encouraged the establishment of independent audit committees. More recently in 1999, with the strong support of the stock exchanges and the accounting profession, new rules were adopted effective in 2001, that enhance the oversight of the financial reporting, disclosure and audits of public companies.

In light of Enron and questions surrounding the oversight of its audit committee, additional recommendations that can further enhance the vital role and quality of audit committees include:

- The exceptions provided for in the rules of the stock exchanges, which permit an audit committee member who is not independent, should be eliminated.
- The definition of an independent director should be modified to prohibit the company from engaging the director for any services other than those provided as a director, and ban financial payments on behalf of the director, such as contributions to charitable organizations or similar types of payments.

- Companies should be required to provide their audit committees with appropriate training and understanding of the business and its financial reporting to ensure their ability to carry out their obligation to investors.

Enhancing the Quality and Transparency of U.S. Accounting Standards

Let me shift gears and switch to the topic of accounting standards. I believe our financial reporting and disclosure system, including the accounting standards we use in assembling the numbers, remains the best in the world. That is difficult to comprehend in light of Enron, but one only has to examine closely the Asian crisis of a few years back to appreciate the quality of our financial reporting.

But as Enron has aptly demonstrated, the job of improving accounting standards is not complete. Our rules and standard setting process here in the U.S. require significant improvements to provide investors and regulators with greater transparency. Improvements that need to be made include:

- Protecting the independence of the accounting standard setters. Transparency in financial reporting has been negatively affected and impeded when industry or Congress has threatened the independence of the FASB. In recent testimony by the former chairman of the FASB before the Senate Committee on Banking, Housing, and Urban Affairs, he stated that the reason the FASB was not able to issue a final standard that reflected the economic reality of stock options was due to interference from Congress. Some continue to this day to renew this threat with the International Accounting Standards Board (IASB).

- Create an independent "no strings attached" funding mechanism for the FASB. This again could be accomplished by a fee charged to issuers and/or members of the exchanges, all of who greatly benefit from the work of the FASB.

- Revising the structure of the Board of Trustees to one where the board members are all representatives of the public rather than any particular special interest.

  It should also be pointed out that several years ago, after a drawn out discussion with the SEC, the FAF agreed to place a minority of public members on the Board of trustees. However, the FAF has refused the request of the SEC to modify its bylaws to make this change permanent.

- The FASB needs to develop accounting standards that reflect the reality of the actual economics of the underlying transactions. Standards that permit hundreds of billions of dollars in synthetic lease financing and other forms of off balance sheet liabilities to be hid from the eyes of investors; that permit companies to avoid consolidation of special purpose entities for which the company itself has the majority, if not practically all of the risks and rewards; and that result in the value of compensation in the form of stock options to be excluded from the income statement are not transparent standards. They are better described as a chapter from Grimm's Fairy Tales.

- The FASB needs to develop and implement a project management system that prioritizes the needs of investors, and then establishes accountability and responsibility for meeting those needs in a more timely fashion. For example, in the mid 1970's the SEC asked the FASB to address the issue of whether certain equity instruments like mandatory redeemable preferred stock are a liability or equity. Investors are still waiting today for an answer. In 1978 the Cohen Commission requested the FASB to require disclosure in a single footnote of all the transactions that were affecting the comparability of the financial statements from one period to the next. This is a disclosure that would have gone a long way towards addressing some of the problems created by pro forma earnings but again nothing has been done. In 1982, the FASB undertook a project on consolidation. One of my sons born that year has since graduated from high school. In the meantime, investors are still waiting for an answer, especially for structures, such as special purpose entities (SPEs). In 1985 the SEC asked the FASB to provide guidance for financial instruments, a project still underway today. In 1998 the FASB was asked to provide guidance to reduce some of the abuses of "big bath" charges, but they continue to this day unmitigated. Time and time again the FASB has asked the SEC to defer to it to establish standards. Yet the standards never come. As a result, in the future the SEC should give the FASB a timetable for completion of these standards and if that timetable is not met, the SEC should act promptly to protect investors.

- The FASB Trustees should undertake to restructure the Emerging Issues Task Force (EITF) of the FASB. The EITF establishes generally accepted accounting principles for many of the new and emerging types of accounting transactions but does not have investor protection and transparency as a key part of its mission statement. Rather it often establishes rules that "grandfather" past accounting practices that are questionable at best. This should surprise no one, as the EITF is comprised solely of members from industry and the accounting profession. The EITF needs major revisions to its charter, should *require* public representation, and as with the IASB, should not be able to pass a new rule without the explicit approval of the FASB.

- The SEC should require disclosure of key performance indicators or KPI's. KPI's, such as backlog, plant utilization rates, revenues generated from new product introductions, etc. provide a very powerful and useful tool that gives investors greater predictive capability with respect to trends in the business.

- The SEC proposed new rules to increase the transparency of "reserves" and large write-downs in the value of assets such as plant and equipment and goodwill. As the Association for Investment Management and Research (AIMR) has recently requested, the SEC should quickly issue final rules similar to those proposed.

In recent weeks the AICPA has seemingly laid the problems associated with Enron at the doorstep of the FASB. They have argued that the lack of transparent accounting standards was the cause of Enron's financial reporting standards. They fail to acknowledge there were problems with the audits while stating the financial reporting model is broken. But

as Jack Bogle, the highly respected founder of the Vanguard funds has stated, perhaps it has been the markets and not the model that were wrong. Perhaps the ostrich is once again placing its head in the sand.

Some have said that investors cannot read financial statements today because they are too complex and written in a language difficult to understand. I certainly support Chairman Oxley's and SEC Chairman Pitt's call for plain English financial statements. But at the same time, one cannot ignore the reality of a business world that is much more complex today than when I joined the profession 25 years ago. It is difficult enough for knowledgeable business executives to understand complex business transactions such as derivatives, affiliations of varying shapes and forms including special purpose entities, and Wall Street engineered financing structures. Most people cannot and will not be able to understand some of the financial disclosures today, any more than members of this committee could be expected to understand the workings of a printed circuit board that makes a computer system work. Instead, we all need to be ably to rely on management, the corporate board, independent auditors and analysts to maintain the integrity of the capital markets and provide the financial information that serves as its lifeblood. Management preparing accurate and timely numbers with transparent disclosures, the auditors ensuring the integrity of the numbers, the board overseeing this process and finally the analysts taking the financial information produced by this process and producing a report to investors with their analysis and recommendations.

Another issue being bantered about involves whether today's accounting standards should be principles based rather than detailed rules. This is not the first time this issue has been raised, and I can assure you it will not be the last. The predecessor to the FASB, the Accounting Principles Board (APB) did write some principles based standards. For example, in 1964 the APB issued a standard on accounting for leases. That standard stated in principle that when a lease is an installment purchase of equipment as many are, it should be reported as a liability on the financial statements. But this standard was no more successful than the current detailed FASB rule on getting this off balance sheet debt back on the balance sheet. We also have broad guidance on accounting for property, plant and equipment and the associated depreciation. But that has not stopped the abuses of understating depreciation and then taking large write-offs of assets when it is convenient. The predecessor to the APB issued what some consider broad principles standard for reporting of inventories. But a recent survey by Andersen and a 1999 report by the Committee of Sponsoring Organizations (COSO) illustrate that overstatement of inventories continue to be a major source of earnings misstatements and SEC enforcement cases. And finally, the FASB standard that establishes when many liabilities are to be reflected in the financial statements, Standard No. 5, is a very broad principle standard that has been responsible for such aggressive accounting practices like "big bath" charges and understatement of liabilities for environmental costs. The real issue is not simply one of broad versus narrow detailed rules. It is a cultural issue of a lack of compliance with both the spirit and intent of the standards. It is an issue of professionalism.

One stark reality today is that before the ink dries on a new FASB standard, the investment banking community and accountants are joining forces to find ways to

structure transactions to get around the new rules. And while the spirit of a rule may clearly say no, I have heard time and time again from a CFO or auditor, "where in the rules does it say I can't do it." It is time to get away from this mentality and a good starting point would be to prohibit auditors from designing and structuring transactions, such as SPE's, that result in less, rather than more, transparency for those they are reporting to.

Strengthening The SEC

Let me move on to perhaps one of the most important considerations for the U.S. capital markets today. That is ensuring we have an adequately staffed and resourced securities regulator. Today, that does not exist.

There are approximately 12,000 actively traded public companies who file 12,000 annual reports, 36,000 quarterly financial statements, and tens of thousands of initial public offerings, registration statements, proxies, and tender offers. In recent years, the Division of Corporation Finance has been staffed with approximately ninety accountants to review these documents. In the Division of Enforcement, the typical caseload is around two hundred to two hundred and fifty cases. There are approximately twenty to twenty five accountants in the Washington D.C office and maybe another thirty or forty around the country to investigate these cases. In the private sector, it is not unusual that three to four accountants assist in preparing for testimony on a financial fraud case. In a case such as Enron, many more staff would be dedicated to such a project. Finally about twenty to twenty five accountants are working in the Office of the Chief Accountant. This office provides a service to the public accounting firms and companies, similar to what the national accounting and auditing offices of each of the Big Five accounting firms provides to their own audit clients and offices. They also have oversight responsibility for all the activities of those entities in the alphabet soup. Comparatively speaking, the national offices of the Big Five accounting firms are each typically a multiple or two larger than the Office of the Chief Accountant.

As you can plainly see, it is physically *impossible* within their current budgetary handcuffs for the SEC staff to carry out their mandate to ensure full disclosure and timely enforcement of the laws and regulations. The Panel on Audit Effectiveness recommended the SEC provide additional resources to combating financial fraud. I hope Congress will respond to the Panel report and provide the necessary funding for doubling the size of the accounting staff in the Division of Corporation Finance and the Office of the Chief Accountant, as well as reasonable compensation levels for existing staff. The SEC Division of Enforcement should also double or triple the number of accountants and attorneys involved with combating financial fraud. Its Financial Fraud Task Force needs to become a permanent fixture within the Division.

The SEC also needs to be provided with the resources to acquire technology that can aid in the electronic screening of filings for potential issues and unusual trends in financial performance. SEC Chairman Pitt has indicated he wishes to hire a qualified Chief Information Officer. This is long overdue and will require additional funds. But new and enhanced technologies can be a powerful, efficient and effective tool in identifying problems at an early date.

The statutory authority of the SEC to undertake certain types of actions should also be evaluated. Recent cases involving Baymark and California Micro Devices have raised serious questions as to whether the standard of recklessness the SEC applies to Rule 102(e) proceedings against accountants, is too high a standard by which to measure unprofessional conduct by an accountant or auditor. Rule 102(e) is the regulation by which the SEC may censure an accountant in a public company or an auditor and deny them the right to practice before the Commission. The rule is used to protect the integrity of the system and processes that are key to efficient markets. It requires that an accountant must be reckless, or have multiple incidences of improper professional conduct in order to be sanctioned. As a result, in cases involving negligence or other unprofessional behavior that is less than recklessness, a 102(e) sanction baring the practice of the accountant before the commission or in a public company cannot be pursued.

It should be noted that some professionals have challenged the SEC with respect to whether a Rule 102(e) proceeding may be initiated against an accountant within a public company, if they are not a currently licensed CPA. Today, many of the CFO's, Controllers and key financial reporting people do not have, or have not maintained a current CPA license. In essence, the lack of current SEC actions pursuant to Rule 102(e) against non-licensed accountants sends a strong message. I think it is the wrong message that CFO's and Controllers are better off without their licenses than they are with them.

Let me switch briefly to the subject of the chief financial and principal accounting officers. Today, CFO's at the major American corporations turn over approximately four times faster than they did at the beginning of the 1990's. And while the turnover ten years ago was often tied to one's retirement, it is much more likely today to be tied to a company missing an earnings estimate. Way too often today the CFO becomes the "fall guy" for such misses while the CEO's, Chief Operating Officers, vice presidents of manufacturing, marketing and other key management positions stay on. And as surveys have shown, it is all too often the CFO who is pressured by other members of management to stir the pot and cook the books. And when the CFO doesn't like the recipe that is handed to him or her, they are shown the door.

As a result, I also believe the SEC should make a change to its rules for Form 8-K. A Form 8-K should be required to be filed whenever a chief financial officer or chief accounting officer is terminated. The report should require disclosure of whether the audit committee approved the termination and whether there were any disagreements regarding financial accounting or disclosure matters. Perhaps a similar disclosure should be required for audit committee members.

Another challenge to the authority and ability of the SEC to enforce the securities laws involves access to the work papers of auditors of foreign issuers, or U.S. issuers with operations audited by a foreign affiliate of the U.S. firm. Time and time again I watched as the public accounting firms failed to provide timely access to the foreign work papers, thereby dragging out the case and hoping it would be dropped due to turnover in the assigned SEC staff. In its international concept release issued in 2000, the SEC noted this was a significant issue it faced in enforcing the SEC's rules. And the SEC is not the only regulator to have been confronted by this issue. In the BCCI case the federal

banking regulators also had to endure difficulties in gaining access to the work papers of the foreign affiliates of the accounting firm. With foreign registrants now comprising approximately ten percent of all actively traded companies, either the Congress or SEC should act quickly to protect investors before investors are unwittingly exposed to greater risk.

Finally Section 10A of the Securities Act needs to be modified. Currently auditors are only reporting a small handful of violations of the law. They define their responsibility very narrow to require reporting only when they have identified an illegal act, have unquestionably proved it is an illegal act, and did not resign before they had to report it. As a result, when financial reporting is questioned as it has been at Enron, this narrow definition of the rule will not result in a Section 10A report to the SEC. I think most investors would agree that is a definition that is too narrow and that fails to protect the public.

Closing

Let me close by noting that many of the issues being debated today, are not new. They were raised again and again in Congressional hearings in the 1970's and 1980's. Issues such as the independence of auditors and greater oversight and improved governance of the accounting profession have been debated from sun up to sun down for the last three to four years. And just as the arguments against meaningful reform have not changed during the past thirty years, neither has the implications for investors.

Some propose a cautious approach to solving issues that have cost thousands of Americans their jobs, their savings for retirement or a child's education, their future. These opponents of meaningful and necessary reforms say there are "untended consequences" to taking action. They want to fight reforms and win the war of attrition. They suggest the use of best practices that are just what they imply; the best practices of a few, not all market participants.

The choice before Congress is not an easy one, but it is simple. Chose between the true consequence of "unintended consequences" which is more of the same for one out of two Americans who invest in the markets; or fixing a problem that has lingered for too long, cost too many too much, and that yearns for action, not further debate.

Thank you.

A P P E N D I X

March 20, 2002

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Legislative Hearing
H.R. 3763, Corporate and Auditing
Accountability, Responsibility and Transparency Act

March 20, 2002

Good morning and welcome to the Committee's second legislative hearing on the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002, or CARTA.

Last week the Committee held its first hearing on CARTA. We heard from a diverse panel of witnesses, including former SEC officials and representatives from the securities industry, a leading consumer organization, and the accounting profession.

The testimony was very instructive. Our witnesses represented a broad spectrum of views about the securities markets and the role of government in protecting investors. Some of the witnesses said that CARTA regulates too much. Others said not enough. Clearly, we must be onto something.

CARTA was carefully crafted to strengthen the oversight of the accountants who audit public companies, without federalizing the accounting profession. The legislation requires companies to give investors accurate and immediate access to important company information, without drowning issuers in red tape. And the bill will make it a crime for company officials to mislead auditors, ensuring both that corporate officers act responsibly and that auditors can do their job effectively.

CARTA encourages business leadership by prompting executives to act in the best interests of shareholders. It requires greater transparency and prevents insiders from benefiting when their employees cannot.

Today's witnesses will further illuminate the important issues that face this Committee as we seek to reassure investors in the strength of America's capital markets. Already the Committee has held extensive hearings in the wake of the Enron bankruptcy. Going as far back as December of last year, the Financial Services Committee has held hearings on the Enron collapse to ensure we fulfill our obligation to protect investors.

Our hearings have revealed that while some bad actors may seek to take advantage of investors, ultimately the laws and the marketplace will catch up with them. No one should doubt that America remains the best place to invest, not only for the ability of our workers and the ingenuity of our entrepreneurs, but also because America does not tolerate cheats.

CARTA represents our further efforts to strengthen America's capital markets so that they remain healthy and vital. I look forward to the testimony of our witnesses, and I now recognize Ranking Member LaFalce for his opening statement.

###

March 20, 2002

Opening Statement for Congressman Paul E. Gillmor
Committee on Financial Services
Full Committee Legislative Hearing on HR 3763, the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002- Day 2

I would like to again applaud Chairman Oxley and Subcommittee Chairman Baker for taking the initiative on this important issue and working so swiftly and diligently to introduce, HR 3763 "the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002 (CAARTA)." I was happy to become an original cosponsor of this legislation and feel it responsibly addresses the systemic problems uncovered in both the accounting industry and corporate management culture by this committee's investigation of the Enron collapse.

I always have been a firm believer in increased management responsibility and accountability to both its shareholders and the American public. I am especially interested in hearing from Chairman Pitt this morning and thank him for his continued willingness to come before this committee and discuss the important issues surrounding Enron's failure.

On February 13th, I introduced HR 3745, "the Corporate Charitable Disclosure Act of 2002 (CCDA)." The CCDA would require corporations to make publicly available, each year, the total value of contributions that they made to non-profit organizations during the previous fiscal year. As the collapse of Enron has made painfully clear, corporate disclosure rules need to be revisited and the legislation being considered today is an important first step in this process.

I would like to thank Chairman Oxley for holding this series of hearings and look forward to the witnesses' learned comments on this most important piece of legislation.

OPENING STATEMENT

HR 3763
Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002

Financial Services Committee
Rep. Stephanie Tubbs Jones
Cleveland, 11th District
(Part II)

Rep. Stephanie Tubbs Jones

Good Morning, Chairman Oxley, Ranking Member LaFalce and Members of this Committee. Mr. Chairman, I ask unanimous consent that my full statement be included in the Record.

Once again we have gathered in this committee for the purpose of delving further into the events that led to the Enron Corporation's sudden filing for Chapter 11 bankruptcy. An event that left millions of investors with unprecedented losses and millions more with questions regarding how this could have happened to such a large company so fast. Although we still require significant inquiry as to who exactly was involved in the debacle and in what capacity, we have learned much about the regulatory environment and inappropriate corporate leeway that was given to Enron and Arthur

Andersen in this particular situation. However, make no mistake; many Americans have paid a significant price for the knowledge that we have gained. The onus now falls on this committee to ensure that what we have learned is used to create an environment where Enron's ordeal can never be repeated.

And what have we learned? We have learned that the danger of inadequate corporate governance is shareholder loss, and that this kind of loss is both unnecessary and unacceptable. We have seen first hand why more stringent regulations with regard to auditor independence are necessary and the dangers of mixing auditing with other corporate services. We now see that a public regulatory board should have a significant role in the general order of the auditing process. And most important, we realize that we do not yet have all the answers to correct a system long overdue to be overhauled.

I must once again thank this esteemed committee for its expeditious and thorough exploration of the issues surrounding the Enron collapse. And again I say that our work is far from over. The Comprehensive Investor Protection Act ("CIPA") as introduced by Ranking Member LaFalce as an alternative to HR3763, will go far to address constituent and investor concerns.

I look forward to the testimony today so that we may continue in our pursuit to ensure that the American people have the objective information needed to make informed investment decisions. Mr. Chairman, I thank you for my time.

Opening Statement
Congressman Ed Royce (CA-39)
20 March 2002
CAARTA Hearing

Mr. Chairman, I appreciate this opportunity to address the issue of flagging investor confidence in the accounting profession and the capital markets caused by the failures of Global Crossing and the Enron Corporation. The bankruptcies of these two formerly highly-touted companies have brought many of the systemic problems associated with the current system of auditor oversight and corporate culture in our country to the foreground of debate. I believe that H.R. 3763, the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002 (CAARTA), is a broad and practical effort that goes a long way towards resolving most of the accounting profession's most troubling and egregious shortfalls.

While I am generally pleased by the reforms included in this bill, I am most interested in the section commissioning a study on the rules, standards and practices meant to maintain the independence of the board of directors for publicly-traded companies. In theory, American corporate directors are elected by a company's stockholders and are responsible as their representatives to oversee corporate operations and to ensure the long-term health of the company. In return, these directors are compensated by the company, generally through a cash salary and stock options. Unfortunately, because in reality the equity shares that individual shareholders hold in these companies are comparatively small - and they are often prevented through bureaucratic hurdles from proffering an alternative slate of directors for consideration - shareholders are often unable to do anything but cede their proxy votes and act as little more than a rubber-stamp for management's nominees to these important and ostensibly independent positions.

I strongly believe that this Committee needs to take a serious look at how the directors of publicly-held companies are selected and compensated for their service to ensure that they appropriately represent the interests of shareholders, and do not simply echo the wishes of management. Ensuring director independence is once of the reforms that CAARTA must include to restore transparancy and public confidence to the accounting profession and the capital markets.

I hope that as members of Congress we acknowledge the important role that directors play in the managerial oversight of a company. It is our responsibility to seize upon this opportunity to enact the appropriate measures to empower corporate directors to act as a true balance to a management whose short-term goal of increasing market capitalization may be at odds with shareholders' interest in maintaining a company's long-term prosperity.

###

TESTIMONY OF

HARVEY L. PITT, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING
THE CORPORATE AND AUDITING ACCOUNTABILITY, RESPONSIBILITY, AND TRANSPARENCY ACT

BEFORE THE COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

MARCH 20, 2002

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

TESTIMONY OF
HARVEY L. PITT, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING THE CORPORATE AND AUDITING ACCOUNTABILITY, RESPONSIBILITY, AND TRANSPARENCY ACT

BEFORE THE COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

March 20, 2002

Chairman Oxley, Ranking Member LaFalce, and Members of the Committee:

I am pleased to appear before the House Financial Services Committee today on behalf of the Securities and Exchange Commission regarding H.R. 3763, the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002. On February 4th of this year, I was privileged to testify before Subcommittee Chairman Baker and Congressman Kanjorski on "Legislative Solutions to Problems Raised by Events Relating to Enron." I know that all Members of this Committee have worked diligently to explore the substantive issues at stake and to develop reform proposals that will help restore confidence in the integrity of our financial markets, and I want to commend the leadership shown by you, Mr. Chairman, and Ranking Member LaFalce, as well as Congressmen Baker and Kanjorski, and all of the Members of this Committee, in this effort. The SEC has appreciated the opportunity to work with you and your staffs on many ideas in your legislative proposals, and we look forward to continuing that cooperation. Whether by legislation, regulation, or some combination of legislation and regulation, we will work together to make our nation's federal securities laws more responsive to the current-day needs of investors.

Mr. Chairman, I would also be remiss if I did not take this opportunity to say how very much the entire Commission and its Staff appreciate your support, Congressman LaFalce's support, and the support of the entire Committee for funding pay parity for our Staff and your concern for our agency's resources at this especially critical time.

INTRODUCTION

The past seven months have tested the mettle and resiliency of our country, our markets, and the investing public's confidence. With the events of September 11th, the bankruptcy of Enron and, just last week, the indictment of Arthur Andersen, we have witnessed how critical our appropriately vaunted capital markets are to the strength, security and spirit of our Country and our economy. All Americans have felt, and continue to feel, the consequences of these events. From the perspective of the federal securities laws, all three crises have much in common. In each, the continuity and

integrity of our capital markets was, or is, put in play. The response to the tragic loss of lives, and the sudden shutdown of our capital markets after the terrorist attacks of September 11th, presented a model for all of us, and the rest of the world, on how to address and respond to a crisis. From the President's unstinting and fearless leadership, to bipartisan cooperation in Congress, we responded quickly and forcefully to an unthinkable crisis. With the implosion of Enron, and the indictment of Arthur Andersen, my hope is that we will follow the model set last September, and work constructively together to restore vital confidence in our capital markets.

With Enron's disintegration, innocent investors, employees and retirees, who made life-altering decisions based upon a stock's perceived value, found themselves locked-in to a rapidly sinking investment that ate up the fruits of years of their hard work. It is these Americans, whose faith fuels our markets, whose interests are, and must be, paramount. America's investors are entitled to the best regulatory system possible. The Commission as an institution, and I both as its Chairman and personally, are committed to doing everything in our power not only to prevent other abuses of our system, but also to improve and modernize our existing system.

In the aftermath of Enron's meltdown, our agency currently is conducting an enforcement investigation to identify violations of the federal securities laws that may have occurred, and those who perpetrated them. Until the investigation is complete, the Commission cannot address the specific conduct of Enron Corporation and those involved with it, or the activities currently under investigation. The public can have full confidence, however, that our Division of Enforcement is conducting a thorough investigation and that the Commission will redress any and all wrongdoing and wrongdoers swiftly and completely.

Nothing that has occurred in recent months should undermine, or be allowed to undermine, investor confidence that our markets, and the regulatory system governing them, are still the best in the world. Our capital markets are still the world's most honest and efficient. Our current disclosure, financial reporting and regulatory systems also are still the best developed, the most transparent, and the best monitored by market participants and regulators. No other system yet matches the depth, breadth and honesty of our markets, and it is important that we not lose sight of that critical fact. While some foreign regulators have publicly claimed that Enron would not have collapsed under their systems, I tell you unequivocally that any such claim, whatever the source, is unsupportable.

But, even though our system is the best at present, we can, and must, do better. As more and more individuals become direct participants in our markets, and face increasingly difficult investment decisions that affect their lives, savings goals and retirement security, we need to maximize the utility of our existing system for individual investors. At the same time, we must find a way to facilitate and promote the ability of American businesses to raise capital efficiently and expeditiously.

OVERVIEW OF NEEDED REFORMS

Our system requires that corporate leaders be faithful to the interests of investors and to act both with ability and integrity. Complete and accurate disclosure and financial reporting to investors and markets are important parts of this duty. The most important challenge to corporate governance today is to restore the preeminence of that duty. This is as much a moral imperative as a legal one.

In recent years, corporate leaders have been under increasing pressure from the investment community, including individual investors, to meet elevated expectations. They also have been operating under a system that can misalign the incentives of investors and those of management. Our culture over the past decade has fostered a short-term perspective of corporate performance. Corporate leaders and directors have been rewarded for short-term performance, sometimes at the expense of long-term fundamental value. Investors have purchased stock not because they believed in the business or its strategy as an investment over the long-term, but simply under the assumption that stock prices would only go up.

But, after a most incredible bull market, we have had to witness the truth of the timeless axiom that whatever goes up can also come down, and not only because of a reversal in business outlook or fundamentals. Corporate leaders, under pressure to meet elevated expectations in the bull market, in too many instances were drawn to accounting devices whose principal effect was to obscure potentially adverse results. Moreover, the effectiveness of a number of the checks and balances intended to ensure that we achieve appropriate corporate governance and financial reporting and disclosure also declined. These include reviews of financial reporting by outside auditors and the activities of audit committees. The moral imperative on those intended to provide the checks and balances has eroded and must be restored. Out of the ashes of the Enron debacle, corporate reputation is reemerging as a significant economic value. Corporate governance appears to be improving as a result of this greater market discipline in the wake of the Enron debacle. But much more needs to be done.

Confidence in our capital markets begins with the quality of the financial information available to help investors decide whether, when and where to invest their hard-earned dollars. Comprehensible information is the lifeblood of strong and vibrant markets. Our system and the global markets supporting that system require accurate, complete and timely disclosure of financial and other information. The current system of federal securities regulation is premised on full and fair disclosure of this information. Companies choosing to access the public capital markets must provide material information about their financial results and condition, businesses, securities, and risks associated with investment in those securities.

Congress wisely built in to the federal securities laws the philosophy that full and fair disclosure is the best way to permit markets to allocate capital. Congress rejected a "merit-based" system of regulation, which could have been construed as government's approval or guarantee of securities issued by public companies and that could unduly

interfere with efficient market allocation of capital. Optimal capital allocation requires that there not be limits on entrepreneurship or companies failing, or on permitting people to invest in companies that will fail. There must, however, be complete, clear, and timely disclosure to support the market's allocation decisions. We believe it is important to maintain a disclosure-based regulatory system that relies on capital allocation decisions made by market participants.

The success of our markets has not been due just to their depth and breadth, but also to their quality and integrity. In the wake of the Great Depression, when world economic forces caused precipitous and calamitous declines in equity market values, this Country learned that investors are willing to commit their capital to markets *only* if they have confidence that those markets are fairly and honestly run, are fully transparent, and affirmatively minimize the risk of loss from fraud and manipulation. Existing statutory and regulatory provisions require that the public statements by or on behalf of publicly traded companies in the United States contain no misstatements of material fact and no omissions that make the statements that are made materially misleading. These protections are supported by a detailed structure of accounting and disclosure requirements intended to ensure financial reporting and other disclosures that meet the mandated standards of accuracy, completeness and comparability. Current law prohibits wrongful activity, including, but very definitely not limited to, fraud in making materially defective or incomplete disclosure.

As the complexity of our financial markets continues to grow unabated, and the number of Americans who participate in them increases steadily, the Commission must ensure that our system's traditional high standards are not compromised. The goal of the SEC is to ensure that our financial markets are transparent and fair to all investors, and to do so, we must make certain that the public is adequately informed about investing and that corporate America provides the disclosure investors need to make fully informed decisions based on sound and reliable information. In addition to our extensive investor education programs, an integral part of our investor protection efforts is the SEC's aggressive law enforcement program, which protects investors from fraudulent and unfair practices.

Of course, no one should believe that we could create a foolproof system; those with intent and creativity can override any system of checks or restraints. Fraud aside, however, both the quality and timeliness of financial reporting and other disclosures can, and must, be enhanced. Financial reporting and disclosure standards can and should be amended to address the evident deficiencies, and the standard-setting process can and should be made more responsive to changing circumstances. As I discuss in more detail below, we believe we can achieve needed improvements by improving standards and our regulations in three principal areas.

- ***First, disclosure by public companies must be truly informative and timely.*** Companies must be subject to an affirmative obligation to provide reliable information that is informative, relevant, comprehensible, and timely. Investors should have all the information they need to make valuation and investment

decisions. We want investors to have an accurate and current view of the posture of their company, as seen "through the eyes of management." This has long been the SEC's disclosure standard, but "through the eyes of management" must be viewed by all of us, and most importantly by companies' top officials, as a broad and fluid obligation, not merely an obligation to disclose specified categories of information at specified times. And, meaningful disclosure is more than a single number. There has been far too heavy an emphasis by all market participants on quarterly and year-end earnings per share, and too little emphasis on a concise, yet totally lucid, presentation of financial information. We recommend additional substantive disclosure requirements that permit fuller understanding of financial statements and thereby improve overall financial disclosure. We also recommend improving other disclosure requirements to provide disclosure of higher quality, while avoiding greater quantity for quantity's sake. Finally, we are seeking to modernize our disclosure system to seek more timely disclosure of the most significant information, while protecting companies from premature disclosure, disclosure of sensitive information and second-guessing over when and how disclosures were made.

- ***Second, oversight of accountants and the accounting profession must be strengthened and accounting principles that underlie financial disclosure must be made more relevant.*** Outside auditors have an important role in ensuring that the companies they audit present an accurate, complete and current picture of their financial condition. Critical regulatory functions, including quality control and discipline, should be moved from the profession to an independent regulatory body that is completely or substantially free from influence or funding by the profession, and is subject to comprehensive and vigorous SEC oversight. Standards of independence should be revisited and strengthened to prevent conflicts of interest that might cause auditors to compromise the performance of their auditing functions. The standard-setting process for accounting and financial disclosure must be more timely and responsive to market changes and independent from undue influence. Present-day accounting standards are cumbersome and offer far too detailed prescriptive requirements for companies and their accountants to follow. That approach encourages accountants to "check the boxes" — to ascertain whether there is technical compliance with applicable accounting principles. We seek to move toward a principles-based set of accounting standards, where mere compliance with technical prescriptions is neither sufficient nor the objective. We support the wisdom of having accounting standards set by the private sector, but subject to our vigorous oversight. That standard-setting authority today resides in the Financial Accounting Standards Board, whose pronouncements govern financial statements because, but only because, the Commission has chosen to accept those standards as authoritative. The SEC should exercise its authority to ensure that FASB's agenda is responsive to issues facing investors and accountants and is completed on a timely basis.

- ***Third, corporate governance needs to be improved.*** Recent events also underscore the need to craft responsible guidance for directors and senior officers to follow. There are a number of ways current corporate governance standards can be improved to strengthen the resolve of honest managers and the directors who oversee

management's actions and make them more responsive to the public's expectations and interests. We think the best way to do that is a two-fold approach: first, make certain that officers and directors have a clear understanding of what their roles are, and second, apply serious consequences to those who do not live up to their fiduciary obligations. The role of audit committees and outside directors also must be strengthened.

In his State of the Union Address in January, the President appropriately demanded "stricter accounting standards and tougher disclosure requirements." He called for corporate America to "be made more accountable to employees and shareholders and held to the highest standard of conduct." Just two weeks ago, the President outlined a substantive, serious and thoughtful program to move toward implementation of these goals. The SEC shares and embraces these principles, and is firmly committed to making them a reality.

The President's Plan specifically calls on the SEC to implement the President's program. We believe we already have statutory authority to adopt rules to implement the President's program, as well as other improvements necessary to address the problems in our system brought to light so vividly by the collapse of Enron. We intend to work closely with you to ensure that the regulatory framework we ultimately propose meets your view of what is appropriate and in the interests of the public. We also plan to work cooperatively with others who are so vital to our capital markets — the investing public, the securities industry, the accounting profession, the self-regulatory bodies, and corporate management.

It is Congress, however, that must make the final judgment whether legislation is necessary or appropriate. We will work, and indeed are already working, with Members on both sides of the aisle, in both the House and the Senate, regarding legislation Congress may consider. We will continue in these efforts and are committed to implementing any legislative changes Congress ultimately believes are necessary.

H.R. 3763: CORPORATE AND AUDITING ACCOUNTABILITY, RESPONSIBILITY, AND TRANSPARENCY ACT OF 2002

Last month, Chairman Oxley and Capital Markets Subcommittee Chairman Baker introduced H.R. 3763, the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002 (CARTA). The proposed CARTA addresses many of the key issues facing our capital markets today, most notably, creating a statutory "public regulatory organization" to oversee the public accounting profession. The bill would also call on the Commission to improve and modernize, through rulemaking, our disclosure process in a number of key respects. Finally, CARTA requires the Commission and others to study a number of other issues about which questions have been raised in the aftermath of Enron's collapse. The Commission has had an opportunity to examine this legislation, and we believe that, given the Commission's existing authority, as well as Section 12 of this bill, we would have adequate authority to enforce the bill if enacted. We commend Chairman Oxley, Subcommittee Chairman Baker, and the bill's other co-

sponsors, for this effort to improve and modernize our system of financial reporting and regulation of the accounting profession in a comprehensive and deliberate fashion. In my testimony today, I will address the key aspects of this proposed legislation.

A. Creation, Authority and Funding of Accounting "PRO"

CARTA would establish a public regulatory organization (PRO) to perform certain review and disciplinary functions with respect to accountants who certify financial statements and other documents filed with the Commission.

We are proposing "private sector" regulation, not "self" regulation. Self-regulation implies that the accounting profession would regulate itself. We are suggesting regulation by the private sector, but not by the profession. Rather than a body that functions under the aegis of the American Institute of Certified Public Accountants, which represents the accounting profession, as we announced on January 17th, the Commission believes that it is necessary to create a new, private sector, independent body that can direct periodic reviews of accounting firms' quality controls for their accounting and auditing practices and discipline auditors for incompetent and unethical conduct. We believe there is substantial consensus on this approach. This private sector body would supplement our enforcement efforts, by adding a layer, or tier, of new regulation.

The proposed PRO in the CARTA legislation shares many characteristics that the Commission believes are necessary for effective private-sector regulation of the accounting profession. It is critical to separate discussion of the regulatory model from the issue of whether there is a need for legislation. While legislation is not required to establish private sector regulation with SEC oversight, if Congress determines that legislation is desirable, we are committed to assisting that process and appreciate the opportunity to work with this Committee in doing so. But regardless of whether Congress acts, I believe it is incumbent that the SEC move forward with the most responsible proposal it can.

Our approach and the CARTA legislation share many key elements. The board of the PRO would include some members of the accounting profession, but the overwhelming majority of members would be unaffiliated with the profession, providing a level of independence that the Commission considers critical for effective oversight. Further assuring the PRO's independence, CARTA requires that the PRO function on a self-funded basis, and not rely solely on fees from the accounting profession. We believe these structural measures will go a long way to addressing concerns with the accounting profession's previous self-regulatory scheme.

The PRO would have the authority to perform reviews of accountants and accounting firms who certify financial statements of public companies, and the power to deem them unqualified if necessary. The PRO would also have the authority to conduct disciplinary proceedings and impose sanctions, including determining that an accountant is not qualified to certify a financial statement required by the securities laws.

The PRO established by CARTA would be a positive step toward establishing an effective, independent private-sector regulator of the accounting profession. One aspect of the bill's PRO that could be enhanced, we believe, is the bill's provisions on SEC oversight of the PRO. If such a body is established by legislation, in addition to mandating that the Commission pre-approve the PRO's rules and granting the Commission the authority to amend those rules, several other oversight features could be added. For instance, the PRO and all of its records should be subject to examination by Commission staff, at the Commission's discretion. The Commission should also have the authority to direct the PRO to conduct special projects, such as a special review of a particular firm's quality control system, or a special review of a particular aspect of every firm's quality control systems. In addition, the Commission should have the authority to approve the PRO's budget and to approve the selection of individuals to the PRO.

B. Auditor Independence

CARTA would address concerns about maintaining auditor independence by stipulating that a public accountant not be considered independent of its audit client if it provides that client with financial information system design or implementation, or internal audit services. Specifically, the bill directs the Commission to revise its auditor independence regulations as they relate to these two non-audit service.

There has been considerable debate concerning what, if any, changes to the Commission's current auditor independence rules are necessary to restore investors' confidence in the integrity of the audit process. The Commission's rules on auditor independence were adopted less than 18 months ago, and were targeted to address problems about which there had been considerable study, discussion and debate. The Commission's approach at that time should be tested by practical application, over a reasonable period of time. If problems are empirically shown to exist in this area, any needed reforms can be tailored to address the precise problems uncovered. Some of the restrictions on non-audit services adopted in those auditor independence rules have not yet even taken effect, due to the rules' phase in provisions. With this in mind, we are considering these matters carefully, in light of the rules adopted previously by the Commission, the additional evidence before us, and legislative proposals that have already been made.

We believe that limiting those services that create an inherent conflict with auditing, barring inappropriate compensation mechanisms (such as compensation for cross-selling services) and penalizing firms whose aggregate and individual audit performance is substandard (most likely by limiting the ability to take on new clients for significant periods of time and compelling termination of client relationships) are more likely to prevent audit failures than the suggestion that we increase the reliance of all audit firms on their audit clients.

C. Improper Influence on Conduct of Audits

The sponsors of CARTA also recognize that an auditor cannot do his or her job if misled or improperly coerced in the course of conducting the audit. The bill therefore includes a provision that would make it unlawful for any officer, director, or affiliated person of an issuer to unduly or improperly influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in auditing that issuer's financial statements, for the purpose of rendering such financial statements materially misleading. The bill grants the Commission exclusive civil enforcement authority over this provision.

We agree with the proposition that issuers have to be forthcoming with their auditors. Anyone who obstructs an auditor is doing something wrong. The Commission has long recognized that the auditor must not be misled or improperly coerced in the course of an audit. We already have the authority to sanction any such improper conduct, and do so. In addition to the general anti-fraud sections of the federal securities laws, which could apply based upon the specific facts and circumstances, Section 13(b)2 of the Exchange Act, and Rule 13b2-2 thereunder, prohibit making materially false or misleading statements to auditors, and Section 20(c) of the Exchange Act prohibits obstruction of the making or filing of any required report with the Commission.

D. Real-Time Disclosure of Financial Information

CARTA would require issuers with securities registered under Section 12 of the Securities Exchange Act of 1934 to make "real time" disclosures of information concerning the issuer's financial condition and operations. The Commission strongly supports this initiative. As a first step toward achieving this objective, we announced on February 13th that we will engage in rulemaking to require accelerated filing by companies of their quarterly and annual reports, and to expand the list of significant events requiring current disclosure on existing Form 8-K.

In addition, CARTA would require that any disclosure concerning any sale of securities by an officer, director, or affiliated person of the issuer of those securities would have to be made electronically to the Commission before the end of the following business day, and would subsequently have to be made available to the public, electronically, by the Commission. The Commission recognizes the need to require corporate insiders to make public their trading activities more quickly than current law requires. Under current law, which dates back to 1934, the principal provision covering reporting by insiders calls for filing by the tenth day of the month after the month when the trading occurred. While that may have been good enough in 1934, it is not nearly good enough today.

E. Insider Trades During Pension Fund Blackout Periods

Recent events have demonstrated the loss of investor confidence that can result when officers or directors of public companies have the right to trade in the company's stock during periods in which the company's employees may not make trades through

their retirement plans. CARTA would address this concern by restricting insider trading during such a blackout period, with appropriate sanctions for those who violate the restrictions. Early last month, the President proposed safeguards to pension laws, including that when a company's employees are blocked from trading the company's stock in their 401K plans (including during a change in administrators of the plan), company executives also should be blocked from trading the company's stock.[1] We agree with this proposal.

F. Improved Transparency of Corporate Disclosures

No factor is more critical for maintaining the investing public's confidence in our markets than corporate transparency. CARTA seeks to improve the disclosures in public companies' registration statements and periodic reports, so that they provide adequate and appropriate disclosure of certain off-balance sheet transactions and relationships and material transactions. As the Commission has recognized, the quality of information public companies currently disclose on these issues should be improved. Moreover, since an issuer's choice of critical accounting principles may play a significant role in its reported financial condition and results of operation, CARTA would require the Commission to consider requiring the identification of, and additional disclosure about the effect of, the key accounting principles that are most important to the issuer's reported financial condition and results of operation. We strongly support these provisions and are already actively working on them using our regulatory authority.

G. Oversight of Financial Disclosures

CARTA would require the Commission to set minimum periodic review requirements to ensure that the periodic reports of the largest issuers will be subject to a regular and thorough review. The SEC would report annually to Congress on its compliance with this requirement.

We agree with the concept that the Commission, through its Staff, must significantly expand its review of financial and non-financial disclosures. In the wake of Enron, we announced that our Division of Corporation Finance would monitor the annual reports submitted by all Fortune 500 companies that file periodic reports with the Commission in 2002.[2] Through this process, the Division will focus on disclosure that appears to be important to an understanding of a company's financial position and results, but which, at least on its face, seems to conflict significantly with generally accepted accounting principles or Commission rules, or to be materially deficient in explanation or clarity. Where problems are identified, the Division will select the filing for expedited review. We are encouraging all companies to consult with our Staff if they have questions concerning disclosure issues *before* they file their reports. We are committed

---

[1] President George W. Bush, Radio Address to the Nation on Pension Protection Plan (Feb. 2, 2002).

[2] "Program to Monitor Annual Reports of Fortune 500 Companies," *SEC News Digest*, Issue 2001-245 (Dec. 21, 2001).

to providing that assistance in a timely fashion; our goal is to address problems before they happen.

We think, however, that circumscribing these periodic reviews through legislation could be impractical or counterproductive. The Commission should have the flexibility to focus on areas that could shift as we identify matters where we believe in-depth scrutiny is necessary. For example, announcing the timing and criteria of our reviews through legislation would be troublesome. Our flexibility would be reduced, and issuers would be on notice regarding the timing and scope of our reviews and could adapt accordingly. Also, regular, thorough reviews of all public companies would require significant resources, since the Commission oversees over 17,000 reporting companies. We intend to increase reviews to a larger number of those companies by focusing on periodic reports and using our resources effectively, including by undertaking targeted reviews.

H. Studies

CARTA also requires the Commission to perform or participate in several studies that may shed light on the need for additional reforms. The Commission supports each these initiatives and, without waiting on the passage of CARTA, is focusing attention on each of these areas.

1. Analyst Conflicts

CARTA mandates that the Commission review any SRO final rules on matters involving equity research analyst conflicts of interest, for effectiveness in addressing matters of objectivity and integrity of equity research analyst reports and recommendations. As the Committee is aware, the Commission has been working with the SROs to improve and more diligently enforce the disclosure of conflicts of interest, and has made repeated efforts to educate investors about analyst risk. We believe that we have made significant progress in addressing this issue, and will continue to move forward in our efforts.

2. Corporate Governance

Another study, conducted by the President's Working Group, would review corporate governance standards and practices, to ensure that they are serving the best interests of shareholders.

3. Identifying reporting areas prone to fraud

The Commission would be required to analyze certain Commission enforcement actions and restatements of financial statements during the last five years to identify the areas of reporting most susceptible to fraud, inappropriate manipulation or inappropriate earnings management.

4. Credit Rating Agencies

CARTA also requires the Commission to study the role and function of credit rating agencies in the operation of the securities markets.

SEC RESOURCE NEEDS

Let me conclude with a point that may be last but is certainly not least. Mr. Chairman, I want to thank you and Congressman LaFalce – indeed all of the Members of this Committee – for your support for pay parity and additional resources for the Commission. I know that separate legislation has been introduced to authorize substantially increased resources for the SEC, and that Members on both sides of the aisle have expressed their strong support for funding pay parity for the agency in Fiscal Year 2003. The entire Commission appreciates your help and support for these resources.

We need legislative assistance in increasing our funding for both this and subsequent fiscal years. The SEC regulates industries and markets that have grown enormously, in both size and complexity. The Commission currently oversees an estimated 8,000 brokerage firms employing nearly 700,000 brokers; 7,500 investment advisers with approximately $20 trillion in assets under management; 34,000 investment company portfolios; and over 17,000 reporting companies.

The President's budget for fiscal 2003 requested an appropriation of $466.9 million for the Commission, an appropriation that made sense when it was first formulated, and that I supported. But since the time that appropriation was formulated, pay parity legislation has passed, and the Commission has had to respond to three crises. As a result of those recent events, we critically need additional funds to enable us to phase-in a modest pay parity plan. We also need authorization to add new staff to address pressing immediate needs. We have discussed our interim personnel and resource needs with OMB, and they have indicated that they are receptive to our request for an additional $15 million to fund 100 new lawyers and accountants.

Given the enormous surge in our enforcement activities, the desire to do a better job than has been done previously at reviewing public company filings, and overseeing a restructured accounting profession, even before looking for efficiencies, the SEC must seek a staffing increase of 100 positions in fiscal 2003:

- 35 accountants and lawyers in the Division of Enforcement to deal with the increasing workload from financial fraud and reporting cases;

- 30 professional staff, including accountants and lawyers, in the Division of Corporation Finance to expand, improve and expedite our review of periodic filings; and

- 35 accountants, lawyers, and other professionals in the other divisions — including the Office of Chief Accountant — to deal with new programmatic needs and policy.

These are the minimum staffing levels required to deal with our *immediate* post-Enron needs. Under a pay parity system, this increased staffing level will require an additional $15 million. The Commission has not received a staffing increase in the last two years, despite the additional responsibilities we have received as a result of the Commodity Futures Modernization Act and the Gramm-Leach-Bliley financial services modernization act. A staffing increase is even more critical in light of recent events.

CONCLUSION

I take quite seriously my stewardship responsibilities and the Oath of Office I took when I became Chairman of the Commission. I look forward to continuing to work closely with you regarding legislation you are considering. We are committed to implementing any legislative changes Congress ultimately believes are necessary. In our view, any such changes should include provisions broadly reaffirming and enabling the SEC to improve the current disclosure and accounting system and to discharge our obligations prudently, generously and in the spirit with which the federal securities laws were adopted: to protect investors and maintain the integrity of the securities markets.

Our system must be improved and modernized. We are up to the task, but only if we are able to tap our best minds to produce our most creative solutions, and only if we are able to discuss these issues openly, honestly, and as constructively as possible. The SEC is committed to that end, and we seek participation by everyone with an interest in our capital markets. Together, we can, we must and we will make a difference. That is our vision and our unalterable mission.

On behalf of the Commission, thank you for the opportunity to testify today. I am pleased to respond to any questions the Committee may have.

NEW YORK STATE COMPTROLLER H. CARL McCALL

TESTIMONY
Before the
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

March 20, 2002

Good morning Chairman Oxley, Ranking Member LaFalce and members of the Committee. Thank you for giving us this opportunity to address issues of corporate accountability and investor confidence. In the past few months, Americans have learned that the integrity of the financial markets and, in fact, the economic well-being of our country depend on these issues.

I commend the Committee for holding this hearing. It's essential that we have a national discussion on these issues. I assure you, our future depends on it.

We need action at the Federal level to prevent another "Enron" in the future. I applaud my good friend, Congressman LaFalce, for his leadership in introducing the Comprehensive Investor Protection Act of 2002.

As Comptroller of the State of New York, I serve as sole Trustee of the State's $112 billion Common Retirement Fund – the pension fund for nearly one million New York State and local government employees and retirees. The Fund owned nearly 4 million shares of Enron through its index portfolio and active managers prior to the company's catastrophic downfall. Our losses are expected to exceed $58 million.

While our Fund is strong enough to absorb the financial blow inflicted by these corporate collapses, we are deeply shaken by the lack of diligent oversight by the independent auditors, boards of directors, rating agencies and analysts on whom investors rely.

And we are not alone. In fact, I believe that the loss of investor confidence is the most devastating effect of the corporate collapses experienced over the last several months.

And if we don't restore that confidence quickly and completely, the consequences will be immeasurable.

The bill before the Committee today – the Corporate and Auditing Accounting, Responsibility and Transparency Act of 2002 – offers measures for enhanced auditor oversight. However, this is no time for small steps. I believe additional

standards are necessary to ensure the restoration of investors' confidence in auditors and their findings.

The Comprehensive Investor Protection Act that Congressman LaFalce introduced goes much further towards that goal. I urge the Committee to consider a legislative compromise that includes some form of the provisions included in the Comprehensive Investor Protection Act that would correct what is currently a failed regulatory structure. I am speaking, in particular, of provisions that align with recommendations I've made as New York State Comptroller.

Let me explain.

First, we need standards to make auditors more independent from the companies they audit. I've submitted proposals to the Securities and Exchange Commission and to the "Big 5" auditing firms and called on companies to take three steps:

1. Prohibit auditors from providing non-audit services to audit clients except under limited circumstances.
2. Limit audit relationships to a maximum of seven years.
3. Restrict auditors from accepting employment with clients for two years following work on an audit.

In short, auditor independence is critical to long-term shareholder value and confidence. That's why I supported the SEC's proposed revision of Auditor Independence Requirements in 2000 – and why I submitted these proposals. And that is why I have pushed for change in my various roles as a public servant.

As a state official, I introduced legislation that would require all New York State agencies to adopt these standards in their relationships with auditing firms. In addition, I issued an Executive Order to implement these standards in the Office of the State Comptroller.

I believe these are important steps towards achieving meaningful auditor independence. But we can't achieve comprehensive reform on a state-by-state basis. We also need a national effort. For this reason, the provisions in the Comprehensive Investor Protection Act that promote auditor independence are extremely important.

As a shareholder, I have adopted a proxy voting policy to oppose the appointment of any auditor that also performs non-audit services to the company.

I also sent a letter to the Common Retirement Fund's 50 largest holdings, explaining our proposed standards and requesting information about how long companies have retained their current auditor. This information will be used to

determine our proxy voting policies going forward.

I sent another letter to all of our private equity partnerships, asking them to urge their portfolio companies to adopt policies that promote auditor independence. As private equity firms take companies public, it will be beneficial to the markets for these policies to be already in place.

As Comptroller, I can take these steps at the Common Retirement Fund, and I can encourage my counterparts around the country to do likewise, but it is essential that we hear from Washington on these matters. It is essential to know that our legislators share our commitment to investor protection. The work of this Committee sends a vital signal to all investors.

To ensure that I continue to develop appropriate proposals to increase investor protection, I have also created a panel of advisors who will focus specifically on measures that enhance board independence and corporate accountability and minimize conflicts of interest in the marketplace.

As a last resort, I have also taken legal action against Enron. I filed a Notice of Joinder in the U.S. District Court for the Southern District of Texas in support of a legal application to freeze the assets of directors and executives who may have benefited from stock sales based on information that was not available to other shareholders.

I applaud this Committee for seeking input from a variety of sources, especially from the private sector. While it is critical that government play a pro-active role in restoring investor confidence, it is essential that the private sector act, as well.

As a member of the Board of the New York Stock Exchange, I serve as co-chairman of the Committee on Corporate Accountability and Listing Standards. The Committee will review corporate governance and shareholder accountability issues such as the composition of corporate boards and committees, disclosure requirements and the role of independent audit committees. The Committee will also consider new listing standards that would have a profound impact on the marketplace.

***

In closing, I would like to say that I am acutely aware of my fiduciary responsibility to the retirees and hard-working people of New York State. Their ability to enjoy an economically secure retirement depends on the faithful and prudent investment of the Common Retirement Fund.

In nine years as Comptroller, I have never heard from as many members of the pension systems as I have in the past few months. They are nervous and frightened, and beginning to question the rationality of equity markets generally.

This is not an encouraging sign for the marketplace. We must restore their confidence. Each of us – fiduciaries, legislators and regulators – has a role to play.

I thank you for your reasoned and constructive approach to the important issues before us. I look forward to working together with you to restore investor confidence and ensure the long-term viability of the American marketplace.

Again, I thank Chairman Oxley, Ranking Member LaFalce and members of the Committee for allowing me to testify today.

Statement by Franklin D. Raines
Chairman, Corporate Governance Task Force of
The Business Roundtable
Before the Committee on Financial Services
U.S. House of Representatives
March 20, 2002

Thank you Chairman Oxley, Ranking Member LaFalce, and Members of the Committee.

My name is Franklin Raines, and I am Chairman and Chief Executive Officer of Fannie Mae. I am here today as Chairman of the Corporate Governance Task Force of The Business Roundtable, and I appreciate the opportunity to express the views of the Business Roundtable with respect to the topic of today's hearing.

Before I do that, Mr. Chairman, let me take this opportunity to recognize the foresight and leadership of this Committee in raising and addressing issues of financial institution safety, soundness and transparency well before the collapse of Enron brought these issues to national attention.

In particular, let me recognize your leadership, and that of Ranking Member LaFalce, Subcommittee Chairman Baker and Subcommittee Ranking Member Kanjorski, for your consistent and strong leadership over the years on issues of corporate responsibility, transparency, and market discipline.

The Business Roundtable is recognized as an authoritative voice on matters affecting American business corporations and as such has a keen interest in corporate governance. Indeed, as leaders of some of our nation's largest businesses, the Roundtable has the strongest interest in corporate governance practices that secure the confidence of shareholders, employers, policy makers and other constituencies.

The Roundtable has been involved in corporate governance issues since 1978, and in 1997, we published our Statement on Corporate Governance, which suggests best practices regarding matters including the functions of the board of directors, board structure and operations, and stockholders' meetings. We are pleased with the number of large corporations that have adopted these practices.

In light of recent events, the Roundtable is reviewing its 1997 statement regarding corporate governance, and we expect to issue a new statement on the subject later this spring.

The Business Roundtable has prepared a detailed analysis of H.R. 3763. With your permission I will submit that analysis for the record.

This morning, I would like to summarize what The Business Roundtable believes should be the guiding principles of corporate governance.

The Business Roundtable has issued a public statement regarding issues related to the bankruptcy of Enron, in which we expressed our views of Enron's collapse and a set of principles we believe should guide the discussion of proposed changes in practices, regulations, and laws.

With respect to Enron, The Business Roundtable believes that a number of the actions and behaviors, revealed in the report of the special committee of the Enron Board of Directors, which contributed to the collapse of the company, are unacceptable.

The Powers report describes a pervasive breakdown in the norms of ethical behavior, corporate governance and corporate responsibility to external and internal stakeholders. The Enron situation appears at this point to derive fundamentally from a massive breach of trust.

We understand why the American people are stunned and outraged by the failure of corporate leadership and governance at Enron. It is wholly irresponsible and unacceptable for corporate leaders to say they did not know – or suggest it was not their duty to know – about the operations and activities of their company, particularly when it comes to risks that threaten the fundamental viability of their company.

The success of the American free enterprise system obtains from the merger of corporate responsibility with individual responsibility, and The Business Roundtable believes that responsibility starts at the top.

The United States has the best corporate governance, financial reporting, and securities markets systems in the world. These systems work because of the adoption of best practices by public companies within a framework of laws and regulations.

The collapse of the Enron Corporation is a profound and troubling exception to the overall record of success. Other less dramatic exceptions may also exist among the thousands of United States public corporations. But they are exceptions in systems that have generally worked very well.

In light of the public interest in issues growing out of the Enron situation, we thought it would be useful to articulate a set of guiding principles of corporate governance.

First, the paramount duty of the board of directors of a public corporation is to select and oversee competent and ethical management to run the company on a day-to-day basis.

Second, it is the responsibility of management to operate the company in a competent and ethical manner. Senior management is expected to know how the company earns its income and what risks the company is undertaking in the course of

carrying out its business. Management should never put personal interests ahead of or in conflict with the interests of the company.

Third, it is the responsibility of management, under the oversight of the board and its audit committee, to produce financial statements that fairly present the financial condition of the company and make sufficient disclosures to investors to permit them to assess the financial and business soundness of the company.

Fourth, it is the responsibility of the board and its audit committee to engage an independent accounting firm to audit the financial statements prepared by management and to issue an opinion on those statements based on Generally Accepted Accounting Principles.

The board, its audit committee and management must be vigilant to ensure that the corporation or its employees do not take any actions that compromise the independence of the independent accounting firm.

Fifth, it is the responsibility of the independent accounting firm to ensure that it is in fact independent, is without conflicts of interest, employs highly competent staff, and carries out its work in accordance with Generally Accepted Auditing Standards.

It is also the responsibility of the independent accounting firm to inform the board, through its audit committee, of any concerns it may have about the appropriateness and quality of significant accounting treatments, business transactions, and about any weaknesses in internal control systems. The firm should do so in a forthright manner and on a timely basis, whether or not management has communicated to the board or the audit committee on the same matters.

Sixth, the company has a responsibility to deal with its employees in a fair and equitable manner. Employee benefit plans, once established, should be operated in a manner that is fair and equitable to all employees.

These responsibilities, and others, are critical to the functioning of the modern public corporation. No law or regulation alone can be a substitute for the voluntary adherence to these principles by corporate directors and management and by the accounting firms retained to serve American corporations.

Several thoughtful proposals have been offered to create new regulations or laws to deal with what appear to be breaches of trust and failures of responsibility at Enron. Two weeks ago the President announced his plan to improve corporate governance. The President's personal involvement in seeking reform is welcome and underscores just how fundamental ethical and responsible corporate governance is to the health of the American economy. Chairman Oxley -- you and Mr. Baker have put forth a number of laudable proposals to improve corporate governance that we are considering today, as have Mr. LaFalce and others.

Some legislation and regulatory changes are necessary and advisable. The Business Roundtable will work closely with policy makers to help ensure that any necessary changes to laws and regulations are effective and efficient, taking care that our responses to the unusual circumstances presented by Enron do not inhibit U.S. public corporations' ability to compete, create jobs and generate economic growth.

Mr. Chairman, that concludes my opening statement. On behalf of The Business Roundtable and its member companies, thank you for the opportunity to participate in today's hearing.

Statement of The Business Roundtable
On Corporate Governance Principles
Relating to the Enron Bankruptcy

February 11, 2002

The Business Roundtable (BRT) believes that the actions and behaviors, revealed in the report of the special committee of the Enron Board of Directors, which contributed to the collapse of the company, are unacceptable. The report describes a pervasive breakdown in the norms of ethical behavior, corporate governance and corporate responsibility to external and internal stakeholders. The Enron situation appears at this point to derive fundamentally from a massive breach of trust.

The United States has the best corporate governance, financial reporting, and securities markets systems in the world. These systems work because of the adoption of best practices by public companies within a framework of laws and regulations. The collapse of the Enron Corporation is a profound and troubling exception to the overall record of success. Other less dramatic exceptions may also exist among the thousands of United States public corporations - but they are exceptions in systems that have generally worked very well.

Since 1990, the BRT has been an authoritative voice on issues of corporate governance. Most recently in 1997, the BRT published its Statement on Corporate Governance, which suggests best practices in areas such as the functions of the board of directors, board structure and operations, and stockholders meetings. Over the years large corporations have increasingly adopted these practices. In light of recent events, the BRT will expedite an updating of the Statement to deal with many of the issues currently under discussion.

In light of the public interest in issues growing out of the Enron situation, we believe it is necessary to restate here our understanding of some guiding principles of corporate governance that should form the basis for considering any proposed changes in practices, regulations and laws.

First, the paramount duty of the board of directors of a public corporation is to select and oversee competent and ethical management to run the company on a day-to-day basis.

Second, it is the responsibility of management to operate the company in a competent and ethical manner. Senior management is expected to know how the company earns its income and what risks the company is undertaking in the course of carrying out its business. Management should never put personal interests ahead of or in conflict with the interests of the company.

Third, it is the responsibility of management, under the oversight of the board and its audit committee, to produce financial statements that fairly present the financial condition of the company and make sufficient disclosures to investors to permit them to assess the financial and business soundness of the company.

Fourth, it is the responsibility of the board and its audit committee to engage an independent accounting firm to audit the financial statements prepared by management and to issue an opinion on those statements based on Generally Accepted Accounting Principles. The board, its audit committee and management must be vigilant to ensure that no actions are taken by the corporation or its employees that compromise the independence of the independent accounting firm.

Fifth, it is the responsibility of the independent accounting firm to ensure that it is in fact independent, is without conflicts of interest, employs highly competent staff, and carries out its work in accordance with Generally Accepted Auditing Standards. It is also the responsibility of the independent accounting firm to inform the board, through its audit committee, of any concerns it may have about the appropriateness and quality of significant accounting treatments, business transactions, and about any weaknesses in internal control systems. The firm should do so in a forthright manner and on a timely basis, whether or not management has communicated to the board or the audit committee on the same matters.

Sixth, the company has a responsibility to deal with its employees in a fair and equitable manner. Employee benefit plans, once established, should be operated in a manner that is fair and equitable to all employees.

These responsibilities, and others, are critical to the functioning of the modern public corporation. No law or regulation alone can be a substitute for the voluntary adherence to these principles by corporate directors and management and by the accounting firms retained to serve American corporations.

Many proposals will no doubt be offered to create new regulations or laws to deal with what appear to be breaches of trust and failures of responsibility at Enron. We must all take care that responses to the unusual circumstances presented by Enron do not inhibit U.S. public corporations' ability to compete, create jobs and generate economic growth. The Business Roundtable is reviewing corporate governance principles and procedures and will work closely with policymakers to help ensure that any necessary changes to laws and regulations are effective and efficient.

# # # #

The Business Roundtable is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and $3.5 trillion in revenues. The chief executives are committed to advocating public policies that foster vigorous economic growth and a dynamic global economy.

Statement on Corporate Governance

September 1997

THE BUSINESS ROUNDTABLE
AN ASSOCIATION OF CHIEF EXECUTIVE OFFICERS COMMITTED TO IMPROVING PUBLIC POLICY

Statement on Corporate Governance

A White Paper from THE BUSINESS ROUNDTABLE
© September 1997

FOREWORD

The Business Roundtable is recognized as an authoritative voice on matters affecting large corporations and, as such, is keenly interested in a proper understanding of the purpose of corporate governance. Past publications of The Business Roundtable that have addressed corporate governance issues include The Business Roundtable's statement on Corporate Governance and American Competitiveness (March, 1990), Statement on Corporate Responsibility (October, 1981) and The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation (January, 1978). In the current publication, The Business Roundtable summarizes its current views on governance issues, thus updating and building on the work of the past.

The Business Roundtable notes with pride that, in the seven years since its last publication on corporate governance, many of the practices suggested for consideration by The Business Roundtable have become more common. This has been the result of voluntary action by the business community without new laws and regulations and reflects the positive impact of interested stockholders. The Business Roundtable believes it is important to allow corporate governance processes to continue to evolve in the same fashion in the years ahead.

TABLE OF CONTENTS

I. INTRODUCTION 1

II. FUNCTIONS OF THE BOARD 4

Management Selection and Compensation 5

Approval of Major Strategies and Financial Objectives. 6

Advising Management 6

Risk Management, Controls and Compliance 7

Selection of Board Candidates 7

Board Evaluation 9

III. STRUCTURE AND OPERATIONS OF THE BOARD 10

Board Composition 10

Committee Structure 14

Board Compensation 16

Operations 17

IV. STOCKHOLDER MEETINGS 20

Agendas and Conduct of the Meeting 20

Management and Stockholder Proposals 20

I. Introduction

The Business Roundtable wishes to emphasize that the principal objective of a business enterprise is to generate economic returns to its owners. Although the link between the forms of governance and economic performance is debated, The Business Roundtable believes that good corporate governance practices provide an important framework for a timely response by a corporation's board of directors to situations that may directly affect stockholder value. The absence of good corporate governance, even in a corporation that is performing well financially, may imply vulnerability for stockholders because the corporation is not optimally positioned to deal with financial or management challenges that may arise.

... the substance of good corporate governance is more important than its form; adoption of a set of rules or principles or of any particular practice or policy is not a substitute for, and does not itself assure, good corporate governance.

Many discussions of corporate governance focus on questions of form and abstract principle: Should a corporation have a non-executive chairman of the board? Should the board have a lead director? Should there be a limit on the number of boards on which a director serves? The Business Roundtable considers such questions important. Indeed, much of this Statement is devoted to discussing them. However, The Business Roundtable wishes to emphasize that the substance of good corporate governance is more important than its form; adoption of a set of rules or principles or of any particular practice or policy is not a substitute for, and does not itself assure, good corporate governance.

Examples of this point abound. A corporation with the best formal policies and processes for board involvement may be at risk if the chief executive officer is not genuinely receptive to relevant board input or if knowledgeable directors hesitate to express their views. A corporation can have excellent corporate governance structures and policies on

paper, but if the CEO and the directors are not focused on stockholder value, it may be less likely the corporation will realize that value. Directors can satisfy the most demanding tests for independence, but if they do not have the personal stature and self-confidence to stand up to a non-performing CEO, the corporation may not be successful. On the other hand, a corporation that lacks many of the so-called "best practices" for corporate governance, or that does not memorialize its practices in formal documents, may nonetheless perform well if its directors and management are highly able people who are dedicated to advancing the interests of stockholders.

Corporate governance is not an abstract goal, but exists to serve corporate purposes by providing a structure within which stockholders, directors and management can pursue most effectively the objectives of the corporation.

One of the reasons why people focus on the formal, structural aspects of corporate governance is that doing so permits evaluations that appear to be objective and verifiable. Formal attributes of good corporate governance can be tabulated to compare corporate governance practices across the spectrum of companies. Such comparisons do have value, but it would be a mistake to lose sight of their limitations. The "soft," subjective factors in corporate governance — such as the quality of directors and the personalities of CEOs and directors — receive less attention from scholars and journalists but are critical in the real world of corporate behavior. Boards and management should not feel that they have discharged their responsibilities in regard to corporate governance just by putting in place a particular set of structures and formal processes. They must also periodically review these structures and processes to insure that they are achieving good corporate governance in substance.

Corporate governance is not an abstract goal, but exists to serve corporate purposes by providing a structure within which stockholders, directors and management can pursue

most effectively the objectives of the corporation. There has been much debate in corporate governance literature about the parties to whom directors owe a duty of loyalty and in whose interest the corporation should be managed. Some say corporations should be managed purely in the interests of stockholders or, more precisely, in the interests of its present and future stockholders over the long-term. Others claim that directors should also take into account the interests of other "stakeholders" such as employees, customers, suppliers, creditors and the community.

In The Business Roundtable's view, the paramount duty of management and of boards of directors is to the corporation's stockholders . . .

The Business Roundtable does not view these two positions as being in conflict, but it sees a need for clarification of the relationship between these two perspectives. It is in the long-term interests of stockholders for a corporation to treat its employees well, to serve its customers well, to encourage its suppliers to continue to supply it, to honor its debts, and to have a reputation for civic responsibility. Thus, to manage the corporation in the long-term interests of the stockholders, management and the board of directors must take into account the interests of the corporation's other stakeholders. Indeed, a number of states have enacted statutes that specifically authorize directors to take into account the interests of constituencies other than stockholders, and a very limited number of state statutes actually require consideration of the interests of other constituencies.

In The Business Roundtable's view, the paramount duty of management and of boards of directors is to the corporation's stockholders; the interests of other stakeholders are relevant as a derivative of the duty to stockholders. The notion that the board must somehow balance the interests of stockholders against the interests of other stakeholders fundamentally misconstrues the role of directors. It is, moreover, an unworkable notion because it would leave the

board with no criterion for resolving conflicts between interests of stockholders and of other stakeholders or among different groups of stakeholders.

Good corporate governance is not a "one size fits all" proposition ...

While The Business Roundtable favors certain broad principles as generally contributing to good corporate governance, not all of these broad principles are necessarily right for all corporations at all times. Good corporate governance is not a "one size fits all" proposition, and a wide diversity of approaches to corporate governance should be expected and is entirely appropriate. Moreover, a corporation's practices will evolve as it adapts to changing situations.

II. Functions of the Board

The business of a corporation is managed under the direction of the board of directors, but the board delegates to management the authority and responsibility for managing the everyday affairs of the corporation. The extent of this delegation varies depending on the size and circumstances of the corporation. In a large corporation that is performing well and has strong management, the board may delegate more; in a smaller or closely-held corporation, or one facing critical challenges, more detailed involvement by the board in the business of the corporation may be appropriate. In a large publicly owned corporation that is not facing extraordinary difficulties, in addition to reviewing and approving specific corporate actions as required by law (e.g., declaration of dividends), the principal functions of the board are to:

(i) Select, regularly evaluate and, if necessary, replace the chief executive officer; determine management compensation; and review succession planning;

(ii) Review and, where appropriate, approve the major strategies and financial and other objectives and plans of the corporation;

(iii) Advise management on significant issues facing the corporation;

(iv) Oversee processes for evaluating the adequacy of internal controls, risk management, financial reporting and compliance, and satisfy itself as to the adequacy of such processes; and

(v) Nominate directors and ensure that the structure and practices of the board provide for sound corporate governance.

Management Selection and Compensation

- The selection and evaluation of the chief executive officer and concurrence with the CEO's selection and evaluation of the corporation's top management team is probably the most important function of the board. In its broader sense, "selection and evaluation" includes considering compensation, planning for succession and, when appropriate, replacing the CEO or other members of the top management team.
- The performance of the CEO should generally be reviewed at least annually without the presence of the CEO and other inside directors. The board should have an understanding with the CEO with respect to the criteria according to which he or she will be evaluated, and there should be a process for communicating the board's evaluation to the CEO.
- Boards have a responsibility to ensure that compensation plans are appropriate and competitive and properly reflect the objectives and performance of management and the corporation. Incentive plans will vary from

corporation to corporation and should be designed to provide the proper balance between long- and short-term performance incentives. Stock options and other equity-oriented plans should be considered as a means for linking management's interests directly to those of stockholders.

Providing advice and counsel to management is a key element of the board's role.

Approval of Major Strategies And Financial Objectives

- Approving major strategies and financial objectives and tracking results is related to the function of selecting and evaluating the CEO. Insofar as the corporation develops and successfully executes sound long-range plans, the CEO and the corporation's management team will generally be deemed to be doing a good job. There may also be circumstances in which the CEO is deemed to be doing a good job even though financial results fall short of plans.
- A corporation may achieve its near-term financial objectives but may ultimately fail if it has not developed an appropriate business strategy. Accordingly, boards should consider financial objectives and results in the context of the wider business strategy of the corporation.
- When a corporation falls significantly short of its important objectives or when plans appear to be inadequate, more intensive board oversight of management is warranted. This kind of circumstance requires the best judgment of people highly experienced in business and management. Alternatives must be considered carefully and appropriate action taken.

Advising Management

- Providing advice and counsel to management is a key element of the board's role. It is fulfilled both in formal

board and board committee meetings and also in informal, individual director contacts with the CEO and other members of management.

- A board member who effectively fulfills his or her role of advising the CEO provides an important service to the corporation.

Risk Management, Controls and Compliance

- The Board must assure that an effective system of controls is in place for safeguarding the corporation's assets, managing the major risks faced by the corporation, reporting accurately the corporation's financial condition and results of operations, adhering to key internal policies and authorizations, and complying with significant laws and regulations that are applicable to it.
- In performing these functions, the board generally relies on the advice and reports of management, internal and external counsel, and internal and external auditors. The board's role should be to review reports from such experts, to provide them with guidance and to assure that management takes appropriate corrective actions when significant control problems are reported.

Selection of Board Candidates

- It is the board's responsibility to nominate directors. The board nominates a whole slate, which should encompass individuals with diverse talents, backgrounds, and perspectives who can work effectively together to further the interests of the corporation's stockholders, while preserving their ability to differ with each other on particular issues as policy is developed. Men and women of different ages, races and ethnic backgrounds can contribute different, useful perspectives.

Each director should represent the interests of all stockholders, not those of any single individual or group of stockholders or any single interest group.

- Each director should represent the interests of all stockholders, not those of any single individual or group of stockholders or any single interest group. Cumulative voting is generally not recommended for large publicly owned corporations because it may lead to the election of directors who represent particular groups of stockholders, which can in turn create factionalism and undermine the effectiveness of the board.
- Effective boards are composed of individuals who are highly experienced in their respective fields of endeavor and whose knowledge, background and judgment will be useful to the corporation. Directors must have the ability and willingness to learn the corporation's business and to express their personal views.
- Each person serving as a director must devote the time and attention necessary to fulfill the obligations of a director. Service on other boards often broadens and deepens the knowledge and experience of directors. In addition, CEOs who serve on other boards frequently gain valuable insight and experience which prove useful in the running of their own companies. However, service on too many boards can interfere with an individual's ability to perform his or her responsibilities. Before accepting an additional board position, a director should consider whether the acceptance of a new directorship will compromise the ability to perform present responsibilities. Similarly, it is advisable for an inside director to consult with his or her own board before accepting a new directorship on the board of another corporation. Because time demands from board to board and capacities of individual directors will vary, The Business Roundtable does not endorse a specific limitation on the number of directorships an individual may hold.

- Each nominating/governance committee should develop its own process for considering stockholder suggestions for board nominees. Should a stockholder desire to suggest a nominee to the board, most corporations request that a letter be written to the secretary of the company providing a resume of the suggested nominee.

Board Evaluation

- The board is responsible for its own evaluation from time to time. Such evaluations will provide the basis for the board's recommendation of a slate of directors to the stockholders. Boards also implicitly evaluate individual directors by endorsing them for re-nomination. Some boards formalize this process through evaluations of individual directors. Other boards formally address individual director performance only when it appears that a particular director is not contributing sufficiently to the performance of the board as a whole. While no particular approach to individual director evaluation is best for all companies at all times, each board should have a process, formal or informal, for discharging its responsibility to nominate good directors.
- The board should from time to time review its own structure, governance principles, composition, agenda, processes and schedule to consider whether it is functioning well in view of its responsibilities and the evolving situation of the corporation.

III. Structure and Operations of the Board

There are, and should be, diverse approaches to board structure and operations. In the following sections we describe approaches that The Business Roundtable considers generally useful for good corporate governance. However, these should not be regarded as rigid rules applicable to all corporations at all times.

It is important for the board of a large, publicly owned corporation to have a substantial degree of independence from management.

Board Composition

- Boards of directors of most large publicly owned corporations typically range in size from 8 to 16 individuals. Optimal board size will vary from corporation to corporation and industry to industry. In general, the experience of many Roundtable members suggests that smaller boards are often more cohesive and work more effectively than larger boards.
- It is important for the board of a large publicly owned corporation to have a substantial degree of independence from management. Accordingly, a substantial majority of the directors of such a corporation should be outside (non-management) directors. The degree of independence of an outside director may be affected by many factors, including the personal stature of the director and any business relationship of the director with the corporation or any business or personal relationship of the director with management. Directors, or firms in which they have an interest, are sometimes engaged to provide legal, consulting, accounting or other services to the corporation, or a director may have an interest in a customer, supplier or business partner of the corporation, or may at an earlier point in his or her career have been an employee or officer of the company. Depending

on their significance to the director and to the corporation, such relationships may affect a director's actual or perceived independence. The Business Roundtable believes that, where such relationships exist, boards should be mindful of them and make a judgment about a director's independence based on his or her individual circumstances rather than through the mechanical application of rigid criteria. This would involve consideration of whether the relationships are sufficiently significant as to interfere with the director's exercise of independent judgment. If a particular director is not deemed sufficiently independent, the board may nevertheless conclude that the individual's role on the board remains highly desirable (as in the case of an inside director) in the context of a board composed of a majority of directors with the requisite independence. The overall result should be a board that, as a whole, represents the interests of stockholders with appropriate independence.

- For certain functions, such as membership on an audit or compensation committee, more specific standards of independence should be used. For example, Section 162(m) of the Internal Revenue Code prescribes certain standards that the compensation committee must meet to permit the deduction for federal income tax purposes of performance-based compensation exceeding $1 million paid to the CEO and the four other highest paid executive officers. There are other examples of prescribed standards for members of the compensation committee under Section 16 of the Securities Exchange Act of 1934 and for members of the audit committee under rules of the New York Stock Exchange. In addition, more particularized rules apply in certain industries, such as banking. It is recommended that the board, or a

committee such as the nominating/governance committee, periodically confirm that the composition of the relevant committees meets the applicable requirements as well as any other criteria determined by the board.

Most members of The Business Roundtable believe their corporations are generally well served by a structure in which the CEO also serves as chairman of the board.

- Inside directors will ordinarily include the chief executive officer and may also include other officers whose positions or potential for succession make it appropriate, in the judgment of the board, for them to sit on the board.
- There has been considerable discussion of mechanisms for providing board leadership independent of management. Such leadership is particularly important when a CEO dies or becomes incapacitated or when there are questions concerning the competence or conduct of management:
  - Most members of The Business Roundtable believe their corporations are generally well served by a structure in which the CEO also serves as chairman of the board. They believe that the CEO should set the agenda and the priorities for the board and for management and should serve as the bridge between management and the board, ensuring that management and the board are acting with common purpose.
  - Some corporations have separated the roles of CEO and chairman of the board, often in response to particular circumstances, such as to provide a smooth transition from one CEO to another.
  - Some other corporations have employed the concept of a lead director. The role of a lead

director is sometimes designed with specific duties, such as consultation with the CEO on board agendas and chairing the executive sessions of the board. In other cases, the lead director has no special duties in ordinary situations, but assumes a leadership role in the event of the death or incapacity of the CEO or in other situations where it is not possible or appropriate for the CEO to take the lead.

Each corporation should be free to make its own determination of what leadership structure serves it best, given its present and anticipated circumstances. The Business Roundtable believes that most corporations will continue to choose, and be well served by, unifying the positions of chairman and CEO. Such a structure provides a single leader with a single vision for the company and most Business Roundtable members believe it results in a more effective organization. Where these positions are unified, The Business Roundtable also believes that it is desirable for directors to have an understanding as to how non-executive leadership of the board would be provided, whether on an ongoing basis or on a transitional basis if and when the need arose. In some boards, the presence of one strong figure might provide the natural leader. In other circumstances, there could be an understanding that leadership would fall to the committee chair responsible for the subject matter that gave rise to the need. In still others, it could be the responsibility of the committee chairs to recommend whether non-executive leadership is required, and if so, in what form. Whether the board's understanding of the process would be codified as a formal board action should be a matter for individual boards to determine.

A wide diversity of approaches in committee structure and function responds to the specific needs of companies facing different business challenges and having different corporate cultures, and reflects the need to allow organizational experimentation.

- It is now common practice to establish rules for the retirement or resignation of directors. These may, for example, include a mandatory retirement age for directors or a requirement that a director submit his or her resignation at such time as the director no longer occupies the position he or she held at the time of election, unless the change in position is as a result of normal retirement. Even in the absence of such provisions, a board should plan for its own continuity and succession — for the retirement of directors and the designation of new board members. Because the composition and circumstances of boards will vary, so too will the retirement policies of different corporations.
- The Business Roundtable recognizes that certain corporations may have histories or circumstances that make term limits desirable for them. However, The Business Roundtable generally does not favor the establishment of term limits for directors. Such limits often cause the loss of directors who have gained valuable knowledge concerning the company and its operations and whose tenure over time has given them an important perspective on long-term strategies and initiatives of the corporation.

Committee Structure

- Virtually all boards of directors of large publicly owned companies operate with a committee structure to permit the board to address certain key areas in more depth than may be possible in a full board meeting. A wide diversity of approaches in committee structure and function responds to the specific needs of companies facing different business challenges and having different corporate cultures, and reflects the need to allow organizational experimentation.

- It is recommended that each corporation have an audit committee, which is required under New York Stock Exchange rules, a compensation/personnel committee, and a nominating/governance committee and that membership in these committees be limited to outside directors. The board may also wish to establish other committees with other specific responsibilities. Other common committees include an executive committee to act for the board between meetings and to handle other specifically assigned duties, a finance committee, and a social responsibility or public policy committee. In some cases a board may wish to establish ad hoc committees to examine special problems or opportunities in greater depth than would otherwise be feasible.
- The number of committees will vary from corporation to corporation. Boards should also be conscious of the limitations inherent in having too much of their business handled in committees. Boards working as a whole on important strategic issues allow the corporation to take advantage of the collective wisdom of the board.
- The primary functions of the audit committee are generally to recommend the appointment of the public accountants and review with them their report on the financial reports of the corporation; to review the adequacy of the system of internal controls and of compliance with material policies and laws, including the corporation's code of ethics or code of conduct; and to provide a direct channel of communication to the board for the public accountants and internal auditors and, when needed, finance officers, compliance officers and the general counsel.

- The compensation/personnel committee is generally responsible for ensuring that a proper system of long- and short-term compensation is in place to provide performance-oriented incentives to management. The compensation committee will also evaluate the CEO's performance for compensation purposes and report on this subject to all of the outside directors, if this function is not performed by the entire board. Likewise, it authors the report on executive compensation required under the proxy rules. This committee is also often responsible for assuring that key management succession plans and managers are reviewed periodically. In some companies, succession planning and review of key personnel issues are handled by the nominating/governance committee. When CEOs serve on each other's boards, it is generally inadvisable for them to serve on each other's compensation committees because of the potential for conflicts of interest.
- The nominating/governance committee is typically responsible for advising the board as a whole on corporate governance matters, developing a policy on the size and composition of the board, reviewing possible candidates for board membership, performing board evaluations, and recommending a slate of nominees. The board should have the benefit of the CEO's involvement in the selection process, but the responsibility for selection of board nominees remains that of the board.

Board Compensation

- Board compensation should be competitive in view of industry practices and the extent of burdens placed on board members. The form of such compensation will vary from corporation to corporation and may depend

on the circumstances of the directors that the board may be seeking to attract and retain.

- Boards should consider aligning the interests of directors with those of the corporation's stockholders by including some form of equity, such as stock grants or options, as a portion of each director's compensation.
- Some corporations may wish to establish a specific goal for equity ownership by directors; however, the desirability of setting such a goal is company specific and may depend on the circumstances of its directors. For example, some directors whose principal occupations are in public service or academic settings may prefer current cash compensation.
- Although there has recently been a trend away from retirement programs for directors, The Business Roundtable believes that the focus should be on the appropriate level of total compensation, rather than on the timing of payments.

There should be an opportunity for the board to meet periodically, at least annually, outside the presence of the CEO and other inside directors.

Operations

- Boards must meet as frequently as needed in order for directors to discharge properly their responsibilities. According to surveys, the typical board of a large publicly owned corporation meets about eight times per year. Depending on the complexity of the organization, the degree of business success and stability, and the desires of the board, greater or lesser frequency may be appropriate. Many directors prefer to have fewer but longer meetings where subjects can be explored in depth.
- There should be an opportunity for the board to meet periodically, at least annually, outside the presence of the CEO and other inside directors. This may be a portion

of a normally scheduled board meeting, and the CEO's annual performance evaluation is a good opportunity for such a meeting.

Board members should have full access to senior management and to information about the corporation's operations.

- A carefully planned agenda is important for effective board meetings, but it must be flexible enough to accommodate crises and unexpected developments. In practice, the items on the agenda are typically determined by the chairman in consultation with the board, with subjects also being suggested by various outside board members. A CEO should be responsive to a director's request to add a specific subject to a future agenda.
- To ensure continuing effective board operations, the CEO should periodically ask the directors for their evaluation of the general agenda items for board meetings and any suggestions they may have for improvement. In particular, the board should ensure that adequate time is provided for full discussion of important corporate items and that management presentations are scheduled in a manner that permits a substantial proportion of board meeting time to be available for open discussion.
- The board must be given sufficient information to exercise fully its governance functions. This information comes from a variety of sources, including management reports, personal observation, a comparison of performance to plans, security analysts' reports, articles in various business publications, etc. Generally, board members should receive information prior to board meetings so they will have an opportunity to reflect properly on the items to be considered at the meeting.
- Board members should have full access to senior management and to information about the corporation's

operations. Except in unusual circumstances, the CEO should be advised of significant contacts with senior management.

- Because the information and expertise relevant to the board's regular decision-making will normally be found within the corporation, the main responsibility for providing assistance to the board rests on the internal organization. There may, however, be occasions when it is appropriate for the board to seek legal or other expert advice from a source independent of management, and generally this would be with the knowledge and concurrence of the CEO.
- In general, the corporation's management should speak for the corporation. Communications with the public at large, the press, customers, securities analysts and stockholders should typically flow through, and be coordinated by, the CEO or other management. From time to time outside directors may be requested by the board or management to meet or speak with other parties that are involved with the corporation.
- It is important that each board consider its policies and practices on corporate governance matters. Whether or not a board will formalize its board practices in written form will vary depending on the particular circumstances. Some corporations have found that over-formalization leads to a rigid structure which emphasizes form over substance, while others have found that insufficient formalization leads to lack of clarity.

IV. Stockholder Meetings

Meetings of stockholders provide an important forum for the consideration of management and stockholder proposals. An orderly discussion of the corporation's affairs is facilitated by following a specific agenda and by adhering to a code that governs the conduct of the meeting.

... matters brought to stockholder attention through the proxy statement should be matters of significance to the business of the corporation and to stockholders as a whole.

Agendas and Conduct of the Meeting

- To facilitate an orderly meeting of stockholders, it is desirable that there be a written agenda made available to all attendees.
- Principal rules for the conduct of the meeting should be set forth in writing and also made available to every attendee. The rules may address matters such as the procedures for moving resolutions and asking questions of the chair, and include any limits on time or number of speakers for matters under discussion.

Management and Stockholder Proposals

- The consideration of management and stockholder proposals and board nominations is largely conducted through the proxy process rather than through proposals raised at stockholder meetings. This gives all stockholders, rather than only those who attend the meeting, the opportunity to consider relevant matters. Although the rules governing inclusion of stockholder proposals in proxy statements have changed over the years and are likely to continue to evolve, certain underlying principles should govern the process. Most importantly, matters brought to stockholder attention through the proxy statement should be matters of significance to the business of the corporation and to stockholders as a whole. Other matters, such as those relating to personal grievances and

political or social issues are more appropriately discussed in other forums. Matters pertaining to the conduct of the ordinary business operations of the corporation should be governed by management and the stockholder-elected board of directors.

- Reasonable notice of topics permits all interested parties to participate in the process in a considered way. As a result, The Business Roundtable recommends that corporations consider advance notice requirements in by-laws because such requirements generally promote good corporate governance.
- Adequate measures to assure the integrity, accuracy and timeliness of the voting tabulation process are highly important.

STATEMENT

OF

THE BUSINESS ROUNDTABLE

ON

THE CORPORATE AND AUDITING ACCOUNTABILITY,
RESPONSIBILITY AND TRANSPARENCY ACT OF 2002
(H.R. 3763)

FOR THE
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

MARCH 20, 2002

The Business Roundtable submits the following discussion regarding the collapse of Enron and analysis of the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002 (H.R. 3763).

The Roundtable is an association of chief executive officers of leading corporations with a combined workforce of more than ten million employees in the United States and $3.5 trillion in revenues. The chief executives are committed to advocating public policies that foster vigorous economic growth, a dynamic global economy and a well-trained and productive U.S. workforce essential for future competitiveness.

The Roundtable is recognized as an authoritative voice on matters affecting American business corporations and as such has a keen interest in corporate governance. Indeed, as leaders of some of our nation's largest businesses, the Roundtable has the strongest interest in corporate governance practices that secure the confidence of stockholders, employers, policymakers and other constituencies.

The Roundtable has issued publications on corporate governance issues since 1978. In 1997, the Roundtable published its Statement on Corporate Governance, which suggests best practices in areas such as the functions of the board of directors, board structure and operations, and stockholders' meetings (attached). We are pleased that a number of practices recommended in 1997 have been increasingly adopted by large corporations as best practices.

In light of recent events, the Roundtable has undertaken an expedited review of its 1997 statement regarding corporate governance, and we expect to issue a new statement on the subject later this spring.

INTRODUCTION

The Roundtable has issued a public statement regarding issues related to the bankruptcy of Enron, in which we expressed our views of Enron's collapse and a set of principles we believe should guide the discussion of proposed changes in practices, regulations, and laws (attached).

With respect to Enron, the Roundtable believes that a number of the actions and behaviors that are revealed in the report of the special committee of the Enron Board of Directors and that contributed to the collapse of the company, are unacceptable.

The report of the special committee describes a pervasive breakdown in the norms of ethical behavior, corporate governance and corporate responsibility to external and internal stakeholders. The Enron situation appears at this point to derive fundamentally from a massive breach of trust.

The United States has the best corporate governance, financial reporting, and securities markets systems in the world. These systems work because of the adoption of best practices by public companies within a framework of laws and regulations.

The collapse of Enron is a profound and troubling exception to the overall record of success. Other less dramatic exceptions may also exist among the thousands of U.S. public corporations. But they are exceptions in systems that have generally worked very well.

Indeed, demonstrating the inherently self-correcting nature of our market system, American businesses already are responding to the lessons learned from Enron's collapse. Companies are strengthening their financial controls, giving critical review to the clarity and transparency of their financial reports. Corporate boards of directors are taking steps to assure themselves, stockholders, employees and the public that Enron-like failures will not occur at their companies. Directors also are insisting that corporate managers and outside auditors carefully review the quality of corporate financial disclosures and the effectiveness of internal controls.

In the last several months, the Securities and Exchange Commission ("SEC") has issued several statements guiding public companies to more complete and forthcoming disclosure, and companies of the Roundtable, and many others, are already heeding that guidance. The annual reports filed with the SEC and sent to stockholders this month by most of our companies contain expanded disclosures and greater transparency in accordance with the SEC guidance and our own strong commitment to provide stockholders with clear and complete information needed to make informed investment decisions. Our most demanding regulators -- investors and the market -- require no less.

In the wake of Enron, the Congress, the Administration and the SEC have proposed new laws and regulations to address perceived breaches of trust, failures of responsibility and lack of candid disclosure at Enron and other companies. The Roundtable welcomes the personal involvement of the President and his "Ten-Point Plan to Improve Corporate Responsibility and Protect America's Shareholders." We also applaud the efforts of leaders in the Congress, including those of Chairman Oxley, to address the issues raised by Enron and related events.

The Roundtable will work closely with policymakers to help ensure that any necessary changes to laws and regulations are effective and efficient, taking care that our responses to the unusual circumstances presented by Enron do not inhibit U.S. public corporations' ability to compete, create jobs and generate economic growth.

It is in that spirit that the Roundtable submits the following analysis and discussion of the provisions of the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002 (H.R. 3763).

OVERSIGHT OF THE ACCOUNTING PROFESSION

The Roundtable shares the widespread recognition that independent oversight of the accounting profession is necessary. We believe H.R. 3763's creation of a new "public regulatory organization" offers a responsible and thoughtful approach. In particular, we support H.R. 3763's provisions for effective oversight by the SEC and a self-funding mechanism that would ensure that the new organization is not solely dependent on the accounting profession for funding or operations.

The proposed legislation would establish a framework for the SEC to recognize one or more public regulatory organizations to oversee the accounting profession, under the oversight of the SEC. The organizations recognized by the SEC would have the authority, among other things, to punish accountants who violate the securities laws and standards of ethics, competency or independence.

This approach appears to be broadly consistent with the President's Ten-Point Plan, which calls for the establishment of a regulatory board under the supervision of the SEC. We understand that the SEC is in discussions with the Congress, the Administration and other interested parties concerning the appropriate structure and responsibilities of the regulatory body. We believe that these parties should continue discussions in order to develop a consensus as to the structure and operation of the regulatory body prior to engaging in specific legislation and/or rulemaking.

AUDITOR INDEPENDENCE

The Roundtable strongly believes that it is critical to take steps to promote and maintain auditor independence, in fact as well as in appearance. H.R. 3763 would direct the SEC to establish rules prohibiting an accountant from providing certain non-audit services -- financial information systems design or implementation services and internal audit services -- to an audit client.

We note -- and applaud -- H.R. 3763's careful approach, designed to focus on the issue of auditor independence. If legislation is warranted in this arena, H.R. 3763 has drawn the line on prohibited non-audit services precisely where it should be. Companies must be allowed to purchase from auditors valuable services that do not raise real questions of independence in fact or in appearance.

The SEC has taken the position, after an extensive rulemaking process, that financial information systems design or implementation services and internal audit services are not consistent with auditor independence. In 2000, the SEC conducted a rulemaking proceeding with respect to its auditor independence rules, including a review of non-audit services provided to audit clients. The final rules, adopted in November 2000, are still being phased in, and prohibit a number of non-audit services and impose restrictions on others, including financial information systems design and internal audit services. At the same time the SEC amended its auditor independence rules, it also adopted new rules requiring disclosure to stockholders of the fees companies pay to their outside auditors for audit and non-audit services.

The fee disclosure rules, accounting industry recommendations such as those in the August 2000 report of the Public Oversight Board Panel on Audit Effectiveness (also known as the "O'Malley Panel")[1], stockholder proposals dealing with non-audit services and the events surrounding the collapse of Enron have caused audit committees throughout corporate America to review carefully their policies and procedures with respect to all services provided by outside auditors. The issue is clearly posed and the American corporate and investor communities are addressing it. Change is occurring at a rapid pace.

In his testimony before this Committee on March 13, 2002, Barry Melancon, President and CEO of the American Institute of Certified Public Accountants, indicated that the accounting profession will not oppose prohibiting auditors of public companies from providing financial information systems design or implementation and internal audit services. The Roundtable is pleased that the accounting profession endorses such a ban and agrees that the ban is appropriate.

Other legislative proposals contain long lists of prohibited non-audit services. Many of these services are considered inconsistent with independence and were either prohibited or strictly limited by SEC rules adopted in late 2000 that are still being phased in. Other useful non-audit services are most efficiently provided by a company's outside auditors, such as pre-acquisition due diligence, tax analysis, statutory audits, assistance with governmental filings, and the provision of comfort letters. These services do not raise real questions of independence in fact or in appearance. Prohibiting them would impose significant unnecessary costs on public companies and their stockholders.

Accordingly, if the Committee concludes that it is necessary to adopt legislation to regulate auditor independence, the Roundtable believes that any limits on the scope of services provided by auditors should go no further than the ban on financial information systems design and implementation services and internal audit services. The provision of other non-audit services could be regulated through existing or additional SEC rules and audit committee oversight.

---

[1] Report and Recommendations of the Public Oversight Board Panel on Audit Effectiveness, Shaun F. O'Malley, Chair (August 31, 2000), *available at* http://www.pobauditpanel.org/download.html.

PROMPT DISCLOSURE

The Roundtable agrees that, in an age of instant communication, there is an increasing need for corporations to disclose material information closer to the time it becomes available. H.R. 3763 would require the SEC to establish rules mandating that public corporations disclose "on a rapid and essentially contemporaneous basis" certain information, as determined by the SEC, about their financial condition and operations.

The SEC has the authority to prescribe, and has announced that it intends to propose, rules in this area.[2] These rules would expand the types of information that companies must provide on current reports and accelerate the deadline for reporting. The Roundtable supports a standard that would provide investors with disclosure as promptly as possible, consistent with the need to allow companies sufficient time to prepare disclosure that is meaningful and accurate.

In this regard, the Roundtable has concerns about whether it would be feasible for companies to disclose information on Form 8-K "on a[n] . . . essentially contemporaneous basis," as proposed in H.R. 3763. Before a company files a Form 8-K, there are normal and prudent internal procedures that need to be followed, including verification of facts, notification of affected parties, and internal and external legal and accounting review of the applicable disclosure. If companies do not have adequate time to follow through on these procedures, there is a danger that disclosures may not be accurate and that the market will be misled rather than better informed.

TRANSPARENT DISCLOSURE

The Roundtable supports H.R. 3763's goal of enhancing the transparency of corporate disclosures, and we agree that the SEC should proceed with rulemaking in this area. We note that the SEC has ample existing authority to prescribe rules and regulations governing the content of the disclosures that companies make to investors, and is already using that authority.

Among other things, H.R. 3763 would have the SEC require disclosure of off-balance sheet transactions and relationships with unconsolidated entities that are "reasonably likely to materially affect the issuer's financial condition." The proposed legislation would also mandate new SEC rules for disclosure of relationships and material transactions that are not arms-length. Finally, the bill would require the SEC to consider additional disclosures concerning key accounting principles and non-exchange traded contracts, as well as the use of "plain language" in disclosure documents.

With respect to the specific topics that H.R. 3763 targets for improved disclosure, the SEC has already issued several important interpretations and has indicated that further rule proposals are imminent. In December 2001, the SEC issued guidance to companies about the

---

[2] SEC Press Release, SEC to Propose New Corporate Disclosure Rules (Feb. 13, 2002), *available at* http://www.sec.gov/news/press/2002-22.txt.

information it expects to see in their Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") about critical accounting policies.[3] The SEC also notified companies about three areas in which they should consider providing better disclosure: liquidity and capital resources, including off-balance sheet arrangements; non-exchange traded contracts accounted for at fair value; and relationships and transactions on terms that would not be available from clearly independent third parties.[4] The annual reports being filed this month by most public companies reflect this guidance. More recently, the SEC indicated that it would propose amendments to its MD&A rules to require disclosure about critical accounting policies.[5] In the area of "plain language," the SEC has initiated successful efforts with respect to prospectus disclosures and SEC Chairman Pitt has expressed an interest in making financial statements more understandable to investors.[6] The SEC has also suggested proposing rule changes that would obligate companies to post their periodic reports on their websites at the time of filing with the SEC.

Given the SEC's existing statutory authority and the steps that the SEC has already taken in the areas covered by the proposed legislation, the Committee may wish to monitor the progress of the SEC's rulemaking efforts before deciding whether additional legislative steps are necessary.

OVERSIGHT OF FINANCIAL DISCLOSURES

The SEC needs flexibility so that it can react to changing market and regulatory conditions. When unexpected events occur, the SEC must be able to reallocate its resources quickly and shift focus to address these conditions. For example, over the past decade, the SEC has had to devote significant resources, at various times, to microcap/penny stock fraud, abuses in connection with real estate roll-up transactions, and derivatives, along with monitoring new rules, such as the executive compensation rules promulgated in the early 1990s. At any given time, the SEC must be able to exercise its judgment as to where its regulatory focus should be targeted. Prescribing by statute the particular kinds of companies, or issues, that should receive SEC attention would unnecessarily constrain the SEC's flexibility. Thus, we do not support statutory minimum periodic review requirements. We believe a better approach would be to

---

[3] Cautionary Advice Regarding Disclosure About Critical Accounting Policies, Release Nos. 33-8040 & 34-45149 (Dec. 12, 2001), *available at* http://www.sec.gov/pdf/33-8040.pdf.

[4] Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations, Release Nos. 33-8056 & 34-45321 (Jan. 22, 2002), *available at* http://www.sec.gov/rules/other/33-8056.htm.

[5] SEC Press Release, SEC to Propose New Corporate Disclosure Rules (Feb. 13, 2002), *available at* http://www.sec.gov/news/press/2002-22.txt.

[6] Harvey L. Pitt, Remarks Before the AICPA Governing Council (Oct. 22, 2001), *available at* http://www.sec.gov/news/speech/spch516.htm.

require the SEC to disclose the amount and types of reviews it conducts in greater detail in its annual report.

ELECTRONIC DISCLOSURE OF INSIDER TRANSACTIONS

The Roundtable agrees that the existing disclosure system is inadequate because of the length of time between the date a transaction occurs and the date it must be reported. We agree that more timely disclosure of insider transactions would benefit investors. We also agree that transactions in the open market and sales of securities back to a company should be reported promptly.

The Roundtable does not oppose legislation directing the SEC to promulgate rules governing the disclosure of transactions by officers and directors. We are concerned, however, about legislation that would set rigid deadlines. Even relatively straightforward transactions by insiders may not lend themselves to immediate reporting. Transactions that investors are likely to consider significant -- such as large sales -- are often effected in a series of transactions over the course of one or two days. Because brokers currently have three days to settle transactions, even basic information -- such as the price at which shares were sold -- may not be available for several days after a transaction occurs. Moreover, there is a wide range of non-open market transactions that involve reportable changes in ownership, and the rules currently applicable to insider transactions are, accordingly, very complex. We believe that any changes need to be considered carefully to ensure companies and their officers and directors have sufficient time to prepare reports that accurately reflect the substance of their transactions.

We note that the SEC is considering new rules that would require issuers to report transactions by officers and directors on an expedited basis.[7] The Roundtable welcomes the opportunity to work with the Congress and the SEC to develop a workable system for timely reporting of insider transactions.

PROHIBITION OF IMPROPER INFLUENCE ON AUDITS

H.R. 3763 would also make it unlawful to violate new SEC rules that would prohibit any officer, director, or affiliated person of an issuer to "willfully and improperly influence, coerce, manipulate or mislead any accountant performing an audit for the purpose of rendering the financial statements being audited materially misleading." The bill further provides that the SEC would have exclusive civil enforcement authority for this prohibition, making clear that a new implied private right of action is not intended – a position the Roundtable strongly supports.

Current SEC rules forbid the type of conduct that is the subject of the prohibition in H.R. 3763. Some years ago, the SEC adopted two rules under Section 13(b)(2) of the Securities Exchange Act of 1934 ("Exchange Act") that prohibit the conduct covered by this prohibition.

---

[7] SEC Press Release, SEC to Propose New Corporate Disclosure Rules (Feb. 13, 2002), *available at* http://www.sec.gov/news/press/2002-22.txt.

Rule 13b-1 makes it unlawful for any person to "directly or indirectly, falsify, or cause to be falsified any book, record or account subject to Section 13(b)(2)(A) of the…[Exchange] Act," and Rule 13b-2 provides that "[n]o director or officer shall, directly or indirectly, make or cause to be made a materially false or misleading statement, or omit to state, or cause another person to state, any material fact necessary in order to make the statement made…not misleading to an accountant in connection with (1) any audit or examination of the financial statements of the issuer…or (2) the preparation or filing of any document or report required to be filed with the Commission." In addition, the Congress amended the Exchange Act to add Section 13(b)(5), which provides that "no person shall knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record, or account described in paragraph (2) [regarding internal accounting controls and maintenance of books, records and accounts]."[8]

The Roundtable believes that the Committee should consider the extent to which the proposed legislative provision may duplicate this existing SEC authority.

TRADING DURING PENSION FUND BLACKOUT PERIODS

The Roundtable supports proposals designed to ensure that company executives do not engage in improper trading during a period of a blackout. Any such limits on trading should provide that, first, the definition of a "blackout" should be consistent with that used for other purposes, such as advance notice requirements. Second, the rules should not apply where a blackout affects only a relatively small part of an employer's workforce (e.g., a small plan merging into a much larger plan). Third, the trading limits should be applied to an appropriately narrow group of top decision-makers in a company and would only apply during periods where the blackout affects the ability of plan participants to trade in company stock.

LITIGATION-ORIENTED PROPOSALS

While not addressed in H.R. 3763, the Roundtable also has concerns about other legislative proposals that would eliminate some of the central limitations on abusive litigation enacted as part of the Private Securities Litigation Reform Act of 1995 ("PSLRA").

The Congress passed the PSLRA to accomplish two principal policy objectives -- encouraging disclosure of more forward-looking information because of its value to investors, and discouraging frivolous lawsuits. The Roundtable strongly advocated the inclusion in the PSLRA of a safe harbor for forward-looking statements. Since 1995, we believe that this safe harbor has significantly improved the content and transparency of corporate disclosure. The safe harbor has encouraged management to share internal projections, strategic goals and other important forward-looking information with the marketplace. Many companies now provide "outlook" sections in their SEC filings to afford investors greater insight into management's

---

[8] The conduct targeted by the new provision may also be prosecuted by the SEC under Exchange Act Sections 20(a - c, e), 21B and 21C.

views about where a company is going. Removing the protections afforded by the statutory safe harbor could make companies reluctant to provide valuable disclosure.

The Roundtable believes that doing away with the PSLRA's safe harbor would usher in a new era of litigation abuses and turn back the clock on reforms that have yielded positive results for companies and investors alike. For these reasons, the Roundtable opposes the provisions of other bills that would weaken the protections of the PSLRA.

CONCLUSION

The Roundtable supports the goal of stockholder protection embodied in the provisions of H.R. 3763. As the Congress considers proposed changes to current laws and regulations, we urge the Committee to consider SEC and private sector initiatives already underway. Notably, these include initiatives of the stock exchanges and organizations such as the National Association of Corporate Directors and the Financial Executives Institute, as well as the Roundtable's current project to update its 1997 Statement on Corporate Governance.

The Roundtable is committed to taking forceful and effective steps to prevent further failures from occurring in the wake of Enron's collapse. While new legislation may be required, it is also important to ensure that the statutory and regulatory tools already in place are enforced. But at the end of the day, there is no substitute for the commitment by business leaders to responsible and ethical leadership. As chief executive officers of some of America's largest businesses, the members of the Roundtable have made that commitment.

70203657_1.DOC

Statement of Joseph V. Del Raso, Esq.
Partner, Pepper Hamilton LLP

House Financial Services Committee

On the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002 (H.R. 3763)

March 20, 2002

Mr. Chairman and distinguished members of the Committee, thank you for this opportunity to present my views on H.R. 3763, legislation which I believe will do much to restore the faith of investors in the way in which public companies report their financial results. I commend the Committee for its level-headed and responsible approach, especially at a time when many pundits and commentators are generating more heat than light on these important issues.

I am Joseph V. Del Raso, a partner in the law firm of Pepper Hamilton LLP. My practice focuses on corporate and securities matters, particularly on matters arising under the Investment Company Act of 1940 and the Investment Advisers Act of 1940. I served as an attorney/adviser with the Securities and Exchange Commission in the 1980s, and I serve as a member of the board of directors of both public and private companies. Having experience on the regulatory side, as a lawyer in private practice and as a corporate board member, I believe I offer the Committee an important perspective on the practical effect of key aspects of this legislation.

Because this Committee has already heard a wealth of testimony on the auditor oversight provisions of H.R. 3763, I will focus my comments on other sections, particularly the transparency of corporate disclosure provisions of Section 6, the corporate governance provisions of Section 9, and the credit rating agency provisions of Section 11.

In each of these sections, this Committee should ensure that the studies and activities undertaken do not attempt to fix things that aren't broken. Federal Reserve Board Chairman Alan Greenspan, in his earlier testimony to this committee, noted a pronounced move toward more transparent reporting and improved corporate governance practices in the wake of the Enron collapse. As Chairman Oxley said at this Committee's hearings last week, while the government

may still need to take action, that action should not stifle the ability and initiative of the financial markets to self-correct.

Corporate Governance

In my practice as a lawyer and counselor, the vast majority of boards of directors – particularly those of publicly held companies – take their responsibilities very seriously. In the last few years in particular, and I'm sure even more so now in the post-Enron and post-Global Crossing world, independent directors have become increasingly aggressive in acting as watchdogs over their respective shareholders' interests.

Audit committees have already been required to adopt charters governing their operation. Boards also have undertaken initiatives ranging from increased oversight in the area of conflicts of interest – including implementation of corporate codes of conduct and conflict of interest disclosure provisions – to establishing various subcommittees dealing with human resources, diversity and other issues directly impacting corporate and shareholder interests.

Whether or not these policies and procedures are aggressively enforced obviously varies from company to company. On the other hand, given the proclivity of the plaintiffs' bar to act as the self-appointed protector of shareholder interests, even the most diligent board of directors is constantly checking itself to avoid costly, unnecessary litigation. This also serves as an important catalyst for directors' instituting improved corporate governance procedures and policies.

This also points to the need for appropriate government action to craft legislation and implement rules that are clearly understood and not easily manipulated. Appropriate implementation and enforcement is just as critical as the legislative effort. Again, while the actions of the plaintiffs' bar keep directors and officers focused and diligent, the appropriate deterrent is and always will be government enforcement and prosecution. The spectre of criminal sanctions and incarceration for the most egregious misbehavior, or civil fines and sanctions for other transgressions, serves the public interest much more sensibly than allowing the elite of the plaintiffs' bar to further

fatten their coffers by extracting or taxing in the form of contingency fees. A more direct distribution of funds to compensate victims of corporate malfeasance, or fines that are used to further bolster government enforcement efforts, are far preferable, and indeed are just plain common sense. Any effort to roll back securities litigation reform will only make business more expensive (by increasing insurance costs, for example) and less productive. Prosecutorial judgment is a markedly more effective approach than "strike-suit" targeting.

Below the board level, the President's Working Group referred to in Section 9 should examine how the financial markets can deter managers and other employees from interfering or influencing third-party professionals, whether they be auditors, outside counsel, rating agencies or other parties that are relied upon in one way or another to put their imprimatur on corporate actions.

The questions that are raised in Section 9 as to audit committee independence and standards are worth further study, but I would submit that significant progress was made with the recent requirement set down on audit committees to implement audit committee charters.

From a practical perspective, any additional government overlay, from either a statutory or regulatory standpoint, may further dampen the enthusiasm of **qualified** people to serve as independent directors. The overwhelming majority of independent directors have been and continue to be good corporate citizens dedicated to discharging their duties to protect shareholder interests. They are keenly aware of the realities of shareholder litigation, the parameters surrounding appropriate indemnities, and the finite limits of directors' and officers' liability coverage if the corporate indemnity is insufficient.

Further initiatives, including personal liability expenses – except in the most egregious cases of willful, wanton misconduct – and onerous regulatory sanctions, may merely serve to deter these individuals from accepting positions as independent directors.

Finally, corporate governance ties in with the provisions in Section 6 regarding the need for improved transparency of corporate disclosures. Boards should be able to discern from

transparent reporting the correct state of affairs – there should be little excuse for a well-informed board of directors to fail in the way of those who were victimized by obfuscation and financial hijinks, under the ruse of off-balance-sheet transactions and other clever financial tricks. Uniform standards of financial reporting will not only sustain a level playing field, but will uphold the integrity of the process

I applaud the work of this Committee in seeking improved transparency, for without it, the efficient functioning of our financial markets may be impeded. Financial investors expect to see – and will demand more than ever – quality of earnings that can only be reported via clear and concise accounting standards, consistently applied. This is especially true when dealing with non-exchange-traded financial instruments and other investments that are not readily tracked in the public markets. This legislation will help put the "fair" back in fair-value accounting.

Credit Rating Agencies

The area of credit rating agencies warrants the study and consideration outlined in Section 11. I am especially heartened that the Committee has recommended not only that this will be studied, but that barriers of entry into the credit rating business will be carefully evaluated. Qualified firms should be afforded access to this business.

On the other hand, it must be clear that the function of a rating agency is most important. The integrity of the work product of these agencies is critical to the efficient operation of the securities markets.

Many of the issues I noted regarding the corporate governance procedures also apply to credit rating agencies, particularly the overwhelming need to avoid conflicts of interest. This again is essential to the efficient operation of the financial markets. Just as with the "seal of approval" the independent accountant provided with certified financial statements, the "grade" awarded by the rating agency will only be worth the strength and integrity of the name behind it.

Conclusion

Mr. Chairman, thank you again for the opportunity to testify today on this important piece of legislation. The dark cloud of the Enron and Global Crossing collapses, while obviously dire to investors, employees and others most immediately affected, may have some element of a silver lining if, as I believe, it serves as a wake-up call to responsible independent directors and corporate officers, and if it provides the Congress the impetus to enact some long-needed reforms to ensure responsible reporting of corporate financial results.

TESTIMONY OF

PHILIP B. LIVINGSTON, PRESIDENT & CEO
FINANICAL EXECUTIVES INTERNATIONAL

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES
FINANCIAL SERVICES COMMITTEE

AT A HEARING ON

H.R. 3763

THE CORPORATE & AUDITING ACCOUNTABILITY, RESPONSIBILITY AND TRANSPARENCY ACT OF 2002

March 20, 2002

My name is Philip Livingston, President & CEO of Financial Executives International (FEI). FEI is the leading advocate for the views of corporate financial management, representing 15,000 CFOs, controllers and treasurers worldwide.

The Committee is addressing a number of important issues – important to all of us who have a stake in the U.S. capital markets and the financial reporting systems. FEI lends its support for H.R. 3763 the "Corporate & Auditing Accountability, Responsibility and Transparency Act of 2002" and applauds this Committee's leadership in identifying and addressing critical issues to improve the transparency of financial reporting and audit effectiveness.

This morning, FEI released its recommendations for ***Improving Financial Management, Financial Reporting & Corporate Governance***, which are complimentary to many of the provisions in H.R. 3763. I ask that the attached copy of these recommendations be included in and made a part of the record of this hearing. These recommendations reflect our view that while most companies are governed and managed in an ethical manner, there is still room for improvement in the management of our companies and the structural elements of corporate governance. Enron's collapse is a shameful failure on the part of its primary participants. However, this event has created a willingness and sincere desire to improve our own performance and the structure within which we operate. We should not waste this chance.

I would like to take the balance of my time to focus on a few of those recommendations as a way to verify FEI's support for H.R. 3763:

ADHERENCE TO A SPECIAL CODE OF ETHICAL CONDUCT FOR FINANCIAL OFFICERS (FEI'S RECOMMENDATION #1)

While H.R. 3763 includes many proposals to improve corporate governance – all of which FEI supports – we recommend that H.R. 3763 include a provision calling upon the SEC to work with the stock exchanges to develop a requirement that senior financial officers of all public companies adhere to a specialized "Code of Ethical Conduct," similar to the one in use today by the FEI for its members. I have included a copy of FEI's Code of Ethical Conduct with my testimony today. We believe adherence to such a code is a crucially important cornerstone of

sound management, appropriate "tone at the top" and successful fiduciary stewardship. In order to reinforce management and board awareness and commitment to ethical conduct, and the maintenance of a strong ethical climate in a company, we strongly recommend that all senior financial officers annually sign such a code and deliver it to their board.

In fact, an FEI member who is CFO of a Fortune 100 company has required all of his company's corporate financial professionals worldwide to sign the FEI Code of Conduct.

HIGHER STANDARDS FOR AUDIT COMMITTEE "FINANCIAL EXPERTS" (FEI'S RECOMMENDATION #9)

Unfortunately, Enron once again demonstrates the need to improve audit committee effectiveness. Audit committees are generally not staffed with individuals capable of understanding today's complex financial reporting standards. Three years ago the ***Blue Ribbon Panel on Audit Committee Effectiveness*** called for all audit committee members to be financially literate, and for each committee to have at least one financial expert. Unfortunately, the criteria for meeting the standard as a financial expert was set so low that no real change or addition to audit committee personnel actually occurred in the ensuing time leading up to Enron's demise. We must now get on with truly raising the bar and adding real expertise to audit committees. We need Congress and the SEC to act on this matter too. The stock exchanges should be required to write tougher standards into their listing agreements. Explicit experience in financial

reporting must be required of such experts. For example, a financial expert should possess:

- An understanding of Generally Accepted Accounting Principles (GAAP) and audits of financial statements prepared under those principles. Such understanding may have been obtained either through education or experience. FEI believes it is important for someone on the audit committee to have a working knowledge of those principles and standards.

- Experience in the preparation and/or the auditing of financial statements of a corporation of similar size, scope and complexity to the one on whose audit committee the individual would serve. The experience would generally be as a chief financial officer, principal accounting officer, controller or auditor of a similar entity. This background will provide a necessary understanding of the transaction environment that produces financial statements. It will also bring an understanding of what is involved in making proper accounting estimates, accrual, reserve provisions, etc. and an appreciation of what is necessary to maintain a good internal control environment.

- Experience in the inner workings of the audit committee, obtained either as an audit committee member, a senior corporate manager responsible for answering to the audit committee or an external auditor responsible for reporting on the execution and results of the annual audits.

PLACE RESTRICTIONS ON CERTAIN NON-AUDIT SERVICES PROVIDED BY INDEPENDENT AUDITORS (FEI'S RECOMMENDATION #5)

Another recommendation found in FEI's proposed recommendations to strengthen corporate management and governance concerns the issue of auditor

independence. As recently as last year, I testified before the Senate Banking Committee in opposition to former Chairman Levitt's proposal to split audit and non-audit functions and services that are being provided by accounting firms. It is still my strong personal opinion that consulting services do not corrupt the integrity of independent audits. The truth in my view is exactly the opposite. Consulting projects enable the auditor to get out of the accounting department and learn about the intricacies of the business and in the end conduct a more effective audit. However, the accounting profession is clearly suffering from post-Enron crisis of confidence. Therefore, certain restrictions should now be imposed on non-audit services supplied by the independent auditor. FEI believes that the independent auditor should no longer provide audit clients with internal audit services or consulting on computer systems used for financial accounting and reporting.

However, we continue to maintain that other advisory services such as tax advisory and compliance services, acquisition due diligence, audits of employee benefit plans and other statutory audits are considered to be acceptable services for audit clients as not normally raising questions of conflict of interest. We do however, strongly recommend that audit committees approve all large non-audit services provided by the auditor.

Following is a concise summary of the balance of FEI's recommendations:

1. Provide means for employees to surface compliance concerns and actively promote ethical behavior.
   Mechanisms should include a written code of conduct, employee orientation and training, a hotline or helpline that employees can use to surface compliance concerns without fear of reprisal, and procedures for voluntary disclosure of violations.

2. Designate the principal financial officer and principal accounting officer as defined in the Securities Act of 1933.
   The principal financial officer should report to the CEO and the principal accounting officer to the principal financial officer. One or both should meet periodically (quarterly) with the audit committee to review significant financial statement issues, including key judgments, estimates and disclosure matters.

3. Create a new oversight body for the accounting profession.
   The SEC should sponsor an independent body with members experienced in accounting and finance but independent of public accounting firms or other accounting industry organizations.

4. Restrict hiring of senior personnel from the external auditor.
   Corporations should adopt policies restricting the hiring of audit and tax partners or senior audit or tax managers.

5. Reform the Financial Accounting Standards Board (FASB).
   Form a committee to recommend within three months FASB reforms in the areas of organization, financial statement content and timeliness of standard setting.

6. Modernize financial reporting.
   Steps here include developing best practices for Management Discussion and Analysis (MD&A) and providing Web site access to financial reports.

7. Continue professional education for audit committee members.
   Companies should disclose in the audit committee report in the annual proxy statement whether members have undertaken such training.

8. Periodic consideration of rotation of the audit committee chair.
   Corporations should evaluate the need to rotate the individual holding the audit committee chair approximately every five years.

9. Disclose corporate governance practices.
   Public companies should provide a report of key corporate governance practices. Current best practice is to have a governance and nominating committee made up of independent directors.

SHAREHOLDER APPROVAL OF STOCK OPTION PLANS

Unfortunately, the current crisis has encouraged some to attempt opportunistic initiatives to advance narrow and unconstructive agendas with little regard for the important matters in front of us. These very tactics were too often employed over the last ten years and are at the core of many of our problems. Unusable accounting standards and dysfunctional financial statements result from processes and regulatory environments unable to recognize the real problems, yet set out to achieve narrow political or governance related objectives.

Stock option accounting is such a case. This debate has a long and acrimonious history between shareholder activists enraged by cases of excessive executive compensation and the corporate preparers of financial statements that find employee stock options as hard to measure accurately as an Enron energy contract or "put" agreement to sell broadband capacity. A charge to the income statement for stock options is the Trojan horse in the battle over governance control of options and executive compensation.

Shareholders should be able to approve all stock option plans and control abusive levels of shareholder dilution in the few cases that it occurs. Because of the intense controversy around this subject, Congress can do a great service to the public by mandating shareholder approval for employee stock option plans.

Employee stock option issues are a corporate governance matter and the decision to offer employee stock options should rest with the shareholders. When recently asked about the ongoing accounting debate, Sarah Teslik, the CEO of the Council of Institutional Investors was quoted in the New York Times as saying, "If we can't vote on these things, then we have to punish them on the balance sheet." Her comments reflect the reality of this issue – it's about the practices and quantities of option grants, not the quality of the income statement.

Recent studies have reported a significant growth in the use of employee stock option programs by companies both in the U.S. and internationally. The National Center for Employee Ownership has estimated that ten times as many

employees received stock options in 2001 with those who received them in 1992. FEI believes that this is because corporations find employee stock option plans to be effective tools for recruiting and retaining talented employees, and to be among the most effective tools available for aligning management interests with those of the shareholders.

PUBLIC SECURITIES LITIGATION REFORM ACT

Briefly, FEI would like to add its continuing support for the Public Securities Litigation Reform Act (PSLRA). FEI testified before the Senate Banking on July 21, 1993, in support of reform because of the abuses of the litigation system -- and our position has not changed. The PSLRA was enacted because plaintiffs' lawyers were bringing strike suits against hi-technology companies whenever the stock price fell for any reason. This type of abusive behavior needed to be corrected. The PSLRA is working today and there is no need to change or modify the current law. Enron's employees and shareholders will not be hindered by the PSLRA in seeking restitution of their losses. Once again, now is the time for real reform, not opportunistic presses of narrow agenda items.

INCREASED APPROPRIATIONS FOR THE SECURITIES & EXCHANGE COMMISSION

FEI recommends that a significant portion of the additional funds for the SEC be earmarked for attracting new, high caliber professional staff. Our members believe that the Commission needs increased funds in order to offer pay packages that will compete effectively with those available in the private sector.

The structure and financing of today's global corporations continues to increase in sophistication and complexity and the Commission needs professionals who can operate comfortably in that environment. The ability to understand and identify problems and resolve them expeditiously is imperative if investors' interests are to be protected without unnecessarily impairing corporations in their efforts to successfully compete in today's global economy.

ESTABLISHMENT OF A NEW PUBLIC REGULATORY ORGANIZATION

FEI supports the creation of a new independent regulatory organization for the auditing profession, as proposed in H.R. 3763. However, FEI believes it is important to clarify that the two-thirds of members who are "not members of the accounting profession" be further defined as individuals who are not currently practicing CPA's or affiliated with the AICPA other than through mere professional membership but that these members are expected to have extensive education and experience in financial management of public companies, auditing or accounting.

We believe this technical background requirement is essential to the PRO's ability to understand and effectively probe the specific audit quality issues reported through a peer review process. Further, FEI recommends that consideration be given by the Committee to structuring the PRO such that a portion of the members are designated as coming from professional organizations that represent constituent interests (e.g. the SIA representing the

securities industry, the FEI, financial executives, the AAA, accounting educators, etc.)

In addition, to maximize the effectiveness of the PRO, FEI recommends that it be made responsible for approving the selection of the audit firms engaged to conduct each peer review, and that the PRO directly receive copies of all draft peer review reports. This will assure that the PRO is directly involved in the review process.

CONCLUSION

In closing, FEI wants to again lend its support for H.R. 3763 because of its commitment to achieve improvements in the transparency of corporate disclosures and audit effectiveness. We believe that this legislation will help point the way toward the improvements necessary to strengthen our financial reporting, accounting and auditing and help assure the continued confidence of investors worldwide in the U.S. capital markets and reported corporate results.

That concludes my remarks. I would like to thank the Chairman and the members of the Committee for allowing FEI the opportunity to testify.

FEI Observations and Recommendations

Improving Financial Management, Financial Reporting and Corporate Governance

Overview

Presented here are the views of Financial Executives International (FEI) on reforms aimed at strengthening financial management, reporting and corporate governance. We believe that most companies are governed and managed ethically and are fulfilling their fiduciary obligations to their stakeholders. However, the investing public and FEI share a common concern over the problems highlighted by the recent failures of corporate management, financial reporting, corporate governance, audit committees and independent audits. The U.S. capital markets are based, in large part, on trust in a checks-and-balances control system fundamental to good corporate governance. The weaknesses exposed in the system are highlighted in public documents, testimony before Congress, press interviews and special reports. We believe these revelations point to certain systemic issues and call for reform. FEI supports a clear and coordinated look at all areas of possible improvement. It is our intention to assist in this effort by making the following observations and recommendations.

We believe the following factors may have contributed to the recent problems observed in the areas of corporate governance, ethical management, financial reporting and external audits:

- Lack of ethical conduct and inappropriate "tone at the top"
- Failure of effective board oversight
- Lack of financial expertise on audit committees
- External audit failure due to compromised independence and failed quality control procedures
- Overly complex accounting standards
- Opaque financial reporting
- Emphasis on form over substance in applying accounting standards

We offer recommendations in four areas:

- Strengthening financial management and commitment to ethical conduct
- Rebuilding confidence in financial reporting, the accounting industry and the effectiveness of the audit process
- Modernizing financial reporting, and reforming the accounting standards-setting process
- Improving corporate governance and the effectiveness of audit committees

Recommendations

Strengthening Financial Management and Commitment to Ethical Conduct

- **Recommendation 1:** All financial executives should adhere to a specialized code of ethical conduct.

FEI recommends that all senior financial professionals be required to adhere to a strong ethical code of conduct. For many years, members of FEI have signed such a code; thus committing to its principles. That code has been updated recently to include a call for all financial executives to acknowledge their affirmative duty to proactively *promote* ethical conduct in their organizations.

Whether or not they are members of FEI, all finance professionals should adhere to a code of ethical conduct containing all the elements of the FEI Code of Ethics. The Code states, for example, that financial arrangements involving actual or apparent conflicts of interest should be avoided.

FEI recommends that all senior financial officers, accounting officers, controllers, treasurers and chief investor relations officers annually sign a code containing all the elements of the FEI Code of Ethics and deliver it to their board or the board's designated committee. Further, we expect that best practice in this area will be that **all** finance, accounting, tax and investor relations personnel annually sign such a code.

The FEI Code is attached to this document as Appendix A.

FEI strongly recommends that Congress and the SEC implement regulations that call for stock exchanges and markets to implement this recommendation through listing agreements.

- **Recommendation 2:** Companies should actively promote ethical behavior and provide employees with the means to report perceived violations of ethical standards without fear of reprisal.

FEI strongly endorses practices by which all companies adopt a code of conduct for their employees and conduct regular training sessions to assure understanding and compliance. We believe companies should provide support and broad protection to employees reporting code of conduct violations. Under such a framework, companies should:

- Adopt a written code of conduct for all employees
- Conduct employee orientation and training with respect to the code
- Provide employees with a mechanism (such as a hotline or helpline) to surface concerns about compliance with laws and regulations
- Adopt procedures for voluntary disclosure of violations of laws
- Participate in best practices forums
- Inform the public of the active commitment to implement these steps

We encourage all companies to set up "hotline" channels, providing employees with the means to report perceived violations of the code or of the law without fear of reprisal. Additionally, employees should be made aware of these lines of communication and be assured that the source of all calls will be kept confidential. Calls should go directly to a person, facilitator or committee specifically identified by the company's board. That designated person or entity should screen each call and initiate appropriate action within the company. The company's board of directors should be informed of calls made and their disposition on a regular basis.

- **Recommendation 3:** Qualifications of the principal financial officer and principal accounting officer.

Management, in support of the audit committee and board of directors, should designate a principal financial officer and a principal accounting officer as those terms are used in the Securities Act of 1933. FEI believes the qualifications and roles of such persons should include the following:

  - The principal financial officer should be that person with overall responsibility for the finance function within the reporting company, and should have knowledge in all areas of finance including, at a minimum, the requisite knowledge proposed for the financial experts of audit committees. The principal financial officer should be responsible for upholding compliance with ethical standards within the finance function.

  - The principal accounting officer should be a licensed public accountant or possess equivalent knowledge and experience, and should be current and knowledgeable in the understanding of GAAP and the SEC's rules and regulations governing the preparation and audit of financial statements.

  - The principal financial officer should report to the chief executive officer, and the principal accounting officer should report to the principal financial officer. It is further recommended that the principal financial officer and/or the principal accounting officer meet with the audit committee periodically (quarterly) to review significant financial statement issues, including key judgments, estimates and disclosure matters.

Rebuilding Confidence in Financial Reporting, the Accounting Industry and Effectiveness of the Audit Process

- **Recommendation 4:** Create a new oversight body for the accounting profession staffed with finance and accounting professionals.

Enhanced oversight of public accounting firms by an independent body would increase public confidence in the audit process and effectiveness of the audit quality control process. This oversight board should be sponsored by the SEC and, recognizing the technical nature involved and the need to adequately understand the audit process, the majority of its members should be executives with knowledge in accounting and finance. Theses individuals should be clearly independent of public accounting firms or other audit industry organizations. We do not believe that a majority of members should be drawn from the audit profession.

This oversight board should oversee the peer review quality control process of the audit firms. Furthermore, the peer reviewers should be accountable to the oversight board for the scope of review, findings, recommendations and corrective actions.

We further recommend that a focused mission and scope will enhance the effectiveness of this body. Therefore, this new body should be principally tasked with the job of audit industry oversight and discipline. As FEI continues to support private-sector accounting standard setting, we believe that a separate and independent body should continue to oversee the FASB.

- **Recommendation 5:** Place restrictions on certain non-audit services supplied by the independent auditor.

Even the appearance of a potential conflict of interest may now undermine an auditor's effectiveness. Therefore, we believe confidence in the integrity of the audit would be enhanced if certain non-audit services were prohibited for audit clients. In this regard:

  - The independent auditor should no longer provide audit clients with internal audit services or consulting on computer systems used for financial accounting and reporting.
  - Advisory services should be prohibited wherever the audit firm could be put in a position of relying on the work product resulting from such services.
  - Tax advisory and compliance services, acquisition due diligence, audits of employee benefit plans and other statutory audits should be acceptable services for audit clients as they would not normally raise questions of conflict of interest. In the unusual instance where such services could present questions of a conflict of interest, such services should not be provided.

Importantly, in addition to the foregoing, we suggest that audit committees approve substantially all large non-audit services. In so doing, the audit committee should consider the impact of such services on the overall independence of the audit firm.

FEI also recommends that the SEC redefine the current classifications of audit and non-audit services to assure that the guidance is clear and that the distinction conveys a

complete and meaningful picture to investors in regard to the proper characterization of audit and non-audit activities.

- **Recommendation 6:** Restrict the hiring of senior personnel from the external auditor.

FEI recommends that companies adopt policies that restrict the hiring of engagement audit and tax partners, or senior audit and tax managers, who have worked on the company's audit for a period specified by the board of directors. FEI believes that this period should be no shorter than two years.

Modernizing Financial Reporting and Reforming the Accounting Standards-Setting Process

- **Recommendation 7:** Reform the Financial Accounting Standards Board (FASB).

FEI recommends that a "Blue Ribbon Committee" be formed to address FASB reform. While we support continuing private-sector standard setting through the FASB, substantive process and structural changes are long overdue. The Blue Ribbon Committee should complete its work promptly and produce initial recommendations within three months of its formation. The Committee should be guided by the basic principle of advancing financial reporting, notwithstanding divergent political interests. The Committee should address the following issues:

- FASB Organization
  - Board mission statement
  - Size of board
  - Length of board member terms
  - Voting majority
  - Staff effectiveness, accountability and structure
  - Restrictions on board member meetings ("Sunshine Rules")

- Timely Standard Setting
  - Timely standard setting with clearly defined priorities, objectives and milestones
  - Agenda management and accountability

- Financial Statement Content
  - A process for defining clear long-term objectives for financial statements produced under GAAP
  - Fair value accounting, in particular, needs to be addressed, given the absence of market values in many areas and the potential for such accounting concepts to create financial statement volatility

- Financial Accounting Standards
  - Reassess the conceptual framework as the basis for standard setting
  - Assure practical implementation of principle-based standards vs. specific, bright-line rules; examples of standard application and financial interpretations based on principles underlying standard
  - Impact of planned globalization of accounting standards
  - Review existing standards and disclosures
  - Address the need to increase the participation of the user and investment community and decrease tension with the preparer community

- **Recommendation 8:** Modernize financial reporting.

FEI expresses strong support for the following improvements in financial reporting and recommends that committees be formed promptly to address these matters.

- Improve Management's Discussion and Analysis (MD&A)

- FEI should take the lead in developing best practices for MD&A disclosure utilizing 2001 annual reports as a primary source for data.

- Implement "Plain English" financial reporting as the new language of professionals involved in investor relations and financial statement preparation.

- Promote voluntary disclosures of business performance metrics
  - FEI recommends that companies consider providing web-based reporting of key performance measures used by management and specific to the industry on a quarterly basis. (A possible source for additional key performance measures is information shared at analyst presentations.)
  - In order to encourage the expansion of reporting additional measures, it is essential that safe harbor rules be strengthened to specifically encompass the additional reporting.

- Develop and complement Web-based financial reporting
  - Internet delivery of hierarchical financial reporting that employs scorecards, current key performance indicators and analytical tools offering differing accounting standards is the future. Industry, users and the SEC should move ahead aggressively to develop models of such reporting frameworks without reducing access for investors in the short term.
  - Mandatory Internet access to financial reports - public companies should make the information available on their Web sites concurrent with SEC filings.
  - Voluntary business performance reporting, discussed above, may be more easily implemented through Web-based reporting.

- Expanded use of reports on Form 8-K
  - Items typically included in these filings could be expanded; however, the SEC's revised guidance should be "principle-based" and the current list of additional items to be disclosed should be presented only as "examples."

- Enhance filing requirements for foreign filers
  - Many foreign filers currently provide quarterly financial statements on a voluntary basis. FEI recommends that the SEC require foreign filers to file quarterly.

- Assess transition impact on paper documents
  - FEI does not suggest that hard copy mailings be eliminated in the near term. However, the content of paper mailings to shareholders should be examined to determine what modifications can be made and over what timeframe.
  - Financial disclosure to shareholders via paper documents has vastly exceeded a user's ability to digest it. The availability of public filings on the Web and analysis of information accessed by users should assist in identifying what is considered important. The resulting information could serve as a basis to expand the disclosures most often accessed and reduce those disclosures that are of little or no interest. This should

improve understanding and communication while reducing costs to corporations and, ultimately, to the shareholders.

Improving Corporate Governance and the Effectiveness of Audit Committees

- **Recommendation 9:** Effective implementation of the 1999 Blue Ribbon Panel Recommendations re: audit committee financial experts.

In 1999 the *Blue Ribbon Panel on Audit Committee Effectiveness* called for all audit committee members to be financially literate and for each committee to have at least one financial expert.

FEI recommends that the NYSE and the NASDAQ set **higher standards** for audit committee "financial experts." These criteria should call for explicit experience requirements in the credentials of such experts. A financial expert should possess:

- An understanding of Generally Accepted Accounting Principles (GAAP) and audits of financial statements prepared under those principles. Such understanding may have been obtained either through education or experience. We believe it is important for someone on the audit committee to have a working knowledge of those principles and standards.

- Experience in the preparation and/or the auditing of financial statements of a company of similar size, scope and complexity as the company on whose board the committee member serves. The experience would generally be as a chief financial officer, chief accounting officer, controller or auditor of a similar entity. This background will provide a necessary understanding of the transactional and operational environment that produces the issuer's financial statements. It will also bring an understanding of what is involved in appropriate accounting estimates, accruals, reserve provisions, etc., and an appreciation of what is necessary to maintain a good internal control environment.

- Experience in the internal governance and procedure of audit committees, obtained either as an audit committee member, a senior corporate manager responsible for answering to the audit committee or an external auditor responsible for reporting on the execution and results of annual audits.

FEI strongly recommends that Congress and the SEC implement regulations that call for stock exchanges and markets to implement this recommendation through listing agreements.

- **Recommendation 10:** Continuing professional education for audit committee members.

FEI recommends that all audit committee members attend continuing education in areas of financial reporting, risk management and/or accounting. Training can be "in-house" or via an outside provider. FEI, the National Association of Corporate Directors or an equivalent entity should establish the minimum content to be covered. Companies should disclose in the annual audit committee report whether members have undertaken such training. Non-audit committee directors are also urged to attend these sessions.

- **Recommendation 11:** Periodic consideration of audit committee chair rotation.

FEI recommends that boards of directors periodically evaluate the need to rotate the individual holding the audit committee chair. Such evaluation may be done approximately every five years. FEI recognizes that outstanding audit committee chairs are valuable and difficult to replace. Yet there is also benefit in developing successors and additional financial experts on the audit committee. Therefore, rotation and successor development may further strengthen the overall governance mechanisms within the board.

- **Recommendation 12:** Disclosure of corporate governance practices.

FEI recommends that all companies annually report their key corporate governance practices. Current best practice in many companies is to have a governance and nominating committee made up of independent directors.

Closing

FEI formed a task force of members to assemble this set of recommendations. The task force also had significant input from FEI's Committee on Corporate Reporting. These recommendations were then reviewed and approved by FEI's Executive Committee led by FEI Chairman David Young, CFO of Adaptec, Inc., and FEI Vice Chairman Ridge A. Braunschweig, CFO of Orion Corporation.

FEI wishes to acknowledge and thank those involved in the preparation of this report.

Task Force Members

Philip D. Ameen
General Electric Company
Vice President and Comptroller

Scott M. Boggs
Microsoft Corporation
Vice President and Corp. Controller

Fred Corrado
The Great Atlantic & Pacific Tea Co., Inc.
Retired Vice Chairman & CFO

John P. Jessup
E.I. du Pont de Nemours & Company
VP Finance and Controller

Dennis D. Powell
Cisco Systems, Inc.
Vice President and Corporate Controller

Peter R. Bible
General Motors Corporation
Chief Accounting Officer

Frank J. Borelli
Marsh & McLennan Companies
Retired CFO

David J. FitzPatrick
United Technologies Corp.
SVP and Chief Financial Officer

Philip B. Livingston
Financial Executives International
President and CEO

J. Pedro Reinhard
Dow Chemical
EVP and Chief Financial Officer

Bryan R. Roub
Harris Corporation
Senior Vice President and Chief Financial Officer

David H. Sidwell
J.P. Morgan Chase & Co.
Chief Financial Officer - Investment Bank

David L. Shedlarz
Pfizer, Inc.
EVP and Chief Financial Officer

APPENDIX A: Code of Ethics of Financial Executives International

FEI CODE OF ETHICS

FEI's mission includes significant efforts to promote ethical conduct in the practice of financial management throughout the world. Senior financial officers hold an important and elevated role in corporate governance. While members of the management team, they are uniquely capable and empowered to ensure that all stakeholders' interests are appropriately balanced, protected and preserved. This Code provides principles to which members are expected to adhere and advocate. They embody rules regarding individual and peer responsibilities, as well as responsibilities to employers, the public, and other stakeholders. Violations of FEI's Code of Ethics may subject the member to censure, suspension or expulsion under procedural rules adopted by FEI's Board of Directors.

All members of FEI will:

1. Act with honesty and integrity, avoiding actual or apparent conflicts of interest in personal and professional relationships.
2. Provide constituents with information that is accurate, complete, objective, relevant, timely and understandable.
3. Comply with rules and regulations of federal, state, provincial, and local governments, and other appropriate private and public regulatory agencies.
4. Act in good faith, responsibly, with due care, competence and diligence, without misrepresenting material facts or allowing one's independent judgment to be subordinated.
5. Respect the confidentiality of information acquired in the course of one's work except when authorized or otherwise legally obligated to disclose. Confidential information acquired in the course of one's work will not be used for personal advantage.
6. Share knowledge and maintain skills important and relevant to constituents' needs.
7. Proactively promote ethical behavior as a responsible partner among peers, in the work environment and the community.
8. Achieve responsible use of and control over all assets and resources employed or entrusted.

NAM National Association of Manufacturers

MANUFACTURING MAKES AMERICA STRONG

Testimony

of Jerry J. Jasinowski
President
National Association of Manufacturers

on behalf of the National Association of Manufacturers

before the Committee on Financial Services
U.S. House of Representatives

on H.R. 3763, the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002

March 20, 2002

1331 Pennsylvania Avenue, NW • Washington, DC 20004-1790
(202) 637-3000 • Fax (202) 637-3182 • www.nam.org

Testimony of

Jerry J. Jasinowski
President
National Association of Manufacturers

Before the
Committee on Financial Services
U.S. House of Representatives

On
H.R. 3763, the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002

March 20, 2002

I. Introduction

Chairman Oxley, Congressman LaFalce, members of the committee, thank you for this opportunity to testify on behalf of the National Association of Manufacturers (NAM), which represents 14,000 members (including 10,000 small and mid-sized companies) and 350 member associations serving manufacturers and employees in every industrial sector and all 50 states.

Let me begin by saying that the issues we are discussing today are both numerous and complex, including accounting standards, financial reporting, corporate governance, the proper role of outside auditors, retirement plans and other issues. First and foremost, I am here to say that the overwhelming majority of corporations and private firms are characterized by high standards of accounting, financial reporting and management – all grounded on the values of honesty and integrity. Additionally, changes in these areas should be made first in the private sector before public policy changes are initiated. While we certainly don't assert that no public policy changes may be necessary, it is important that we move carefully, fully analyze all the facts, and put things into accurate perspective. Particularly in light of pending criminal charges, it is critical that we pay close attention to due process and not rush to judgment.

II. Importance of Honest and Complete Information

On behalf of our broad membership, I want to emphasize that we believe the success of our economic system is predicated on certain fundamentals, the most critical being the availability of complete, accurate, timely and transparent information on the companies that comprise our private market system. Prompt and reliable information is essential to enable capital markets to efficiently allocate capital to uses that increase productivity and growth, for investors to determine if their capital is being properly employed, and for the broad public to be served.

Of course, it is one thing to state the necessity of complete and accurate information and another to both define it and do it. The accepted standard for determining whether information is complete and accurate is the Generally Accepted Accounting Principles (GAAP), in conjunction with SEC regulations. The purpose of GAAP, as you know, is to state fairly and completely the financial condition of a company, presenting revenues and expenditures, assets and debts, in the proper time period. This is essential to accurately calculate earnings, cash flow and other measures of performance. Timely, accurate and complete reporting of sound measures of performance is critical for ensuring that investors and employees have the information necessary to assess the success and viability of businesses for the present and the future.

The NAM believes that the responsibility for providing complete and accurate information to investors and the public rests first with management, attested to by independent auditors, supported by a knowledgeable and informed audit committee, working under the attentive scrutiny of the company's board of directors. Public policy has the broad responsibility to provide appropriate traffic rules, incentives and penalties.

III. Reinforcement of Best Practices

Accordingly, each of these parties needs to adhere to best practices for financial and corporate governance. There is an elaborate body of best practices guidelines available that need continuous emphasis and improved application.

Management

Management is the first line of defense in ensuring that the highest standards of integrity are observed in providing the full disclosure of financial and accounting information to auditors, the audit committee and the board. Management must exercise due diligence to obtain as full and complete a picture of the enterprise's operations as is possible, and to share relevant information with the auditors, audit committee, the board and, where appropriate, the public at large. Management's attitude and philosophy regarding the importance of maintaining the highest standards of integrity, particularly with regard to financial reporting, play an important role in ensuring that such standards are upheld at all levels throughout the organization.

Outside Auditors

Independent auditors must be truly independent in order to fulfill their responsibility of providing complete and accurate audits, including an assessment of the adequacy of internal controls. Management and the audit committee should encourage and require such independence, not compromise it. The audit committee should be composed of knowledgeable directors recommended by management and approved by the nominating committee. The committee should be empowered to take all necessary actions to assure audits are accurate and credible, including the setting of fees, the terms of the contract and review of any consulting agreements. It should also set clear rules about what additional services the auditing firm can provide to the company.

Also, it is clear that there needs to be sharper delineation between auditing and consulting. That is not to say that companies should not be able to legitimately use certain non-audit services of the auditing firm. In some cases, it may be in the company's and the public's best interest to capitalize on the firm's knowledge of the business, to save both time and money and to provide the most accurate information. However, auditors certainly cannot audit what they have created, i.e., a firm cannot design the accounting system if it is also going to audit the financial system. Finally, auditors should not be in the position of worrying about their firm's

consulting relationship with the client when making audit-related decisions. Nor should they feel pressure to negotiate down auditing fees based on how much the client spends on consulting. This is an obvious conflict of interest that should be avoided.

Audit Committee

The audit committee must be composed of members who are knowledgeable about corporate accounting and finance and experienced in corporate management. The committee must work closely with management and the outside auditors while maintaining appropriate independence in order to fully exercise its supervisory review function. The audit committee should also have the primary relationship with the outside auditor, ensuring that the auditor understands that his primary obligation and reporting responsibility are to the audit committee.

Board of Directors

The board of directors has the broad responsibility for assuring that the enterprise's management, outside auditors and audit committee are fulfilling their basic functions and preserving their independence in the quest for providing complete and accurate information about the enterprise's operational and financial status.

One good guide to these principles is the SEC's statement regarding the selection and disclosure by public companies of critical accounting policies and practices (12/13/2001), which stresses the judgment required by auditors in addition to mere adherence to GAAP. It also emphasizes the importance of Management's Discussion and Analysis (MD&A). This bulletin is a very good guidance document, stressing the appropriate ideals that should be the goal for all public and private companies. Had these principles been followed, a strong case can be made that the Enron problem could have been prevented. This again points out the importance of understandable, accurate and full disclosure of relevant investor information buttressed by careful judgment on the part of outside auditors and the audit committee.

While we believe that the overwhelming majority of firms in the NAM membership adhere to these high standards, best practices for financial and corporate governance need to be re-emphasized and, where appropriate, strengthened. All firms should strive to achieve world-class quality status not only in products and services, but also in the information they use to manage and represent their companies. Clearly, this improvement is the broad responsibility of the private sector.

IV. Possible Reforms to Consider

That said, in the current environment, it would be wise to review what public policy changes may be needed. I know that this committee will do this, and we welcome the opportunity to work with you.

For example, one idea that merits study is the Public Regulatory Organization (PRO) that H.R. 3763 would create. This PRO appears to have the authority and responsibility to take on preventative investigations of accounting firms before the damage is done. Such a PRO may be better suited to discipline accountants and accounting firms than the profession or the SEC presently can.

Another public policy change to consider is increasing the resources of the Financial Accounting Standards Board (FASB) and the SEC. Additional resources would help to improve the quality of public standards, education and prevention. Some of these resources could be used to simplify and improve the clarity of the current system.

Additionally, section 6 of H.R. 3763 seems to track many of the goals included in the SEC's statement regarding the selection and disclosure by public companies of critical accounting policies and practices (12/13/2001) referenced in section III above. It would ensure that both management and auditors exercise judgment about what key accounting principles are affecting the apparent financial position of a company and how.

In addition, the President has recently offered a ten-point plan to improve corporate responsibility for complete and accurate information. Overall it is a mixed bag, but it does include some very good ideas. In particular, I would note his first two points regarding investor access to information. First, the President correctly asserts that each investor should have quarterly access to information needed to judge a firm's financial performance, condition and risks. Secondly, he emphasizes prompt investor access to critical information. Timely access to accurate information and transparency are key to wise investment choices.

Some of the President's other proposals are less clear, both in their intent and in how they would be applied. For example, point four of the plan states that CEOs or other officers should not be allowed to profit from erroneous financial statements, and point five suggests that CEOs or other officers who abuse their power should lose their right to serve in any corporate leadership positions. While the objectives of these recommendations are appropriate, the definition and determination of wrongdoing are unclear.

Section 2 of H.R. 3763 also warrants additional exploration. This provision would restrict the ability of auditors to provide services, other than the audit, to audit clients. While there is certainly merit to avoiding conflicts of interest, an absolute prohibition against providing any internal audit service is impractical. For example, there may be times when it would be in the best interest of the company and investors to have the same firm that provides its external audits conduct an internal audit of a discreet process, either because the firm is particularly suited to follow up on questions raised in the audit, or because the firm knows and understands the company's business best. Therefore, the firm would be in the best position to detect weaknesses and provide best-practice recommendations to management. In any case, as long as a conflict of interest can be avoided, wholesale prohibition is unnecessary.

We are still in the process of looking at many of these and other proposals and gathering information on them. The NAM has not taken a position on any of the above measures but is committed to carefully considering and advocating measured reforms to improve the system and protect investors.

That said, there are several areas which currently work quite well and should be left alone. For example, the NAM is extremely concerned that hasty legislative action in response to the collapse of Enron will have a negative impact on our voluntary retirement system, widespread stock ownership among employees, and the 401(k) assets and retirement security of millions of employees. It is imperative that Congress and the Administration fully investigate the facts surrounding the Enron case before making any changes to current retirement policy or regulation. I have yet to see where mistakes at Enron merit wholesale changes to our 401(k) programs. Currently, 56 million American workers participate in 401(k), profit sharing and employee stock ownership plans (ESOPs). One of the hallmarks of the current system – flexibility for employers to design benefits packages that are most appropriate for their workers – is a crucial component of the system's success. Percentage caps, limits on holding periods and diversification mandates will limit employee choice and deter employer matches. Imposing a one-size-fits-all approach by limiting certain investment choices – most notably company stock – will hurt many workers who strongly support their ability to make their own investment choices. We urge Congress to focus instead on encouraging investment education and professional investment advice so that workers have the tools they need to make wise retirement planning decisions.

Secondly, there should not be major changes to accounting for stock options. Stock option accounting in no way led to the Enron situation, and there is no basis for requiring changes to current practice. The current accounting rules for stock options provide a great deal of transparency and provide extensive, high-quality information to investors. Moreover, stock options provide employees with an ownership stake in the company and encourage increased productivity and innovation. They are a driving force behind economic growth. Major changes to the method of accounting for them would likely result in companies no longer providing broad-based stock option plans.

Finally, Congress is often tempted to create new legal liability in the face of a bad situation or bad actors. But the current rules are, in fact, working as intended to protect investors and the public. Securities fraud class action suits are alive and well. Settlement value of meritorious claims is up significantly, and auditors who engage in wrongdoing continue to face

substantial liability. Also, additional funding for the SEC, as mentioned above, would allow the enforcement division of the SEC to take full advantage of current law to prosecute more fully and quickly. The criminal charges pending against Andersen are further proof that current law provides more than adequate redress. It is not necessary to increase or create new legal liability.

V. Conclusion

In conclusion, we must maintain proper perspective on recent errors in company and accounting conduct. The vast majority of the more than 14,000 publicly-traded companies in the United States continually produce reliable financial statements. We have a good and dependable system that deserves the international respect it has had over the years.

Secondly, we must improve application of current standards. There are a lot of good ways to improve the system simply by diligently applying the rules of the current system. In fact, progress in transparency is already evident in the wake of recent SEC initiatives. We are seeing greater emphasis on GAAP rather than pro forma earnings, disclosure of key accounting policies, and more comprehensive liquidity discussions. Things are already moving in the right direction within the existing framework, and we should continue to reemphasize best practices for financial accounting and corporate governance.

If we apply and use best practices, little new legislation or regulation should be required. Any new laws should be limited so as not to do harm by adding undue cost, complexity or liability, while still protecting the investor.

The NAM looks forward to working with you as you sort through these thorny issues. We appreciate the opportunity to be here today and present our views. Thank you.

Testimony before the House Committee on Financial Services

March 20, 2002

Peter C. Clapman
Senior Vice President and Chief Counsel, Corporate Governance
TIAA-CREF

Mr. Chairman and members of the House Committee on Financial Services, I am pleased to have the opportunity to express our views on how corporate governance issues impacted on the demise of Enron, and on which corporate governance improvements in that area would be helpful.

My name is Peter Clapman, Senior Vice President and Chief Counsel for corporate governance of TIAA-CREF. TIAA-CREF is the largest private pension system in the world, providing retirement and other benefits for the educational community, with approximately $275 billion under management. We also sell mutual funds and other financial products to the general public.

I have managed our corporate governance program for a number of years. In recent years, I also have been working on the global dimension of corporate governance. Currently I am chairman of the International Corporate Governance Network, an organization with 250 members worldwide with combined assets of approximately $12 trillion under management. Until recently, US corporate governance was regarded as the most protective of shareholder interests in the world. That high regard is now being challenged by events such as the Enron collapse.

TIAA-CREF LEADERSHIP ROLE IN CORPORATE GOVERNANCE

TIAA-CREF has been a leader in corporate governance for many years. We are convinced our initiatives to improve corporate governance will produce better returns for our more than 2 million pension participants and shareholders. We also believe it is our responsibility to monitor the managements of our portfolio companies and hold them accountable. Fulfilling this responsibility includes conscientious use of our proxy vote, and proactive efforts to encourage better governance standards generally and in particular at our portfolio companies.

Strong corporate governance is particularly a concern for CREF, our public equity arm, which holds about $150 billion in equity in U.S. and other public companies. It has to be understood that, unlike other groups that have dealings with the corporation, common shareholders do not have contractual protection of their interests. They must rely on the board of directors—whom they elect—and on the governance structure of the corporation to protect their interests. Over the years many shareholders have followed the practice of simply selling stock in companies in which they did not have confidence in management and in governance arrangements. CREF long ago found this response inadequate, both because the exercise of shareholder responsibilities is important for the proper functioning of the overall system, and because CREF was so large that limitation of investments posed problems. By the early 1970s, CREF had concluded that it was important to exercise its ownership responsibilities by using its proxy vote consistently and conscientiously and by advocating good corporate governance. Today, a major component of our equity investment is indexed, meaning that we maintain our

investments in each company for the long haul. We are long-term investors through our common stock holdings in about 3,000 U.S. and 1,500 non-U.S. companies.

THE CRITICAL ROLE OF THE BOARD OF DIRECTORS

In basic terms, corporate governance is the relationship between the management, the board of directors (including its committees) and the shareholders. Shareholder rights are important in this equation, but the board of directors is the fulcrum for managing this relationship, and for holding management accountable to shareholders. Thus, good corporate governance depends critically on the performance of the board of directors and on its key committees – the compensation, audit and nominating committees. Shareholders do not attend board meetings, and must rely on the quality of board processes. The primary responsibility of the board of directors is to foster the long-term success of the corporation consistent with its fiduciary responsibility to the shareholders. If the board is not independent; if the directors lack the proper qualifications; if the directors do not pay sufficient time and attention to fulfill this role—then, an Enron is not only possible, it is likely. Are there other Enrons out there? We can hope there are not, but prudently cannot trust that will be the case without reforms.

The *TIAA-CREF Policy Statement on Corporate Governance*, our basic formal guidance on these issues, puts great emphasis on the independence of the board and of its key committees. We believe the board should be composed of a substantial majority of independent directors, by a stringent definition, and that the board should have audit, compensation and nominating committees that consist entirely of independent directors. In determining board independence, it is helpful to have strong standards for such

independence, that, for example, would exclude individuals with financial ties to top executives (as well as to the company itself). We were heartened over the last few years as the New York Stock Exchange and Nasdaq provide strengthened definitions of independence for purposes of the board audit committee, but the definition should be strengthened further, and extended to the compensation and nominating committees, as well as to the full board.

Independence is a necessary but not sufficient criteria for board success. Board members also need to be qualified, engaged, and dedicated to effective oversight. They must be able to work with each other and with management collegially, while also bringing tough-mindedness and courage to their directorships. This is a challenging assignment, particularly when companies run into difficulty, and the effectiveness of boards—and particularly of individual directors—is hard to evaluate from the outside. In our own attempts to evaluate boards and urge their strengthening, we look at such elements as long-term company performance (which, when consistently subpar and when combined with lack of action to change management, can indicate board passivity); excessive takeover defenses (which can indicate a mindset of management to entrench itself, and of board willingness to protect management at the expense of shareholders); and executive pay practices (which, when marked by clearly excessive pay, dilutive and unfairly enriching stock plans, and loose and subjective bonus awards, can strongly suggest weakness and the need for fresh perspective at the board level).

NEEDED REFORMS

I will now address more fully which reforms are needed and how they may best be accomplished. This includes the proper role of the professionals such as the accountants, the lawyers, the major stock exchanges, the SEC, institutional investors, and the legal system. Also, is there a role for Congress? Our goal should neither be to merely punish the wrongdoers—although that must happen to demonstrate the system does not protect the "mighty"—nor to make board membership so onerous that we discourage such service. Our goal must be to identify those areas of corporate governance that perform badly, and then determine the most efficient and effective means to improve the governance system.

CONFLICTS OF PROFESSIONALS

One area that must be addressed is the conflicts within the key professions. Too often accountants and lawyers ostensibly representing the company in fact wind up representing only its senior management. Such conflicts were at the heart of the problems at Enron. The professional organizations themselves must do a better job through education and discipline to minimize these abuses.

Related to this is the imperative that boards control—and not cede to management—their relationships with professional advisors. Boards must properly exercise authority over appropriate areas of their responsibility. This includes, perhaps foremost, control of the relationship with the outside auditor.

The conflict issues inherent in some of the non-audit relationships of accountants played an important role in the Enron story. Congressional hearings have uncovered that

the accounting practices of Enron were recognized by Enron auditors early on as aggressive and creative, terms not usually used as a mark of respect. Later, these financial statements were shown to be incorrect, requiring a restatement. It seems clear that the audit firm in this case demonstrated its primary loyalty to senior management. If accounting practices were aggressive and creative, these facts should have been immediately reported to the audit committee and the board. Subsequently, these facts should have been disclosed to the market. Disclosure is critical here. In the aftermath of Enron, the market showed its skepticism of accounting practices across the board, as many other companies were viewed with suspicion. It should be added that the conduct of inside and outside counsel of Enron raised similar conflict issues.

The board and the outside auditor should both see to it that in fact as well as appearance the outside auditor reports only to the independent board audit committee, acting on behalf of shareholders. A key reason why the fact of consulting contracts and other non-audit work awarded to the audit firm is troubling—a reason that many have overlooked—is that while the audit committee is formally (and should be in fact) responsible for hiring and firing the outside auditor, management controls virtually all the other types of work that firm may do for the company. These contracts therefore help to blur the reporting relationship, and it is difficult to believe that auditors can totally put aside awareness of the extent to which the success of their firm, and even their own compensation packages, may be tied to services being provided by their firm to management of the company in question.

More generally, we think that auditor independence from management is important to investor confidence in the reliability and transparency of corporate financial reporting. Aside from the issue of non-audit fees to the auditor, we believe that companies should consider rotation of auditors, and of limitations on hiring executives from the ranks of their audit firm (something that apparently was quite common at Waste Management and Enron). In his testimony before the Senate Banking Committee on February 27, TIAA-CREF Chairman and CEO John H. Biggs noted that we have a rule excluding the outside auditor from other work for TIAA-CREF, and that we consider the rotation of the auditor after a five- to ten-year period. As Mr. Biggs said, we believe the rotation policy has been successful and highly energizing for our financial management work, and that costs of such a policy can be managed.

Finally, another step that a board can take to enhance the independence of their outside auditor is to institute explicit policies limiting hiring of company finance staff from the ranks of the outside auditor. If the career path of individuals on the outside audit team lead directly to the company being audited, the independence of the auditor can be compromised.

REGULATION OF ACCOUNTING PROFESSION

The regulation of the accounting profession demands change and already excellent proposals have been made. In his Senate Banking Committee testimony, TIAA-CREF Chairman and CEO John Biggs urged among other things that an independent board oversee the accounting profession with its own funding and with the legal authority to enforce rules and regulate wrongdoing. He suggested that this is one

area where Congressional action may be appropriate, to assure that the disciplinary board will have a clear public mandate. There is fear, as Columbia University Law Professor John C. Coffee has stated, that "Three years from now, when nobody is paying attention, a private board can just let things slide." Moreover, the investigative authority of a new accounting regulatory body needs to be clear-cut, and not simply a derivative of the SEC. Accounting firms must know that they cannot refuse to open their books or prevent their staff from cooperating with the new agency. Moreover, as Mr. Biggs testified, the new agency should have a reliable funding source that does not come from the accounting profession on a voluntary basis. We also should end what he called the "tin-cup" process now used for support of the Financial Accounting Standards Board and the International Accounting Standards Board.

EXECUTIVE COMPENSATION: STOCK OPTION ACCOUNTING, NEED FOR SHAREHOLDER APPROVAL

Related corporate governance reforms that are needed relate to executive and director stock ownership, executive compensation, and the use of stock options. President Bush and SEC Chairman Harvey Pitt have proposed a simple and crucial reform in this area, with a new rule that would require prompt disclosure of executive stock sales. Under present rules, if the executive sells stock to the company directly, it need not be reported for a period that can stretch more than a year. The President's proposal would require disclosure of all stock purchases and sales by executives and directors within two days after the fact, which will be very helpful.

But there is a more fundamental problem here with reference to stock options. Options can be a very useful tool for management and of great value in providing some alignment of managerial and employee interest with that of shareholders. But options are overused and at times abused, we believe, with the accounting rules largely to blame. The true costs of fixed price options escape the earning statement, encouraging this overuse. Financial statements thus obscure transactions rather than provide full disclosure about them.

FASB and the SEC have taken important steps to enhance disclosure of stock option plans, including a new SEC rule that will kick in later this year that will provide greater transparency on potential dilution from stock option plans. But in our view, the fact that most companies shield the earnings statement from the impact of stock options has a huge behavioral effect on boards and management, which are very focused on enhancing that earnings number. We have been told repeatedly by companies that they would not consider expanded use of alternatives to fixed-price stock options—which get this preferential accounting treatment—because of the accounting hit they would take. The accounting tail is wagging the dog here. Optimal compensation strategies, which could include more cash compensation, or pay in restricted stock or a variety of performance-based programs (including stock options tied to an index such as the S&P 500, which would reward only above-average performance), may be sacrificed in the interest of protecting that earnings figure.

The perversity of the current system is revealed by the number of companies in the last year or so that have repriced their stock options—setting new, lower exercise prices because of the declines in their stock prices—in a manner that is manifestly worse

for shareholders, but that escapes taking an accounting charge. In the last year, more than 100 companies, according to proxy advisory firms, have cancelled stock options with a promise to issue new options in six months plus one day, which permits this repricing without taking an accounting hit. This creates an incentive for executives and others receiving these options—even outside directors in some cases—to reduce the stock price in the short term, so that the new exercise price, which is the market price six months and one day out, will be as low as possible.

Moreover, shareholders are not always allowed to vote on stock option plans. Increasingly, companies are adopting plans that meet loose stock exchange rules for "broad-based" stock option plans that can be implemented without shareholder approval. The lack of accounting and increasing lack of control by shareholders are a major structural failure of our corporate governance system.

The reforms needed are (1) require that the cost of stock options be reflected in financial statements, and (2) require shareholder approval for dilutive stock option plans, thus introducing greater accountability in this most important area of executive compensation.

WHERE WILL REFORM COME FROM?

- **Role of National Stock Exchanges**

As a group, the national stock exchanges—the New York Stock Exchange, NASDAQ and the American Stock Exchange—must be an important engine for needed reform. The exchanges, however, have dual objectives as organizations. While they must regulate companies and brokers in the public interest, they also as businesses seek

listings from the very companies they must regulate. Nevertheless, listing must be meaningful in terms of the quality of corporate governance practices. To the credit of Chairman Harvey Pitt, the SEC has already requested that the exchanges evaluate which corporate governance reforms are necessary. The exchanges must respond by imposing stronger standards of independence, requiring shareholder approval of all material equity compensation plans, promoting education of directors, and more stringent policies to ferret out conflicts of interest. If the exchanges fail to act, the SEC using its regulatory powers and persuasive influence should press for needed reforms.

- **Education of Directors**

The education of directors is a major concern. Not all individuals are qualified to be directors in today's complex market place simply because they are asked to serve. Directors on audit committees only recently had to meet a standard of financial literacy---literally to have the ability to understand a financial statement. We believe directors on compensation committees at times do not take a pro-active role on behalf of the company because they lack understanding of compensation issues and do not obtain independent consultants when needed. The abuse and overuse of stock options, with the lack of complete and transparent reporting of the cost, is a product in part of inadequate performance of compensation committees and the board as a whole.

- **Role of Congress**

What is the role for Congress? It is not clear how many new laws are needed. But your oversight role is critical. At some point, memories of Enron may fade as other issues take center stage. But the corporate governance problems that Enron's downfall

revealed will still be there unless properly remedied. It is important that the reforms being suggested not lose their momentum.

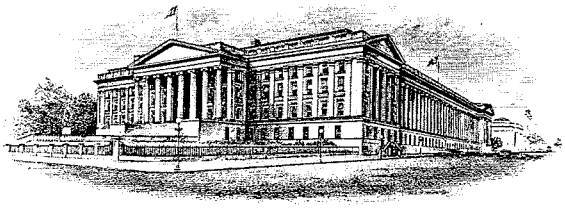
CONCLUSION

I have outlined a number of corporate governance problem areas where I believe reform is both possible and necessary, including:

- Conflicts of Professionals
- Regulation of Accounting Profession
- Executive Compensation: Stock Options
- Role of Stock Exchanges
- Education of Directors

You may be sure that TIAA-CREF, as an organization will continue to press for these reforms. We hope that the current widespread public interest in such issues will produce the necessary impetus for these reforms.

Thank you for giving me the opportunity to comment on these matters.



DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

For immediate release
March 20, 2002

Contact: Betsy Holahan
(202) 622-2960

STATEMENT OF PETER R. FISHER
UNDER SECRETARY OF THE TREASURY FOR DOMESTIC FINANCE
BEFORE THE
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

Thank you, Chairman Oxley and Ranking Member LaFalce, for the opportunity to testify this morning before your committee on reforming corporate disclosure. The President and Secretary O'Neill are emphatic about the need for change.

I would like to describe first the underlying problems in corporate disclosure and second the President's plan for resolving them.

The Administration wants to work closely with Congress and the Securities and Exchange Commission to achieve the objectives spelled out in the President's 10-point plan. Looking at all the proposals now circulating, while there are still some important unresolved issues, there are also a number of areas of broad agreement. I would like to highlight some of both in my testimony this morning. Let me say at the outset that the bill that most closely parallels the President's plan is the Chairman's and Representative Baker's bill, H.R. 3763, the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002.

The underlying problem

The United States enjoys the deepest, most liquid, and most transparent capital markets in the world. Over the past few months, however, we have learned once again not to take the performance of our capital markets for granted. For investors to price risk properly and to allocate capital to the most promising firms, they must have access to reliable information. Nothing could be more important for the long-run health of our economy and for investor protection.

The quality of corporate disclosures has not kept pace with the growing complexity of corporate finance for at least a decade. While our capital markets have been racing along at 100 r.p.m., our accounting and corporate disclosure regime has been crawling along at 10 r.p.m. The gap has just kept widening.

I am particularly pleased to be here today because for almost 10 years I have been watching this gap grow and endeavoring to close it. In 1994, I joined with other G-10 central bankers to try to update bank disclosures to reflect evolving corporate finance and risk management. I did the same in 1999, that time also with banking, securities, and insurance regulators. Both committees came up with good ideas but not much happened. It is exciting for me to have the opportunity to work with Secretary O'Neill and the President on these issues, and to see this Committee and Chairman Pitt focused on the same problems.

What is driving this gap? The true culprit is an ethic in boardrooms and auditing firms that too often equates GAAP compliance with adequate disclosure. This ethic sets the bar too low. It encourages corporate executives to prepare, and auditors to certify, financial statements that may meet the technical requirements of GAAP but fail to provide investors with a realistic picture of a firm's condition. For our corporate disclosure regime to work, a company's CEO and its auditors must be made accountable for disclosing the information that a reasonable investor would find necessary to assess the company's value (excepting competitive secrets).

The President's plan to restore corporate accountability

The President's 10-point plan is guided by three core principles: first, providing better information to investors; second, making corporate officers more accountable; and, third, developing a stronger, more independent accounting and auditing system.

As the President made clear, and as the Securities and Exchange Commission has recently re-affirmed, mere compliance with GAAP is not enough. Each investor should have access to a true and fair picture of the company, in plain English, and should be promptly informed of critical events that affect the condition of the company. By forcing companies to stop hiding behind technical GAAP compliance and demanding additional disclosure – by re-clarifying what satisfies the law – the President's proposals would raise the bar for what constitutes adequate disclosure.

President Bush directed our attention to CEOs because "reform should start at the top." We believe that CEOs should personally vouch for the veracity, timeliness, and fairness of their companies' public disclosures, including their financial statements. If a CEO or other corporate officer is guilty of misconduct that caused financial restatements, the SEC should force him or her to give back any compensation gained thereby. If corporate leaders abuse their power, the SEC should deny them the right to serve as a director or officer of a public company. And corporate leaders should have to tell investors within two days whenever they buy or sell the company's stock for personal gain.

What about catching those guilty of fraud? The President has urged the SEC to step up its enforcement against securities fraud. We think existing legal standards are sufficient for this

task. Neither the President nor anyone else on his economic team thinks more private litigation would improve corporate disclosure.

Finally, the President believes that we need a stronger and more independent auditing and accounting system. To do this, we need a new, independent private-sector regulatory board, under the SEC's supervision, to develop standards of professional conduct and competence. In addition, the SEC needs to exercise more effective and broader oversight of FASB to ensure that accounting standards are issued more promptly and are more responsive to the needs of investors.

The efficiency of our capital markets rests in part on investors' relying on the independent judgment of outside auditors. The President is committed to bolstering that independence. He is also committed to doing so in measured ways that avoid perverse or unintended consequences.

A strong defense for investors is an active, informed audit committee, and so the President would urge making audit committees more accountable. The President has proposed that the SEC issue new guidelines for audit committees to use in deciding whether a non-auditing service would compromise an auditor's integrity. Audit committees would also report their choice of auditor directly to the shareholders. And the President encourages the SEC to prohibit outside auditors from providing internal audit services to the same client. This would eliminate the largest obstacle to auditor independence.

The President does not support a statutory mandate to rotate outside auditors. A rigid rule like this would impose unwarranted costs on companies and investors. For an outside auditor, just understanding the intricacies of a client's business – like mortgage-backed securities – can take a long time. So does learning about a company's people, processes, and problems. This deep knowledge is in fact the key to effectively reviewing a company's books. It is also why companies often hire auditors to deliver other services such as tax consulting. A rigid rotation rule would erase that intellectual capital every X years, no matter the circumstances. It might also undermine auditor effectiveness by periodically re-establishing auditor ignorance.

Imagine that to stamp out Medicare fraud, the Federal government required all patients to rotate doctors every few years. While this might reduce the risk of financial abuses in some cases, I think most Americans would think this an excessive intrusion into their own judgment about whom they want for a doctor, and an unjustified impairment of their physicians' ability to care for them. The analogy may be imperfect, but the logic is really the same for mandatory rotation of auditors.

Individual companies are of course free to *choose* to rotate. We hope that companies and their auditors will always aspire to best practices, not just avoid breaking the law. If an audit committee judges that in its company's specific circumstances, rotation makes sense, we would applaud. For the same reasons, we would discourage rigid bans on audit firms providing any non-audit services to the same client. As I noted above, the President does favor the SEC's banning combined internal/outside auditing.

The reform agenda I've just outlined focuses on government's role. We can raise the legal minimums that public companies' senior executives must meet. But in a society committed to democracy and freedom of choice, government should not be the only source for setting behavioral norms for CEOs. Legal minimums enforced by fines and penalties will only take us so far. Going beyond that – to ever-improving best practices, more efficient financial markets, stricter ethics for our corporate leaders – is a job for the business community itself.

Required legislation

As I canvass the major bills offered here in the House and in the Senate, I am heartened that we will find a number of spots of convergence. We all want to serve the same goals of better corporate disclosure and improved investor protection. And we all know our corporate disclosure regime is the best in the world, even while we strive to improve it.

The thoughtful bill that you, Mr. Chairman, and Representative Baker have offered is the clearest example of the common ground I see. You have called for a public regulatory organization to police the audit profession that closely resembles the President's proposal, as does your call for real-time disclosure of critical events and insider sales. You would press for fuller disclosure beyond GAAP's limits, such as off-balance sheet items and related-party transactions.

I think we will find common ground on where we will need legislation and where new SEC regulations will suffice. The 1933 and 1934 Acts provide the SEC with tremendous power and flexibility to implement the President's reforms, especially given the substantial consensus between his proposals and the major bills in Congress. If the SEC requires additional resources, the President has said he is open to working with Congress to address that need. And we may find there are specific areas – perhaps the need for a self-regulating organization to police the auditing profession – where legislation may be a useful complement to regulatory action.

One area where the SEC will need new legislative authority is to enable it to administratively bar wrongdoers from positions of corporate trust. Under current law, the SEC must first go to court to bar a director or officer guilty of serious misconduct from serving in such a position again in a public company. The President would urge you to empower the SEC to do so through administrative proceedings (preserving a right of appeal to the courts) – a power much like bank regulators have for bank executives.

We look forward to working with this Committee to find common ground and strengthen our capital markets. I am happy to try and answer any questions you may have.

Thank you.

SPEech at Yale Law & Business Schools

by

Eugene A. Ludwig
Former Comptroller of the Currency

February 15, 2002

The Enron debacle is a major wake up call for America. In many ways it is for finance, what 9/11 is for geopolitics. In the Enron matter, it is not just that a large company has failed. Every down cycle produces its share of failures. What makes Enron a watershed event for those of us who care about financial stability is reflected in conjunction of the following five factors:

- **First, only months before, Enron was widely believed to be the model of a well run company;**
- **Second, one of Enron's core competencies was believed to be in risk management;**
- **Third, Enron techniques that duped the public were blessed by one of the world's most prominent accounting firms;**
- **Four, Enron is not an isolated incident. It is by far the largest and most spectacular of several failures and near failures over the past several years that have had many of the same elements.**
- **Five, the failure took a toll on many middle and lower income company employees who were close to impoverished while those in charge walked away with bags of money and only a scratch.**

There are many lessons to be learned from Enron. These include: the importance of portfolio diversification for 401 (k) participants and of providing greater investment choices for workers; the consequences of not holding companies to high standards of corporate accountability; and the problems created by the need of politicians for corporate donations.

These are important issues without question. However, my experience in government was as a regulator of financial institutions. And today I would like to bring that experience to bear upon what I believe was the primary cause of the Enron debacle: poor regulatory oversight.

Now I understand well that financial service regulation is not a complete panacea for all companies and in all times and places. Of course, from time-to-time regulated institutions have serious financial difficulties. And supervision and regulation brings with it some level of moral hazard. However, situations as misguided as Enron would not have happened had Enron been regulated adequately. Further, a history of financial disasters over the last 150 years teaches

that while supervision and regulation is not perfect, it has in fact improved financial stability and done it in an increasingly more complicated financial world.

The three primary culprits in the Enron case appear to have been: (1) substantial financial accounting irregularities that masked Enron's overstatement of earnings; (2) pushing the envelope on model-based trading strategies that were initially intended to have risk mitigation characteristics but devolved into unrestrained proprietary trading exercises whose losses it was deemed necessary to hide and (3) insider trading violations.

To prevent these irregularities in the future, Congress and the President need to take swift action to restore investor confidence in the markets and the accounting profession. First, the President and Congress should create a federal regulatory organization for the accounting profession. At a minimum this should be a self-regulatory organization (SRO) similar to the New York Stock Exchange for accounting firms. This self-regulatory entity would set stringent standards for the whole industry -- with the authority to punish those firms that fail to meet the ITS standards. To ensure the SROs independence, a user fee would be assessed on publicly traded corporations and other institutions like mutual funds and securities firms. And unlike FASB, a congressionally mandated SRO would have the authority to issue subpoenas and fines, giving it the tools and independence to enforce its rules.

Second, financial services type regulation should be developed for large companies like Enron that perform functions that would be regulated were Enron to have a banking charter. Either the banking industry should not be regulated so vigorously or a company like Enron should be regulated. Having said that I recognize that to create a supervisory regime for large financial services entities that are not banks is a complex undertaking, but I believe it is essential to explore. For example, the Fed believed that Long Term Capital Management could have brought the financial system to its knees so it used its prestige to work out a bailout. If that entity was so central to the financial markets, it should have been regulated more vigorously in my view.

Third, the Securities and Exchange Commission should adopt a rule proposed by former Chairman Arthur Levitt two years ago to put in place a firewall between auditing and consulting activities. The Levitt proposal would have forbid auditing firms from earning other fees from its clients. He believed that the firms had grown so dependent on fees that they created a conflict of interest. The accounting firms fought the proposal aggressively and only a few restrictions were put into effect.

Fourth, to ensure accounting firms are doing their job correctly without heavy government interference, the SEC should require that all publicly traded companies hire a second auditing company to review its books every three years. This will keep the companies auditors on its toes and raise the level of quality and

competition in the accounting industry.

Fifth, we need to give the SEC the resources to do its job. The SEC has only 90 accountants to review the financial statements of 12,000 companies each quarter. Its computer systems are antiquated. The staff does not have the resources to read the annual report of every Fortune 500 company. And it did not review Enron for five years. The SEC should have the resources to review each company at least every three years. Furthermore, it has been proposed by the Administration that SEC employees be put on the bank regulatory agency pay scale. But the Administration has yet to find the funding. This should be accomplished immediately.

Seventh, **we should give the SEC the authority to "Disboard" senior corporate executives and directors. Just as lawyers can be debarred for unethical or illegal practices, the SEC should have the authority to "disboard" unethical executives or directors from serving on the board of other publicly traded companies or in a senior management position. In addition, the SEC should have the ability in extraordinary circumstances to deny bonuses, stock options, or other financial perks of "disboarded" executives.**

One final point, we must not forget the working person, the average everyday employee of Enron who was badly injured in this debacle. It is a fine thing to consider how we can change 401K rules in the future and we should. But the average Joe and Suzy should just not be allowed to go home penniless without a retirement while permitting those who have been unjustly enriched by this affair to escape with 8 figure retirements.

We undercut the legitimacy of our democracy, if we don't bend our minds and our public wallets in ways that help the little guy who worked hard and had absolutely no way of knowing that this bomb would drop on their finances. It is too easy to clinically deal with macro issues of state and fail to resolve the nitty-gritty of real human loss and pain.

In this regard, I turn to the great schools of Law and Administration at Yale and their extraordinarily talented Deans, Tony Kronman and Jeff Gartner, to their exceptional faculty, and to their committed and talented student bodies to devote themselves to thinking up public policy solutions to this problem.

A P P E N D I X

April 9, 2002

April 9, 2002

Opening Statement for Congressman Paul E. Gillmor
Committee on Financial Services
Full Committee Legislative Hearing on HR 3763, the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002- Day 3

I would like to again applaud Chairman Oxley and Subcommittee Chairman Baker for taking the initiative on this important issue and working so swiftly and diligently to introduce, HR 3763 "the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002 (CAARTA)." I am an original cosponsor of this legislation and look forward to swift committee action on this measure.

I look forward to hearing the witnesses' opinions this morning and welcome this opportunity to hear a comparison of HR 3818 and HR 3763. Further discussion on the underlying issues addressed by CAARTA will serve to strengthen the final version of this legislation to be approved by this committee.

I always have been a firm believer in increased management responsibility and accountability to both its shareholders and the American public. On February 13th, I introduced HR 3745, "the Corporate Charitable Disclosure Act of 2002 (CCDA)." The CCDA would require corporations to make publicly available, each year, the total value of contributions that they made to non-profit organizations during the previous fiscal year. As the collapse of Enron has made painfully clear, corporate disclosure rules need to be revisited and the legislation being considered today is an important first step in this process.

Again, I would like to thank Chairman Oxley for holding this series of hearings and look forward to the upcoming markup of this important piece of legislation. The systemic problems made clear through the investigation of Enron's collapse cannot remain unaddressed.

OPENING STATEMENT

HR 3763/3818
Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002

Financial Services Committee
Rep. Stephanie Tubbs Jones
Cleveland, 11th District

Rep. Stephanie Tubbs Jones

Good Morning, Chairman Oxley, Ranking Member LaFalce and Members of this Committee. Mr. Chairman, I ask unanimous consent that my full statement be included in the Record.

This is the third time that this esteemed committee has gathered to discuss the issues made infamous when on December 2, 2001 Enron Corporation shocked the world by suddenly filing for Chapter 11 bankruptcy leaving millions of investors holding virtually worthless stock in what was once one of the most admired companies in the world. Many of these investors made the decision to commit their hard-earned money to Enron based in large part on the financial information that was made available to them; information that was trusted to be accurately and objectively reviewed by independent auditors. The result of all of this was a loss in billions of dollars of equity to investors,

thousands of jobs and countless questions as to how all of this could have happened so quickly.

A particular piece of legislation, HR 3763, which was introduced by Chairman Oxley in response to this debacle, has been debated at length in the previous two hearings regarding this matter. I am pleased that this committee has seen fit to also formally address what I think is a much more comprehensive and effective means of addressing these issues, HR 3818 which was introduced by Ranking Member LaFalce.

Mr. Chairman, we are here this morning so that what happened with Enron will not happen again. We must determine the best ways to address the issues of auditor independence, timely and accurate disclosure of information to investors, effective and ethical corporate governance, and corporate accountability. However we must address these issues in a manner that will be both comprehensive and effective so that we can eventually ensure that the doors of unethical corporate governance and poor auditing standards are permanently closed.

For these reasons, I support the measure introduced by Ranking Member LaFalce through the Comprehensive Investor Protection Act or (CIPA as it is often referred to) as an alternative to H.R. 3763 introduced by Chairman Oxley. CIPA provides a clear and concise definition of independence as it pertains to corporate auditors, and creates a public auditing regulatory board. The legislation also serves to outline the roles and responsibilities of corporate boards with respect to the corporate auditing function. CIPA imposes strict restrictions for directors and other insiders with regard to company stock sales so that it is not just investors that are left accountable for the mistakes of management or the company's board.

There is still a lot of work to be done by this committee to incorporate the regulatory restrictions suggested by CIPA in such a way as to preserve the ability of the nations auditors to attract talent and remain profitable. Although we have more work to do, I applaud Chairman Oxley and especially Ranking Member LaFalce for providing a working framework from which to quickly and effectively address these issues. I look forward to the testimony today so that we may continue in our pursuit to ensure that the American people have the objective information that they need to make informed investment decisions.

Mr. Chairman, I thank you for my time.

United States General Accounting Office

GAO

Before the Committee on Financial Services, U.S. House of Representatives

For Release on Delivery
Expected at 2:00 p.m. EST
Tuesday, April 9, 2002

PROTECTING THE PUBLIC'S INTEREST

Considerations for Addressing Selected Regulatory Oversight, Auditing, Corporate Governance, and Financial Reporting Issues

Statement of David M. Walker,
Comptroller General of the United States

GAO- 02-601T

OPR: OP

GAO Form 515 (Rev. 3/99)

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to share my perspectives on a range of issues emanating from the sudden and largely unexpected bankruptcy of the Enron Corporation (Enron) and financial related activities relating to several other large corporations. These matters have caused a number of accounting profession oversight, auditor independence, corporate governance, and other related issues that are now receiving extensive national attention. The failures of Enron and certain other public companies have resulted in substantial losses to employees, shareholders, and other investors. Certain significant financial statement earnings restatements and the proliferation of pro forma earnings assertions have raised questions about the soundness of the current financial reporting, independent auditing, and corporate governance functions relating to public companies. These events have also raised a range of questions regarding how such dramatic and unexpected events can happen under our current system and the role and capacities of various key players under that system.

To assist the Congress in framing needed reforms, on February 25, 2002, we convened a forum on corporate governance, transparency, and accountability to discuss a variety of systemic issues. These entailed regulatory oversight, auditing, accounting/financial reporting, and corporate governance matters. Forum participants included prominent individuals from federal and state government, the private sector, standards setting and oversight bodies, and a variety of other interested parties. As expected, the forum participants expressed a range of views on these broad topics, which do not necessarily

represent our views. However, there was general agreement by the participants that there are no simple solutions, or a single "silver bullet," to resolve the perceived problems that exist. In fact, there was general agreement that while some actions were clearly called for in the wake of Enron and other recent events, care should be taken to ensure that government does not overreact in a manner that could have unintended adverse consequences. This requires a careful balancing of interests with a focus on what is in the best overall interest of the investing public. On March 5, 2002, I issued highlights of the forum meeting, which I would like to enter into the record.[1] Also, on March 5, 2002, I testified before the Senate Banking Committee to further elaborate on these issues.[2]

As you requested, my comments today will primarily focus on oversight of the accounting profession and related auditor independence and corporate governance issues raised by Enron's failure. I would also like to take this opportunity to provide our perspectives about the related issue of financial reporting. It should be recognized that these overarching areas are interrelated keystones to protecting the public's interest. Failure in any of these areas can place a strain on the entire system. Any potential actions should be guided by the fundamental principles of having the right incentives for the key parties to do the right thing, adequate transparency to provide reasonable assurance that the right thing will be done, and full accountability if the right thing is not done. These

[1] *Highlights of GAO's Forum on Corporate Governance, Transparency, and Accountability* (GAO-02-494SP, March 5, 2002).

[2] *Protecting the Public Interest: Selected Governance, Regulatory Oversight, Auditing, Accounting, and Financial Reporting Issues* (GAO-02-483T, March 5, 2002).

three fundamental principles represent a system of controls that should operate in conjunction with a policy of placing special attention on areas of greatest risk.

The issues raised by Enron's failure are multi-faceted, involving many different problems and players with various roles and responsibilities. In that respect, needed changes to the government's role should vary depending on the specific nature and magnitude of the problem. Specifically, the government's role can range from direct intervention to encouraging certain non-governmental and private-sector entities to take certain steps designed to enhance trust and better protect the public interest. For example, the issues surrounding the accounting profession's current self-regulatory system for auditors involves many players in a fragmented system that is not well coordinated, involves certain conflicts of interest, lacks effective communication, and has a discipline system that is largely perceived as being ineffective. In this case, direct government intervention to statutorily create a new independent federal government body to regulate the accounting profession is needed. On the other hand, the issues concerning corporate governance may be best addressed through the Securities and Exchange Commission (SEC) encouraging the stock exchanges to enhance public companies' listing requirements and promote "best practices" in connection with the boards, key committees, and officers of public companies. If such an approach is not successful in achieving the expected corporate behavior, the government can then take further action.

In considering changes to the current system that gave rise to Enron and other areas of concern, it will be important that the Congress consider a holistic approach to addressing

the range of interrelated issues. It is important to realize that effectively protecting the public interest is a multi-dimensional challenge involving a variety of players and issues. For example, it involves company management, boards and board committees, the accounting profession standard setters, analysts, regulatory oversight agencies, investors, and various other parties. In addition, in the audit area it involves a redefinition of who the client is, various audit scope and responsibility issues, the number of firms, the quality of the firms' quality assurance systems, and the quality of the firm's personnel. It is also important that any responsible governmental bodies, such as the SEC, have adequate resources to fulfill its responsibilities in these areas, which I will briefly address later.

REGULATION AND OVERSIGHT OF THE ACCOUNTING PROFESSION

The current model for regulation and oversight of the accounting profession involves federal and state regulators and a complex system of self-regulation by the accounting profession. The functions of the model are interrelated and their effectiveness is ultimately dependent upon each component working well. Basically, the current model includes:

- licensing members of the accounting profession to practice within the jurisdiction of a state, as well as issuing rules and regulations governing member conduct, which is done by the various state boards of accountancy;

- setting accounting and auditing standards, which is done by the Financial Accounting Standards Board (FASB) and the Auditing Standards Board (ASB), respectively, through acceptance of the standards by the SEC;

- setting auditor independence rules, which within their various areas of responsibility, have been issued by the American Institute of Certified Public Accountants (AICPA), the SEC, and GAO; and

- oversight and discipline, which is done through a variety of self-regulatory and public regulatory systems (e.g., the AICPA, the SEC, and various state boards of accountancy).

Enron's failure and a variety of other recent events has brought a direct focus on how well the current systems of regulation and oversight of the accounting profession are working in achieving their ultimate objective that the opinions of independent auditors on the fair presentation of financial statements can be relied upon by investors, creditors, and the various other users of financial reports.

The issues currently being raised about the effectiveness of the accounting profession's self-regulatory system are not unique to the collapse of Enron. Other business failures, restatements of financial statements, and the proliferation of pro forma earnings assertions over the past several years have called into question the effectiveness of the current system. A continuing message is that the current self-regulatory system is fragmented, is not well coordinated, and has a disciplinary function that is not timely, nor does it contain effective sanctions, all of which create a public image of ineffectiveness. In addressing these issues, proposals should consider whether overall the system creates the right incentives, transparency, and accountability, and operates proactively to protect the public interest. Also, the links within the self-regulatory system and with the SEC and the various state boards of accountancy (the public regulatory systems) should be considered as these systems are interrelated, and weaknesses in one component can put strain on the other components of the overall system.

I would now like to address some of the more specific areas of the accounting profession's self-regulatory system that should be considered in forming and evaluating proposals to reshape or overhaul the current system.

Accounting Profession's Current
Self-Regulatory System

The accounting profession's current self-regulatory system for public company audits is heavily reliant on the AICPA through a system that is largely composed of volunteers

from the accounting profession. This system is used to set auditing standards and auditor independence rules, monitor member public accounting firms for compliance with professional standards, and discipline members who violate auditing standards or independence rules. AICPA staff support the volunteers in conducting their responsibilities. In 1977, the AICPA, in conjunction with the SEC, administratively created the Public Oversight Board (POB) to oversee the peer review system established to monitor member public accounting firms for compliance with professional standards. In 2001, the oversight authority of the POB was expanded to include oversight of the ASB. The POB had five public members and professional staff, and received its funding from the AICPA.

On January 17, 2002, the SEC Chairman outlined a proposed new self-regulatory structure to oversee the accounting profession. The SEC's proposal provided for creating an oversight body that would include monitoring and discipline functions, have a majority of public members, and be funded through private sources, although no further details were announced.[3] The POB's Chairman and members were critical of the SEC's proposal and expressed concern that the Board was not consulted about the proposal. On January 20, 2002, the POB passed a resolution of intent to terminate its existence no later than March 31, 2002, leaving a critical oversight function in the current self-regulatory system unfilled. However, the POB's Chairman has stated that the Board will work to assist in transitioning the functions of the Board to whatever new regulatory body is

[3] Subsequently, on March 21, 2002, the Chairman of the SEC in his statement before the Senate Committee on Banking, Housing, and Urban Affairs provided additional details in a working proposal for creating a new private-sector, independent body, subject to SEC oversight, to regulate the accounting profession in the areas of quality control reviews and disciplinary powers.

established. In that respect, the SEC announced on March 19, 2002, that a Transition Oversight Staff, led by the POB's executive director, will carry out oversight functions of the POB. However, on April 2, 2002, the POB members voted to extend the POB through April 30, 2002, to provide additional time solely to finalize certain POB administrative matters and to facilitate a more orderly transition of oversight activities.

NEED TO CREATE A NEW INDEPENDENT FEDERAL GOVERNMENT OVERSIGHT BODY

The issues of fragmentation, ineffective communication, and limitations on discipline surrounding the accounting profession's self-regulatory system strongly suggest that the current self-regulatory system is not adequate in effectively protecting the public's interest. We believe these are structural weaknesses that require congressional action. Specifically, we believe that the Congress should create an independent statutory federal government body to oversee financial audits of public companies.

The functions of the new independent body should include:

- establishing professional standards (auditing standards, including standards for attestation and review engagements; independence standards; and quality control standards) for public accounting firms and their key members who audit public companies;

- inspecting public accounting firms for compliance with applicable professional standards; and

- investigating and disciplining public accounting firms and/or individual auditors of public accounting firms who do not comply with applicable professional standards.

As discussed later, this new body should be independent from but should closely coordinated with the SEC in connection with matters of mutual interest. In addition, we believe that the issues concerning accounting standard-setting can best be addressed by the SEC working more closely with the FASB rather than putting that function under the new body.

Powers/Authority of the New Body

The powers/authority of the new body should include:

- requiring all public accounting firms and audit partners that audit financial statements, reports, or other documents of public companies that are required to be filed with the SEC to register with the new body;

- issuing professional standards (e.g., independence) along with the authority to adopt or rely on existing auditing standards, including standards for attestation and review engagements, issued by other professional bodies (e.g., the ASB);

- enforcing compliance with professional standards, including appropriate investigative authority (e.g., subpoena power and right to maintain the confidentiality of certain records) and disciplinary powers (e.g., authority to impose fines, penalties, and other sanctions, including suspending or revoking registrations of public accounting firms and individual auditors to perform audits of public companies);

- requiring the new body to coordinate its compliance activities with the SEC and state boards of accountancy;

- requiring auditor reporting on the effectiveness of internal control over financial reporting;

- requiring the new body to promulgate various auditor rotation requirements for key public company audit engagement personnel (i.e., primary and second partners, and engagement managers);

- requiring the new body to study and report to the Congress on the pros and cons of any mandatory rotation of accounting firms that audit public companies, and take appropriate action;

- establishing annual registration fees and possibly inspection fees necessary to fund the activities of the new body on an independent and self-sustaining basis; and

- establishing rules for the operation of the new body.

Structure of the New Body

The new body should be created by statute as an independent federal government body. To facilitate operating independently, the new body's board members should be highly qualified and independent from the accounting profession, its funding sources should not be dependent on voluntary contributions from the accounting profession, and it should have final approval for setting professional standards and its operating rules. In that respect, the new body would have independent decisionmaking authority from the SEC. It would approve professional standards, set sanctions resulting from disciplinary actions, and establish its operating rules. At the same time, it should coordinate and communicate its activities with the SEC and the various state boards of accountancy. The new body should set its own human resource and other administrative requirements and should be given appropriate flexibility to operate as an independent entity and to provide compensation that is competitive to attract highly competent board members and supporting staff. The new body should also have adequate staff to effectively discharge its responsibilities.

Candidates for board membership could be identified through a nominating committee that could include the Chairman of the Federal Reserve, Chairman of the SEC, the Secretary of the Treasury, and the Comptroller General of the United States.

The number of board members could be 5 or 7 and have stated terms, such as 5 years with a limited renewal option, and the members' initial terms should be staggered to ensure some continuity. The members of the board should be appointed by the President and confirmed by the U.S. Senate. At a minimum, the chair and vice-chair should serve on a full-time basis. Importantly, board members should be independent of the accounting profession. In that regard, board members should not be active accounting profession practitioners and a majority of board members must not have been accounting profession practitioners within the recent past (e.g., 3 years).

Funding for the New Body

The new body should have sources of funding independent of the accounting profession. The new body could have authority to set annual registration fees for public companies. It could also have authority to set fees for services, such as inspections of public accounting firms, and authority to charge for copies of publications, such as professional standards and related guidance. The above fees and charges should be set to recover costs and sustain the operations of the new body.

Reporting Requirement of the New Body
and GAO Access to Records

For accountability, we believe the new body should report annually to the Congress and the public on the full-range of its activities, including setting professional standards, inspections of public accounting firms, and related disciplinary activities. Such reporting also provides the opportunity for the Congress to conduct oversight of the performance of the new body. The Congress also may wish to have GAO review and report on the performance of the new body after the first year of its operations and periodically thereafter. Accordingly, we suggest that the Congress provide GAO not only access to the records of the new body, but also to the records of accounting firms and other professional organizations that may be needed for GAO to assess the performance of the new body.

THE INDEPENDENT AUDIT FUNCTION

For over 70 years, the public accounting profession, through its independent audit function, has played a critical role in enhancing a financial reporting process that has supported the effective functioning of our domestic capital markets, which are widely viewed as the best in the world. The public's confidence in the reliability of issuers' financial statements, which relies in large part on the role of independent auditors, serves to encourage investment in securities issued by public companies. This sense of

confidence depends on reasonable investors perceiving auditors as independent expert professionals who have neither mutual, nor conflicts of, interests in connection with the entities they are auditing. Accordingly, investors and other users expect auditors to bring to the financial reporting process integrity, independence, objectivity, and technical competence, and to prevent the issuance of misleading financial statements.

Enron's failure and certain other recent events have raised questions concerning whether auditors are living up to the expectations of the investing public; however, similar questions have been raised over a number of years due to significant restatements of financial statements and certain unexpected and costly business failures, such as the savings and loan crisis. Issues debated over the years continue to focus on auditor independence concerns and the auditor's role and responsibilities. Public accounting firms providing nonaudit services to their audit client is one of the issues that has again surfaced by Enron's failure and the large amount of annual fees collected by Enron's independent auditor for nonaudit services.

Auditors have the capability of performing a range of valuable services for their clients, and providing certain nonaudit services can ultimately be beneficial to investors and other interested parties. However, in some circumstances, it is not appropriate for auditors to perform both audit and certain nonaudit services for the same client. In these circumstances, the auditor, the client, or both will have to make a choice as to which of these services the auditor will provide. These concepts, which I strongly believe are in the public's interest, are reflected in the revisions to auditor independence requirements

for government audits,[4] which GAO recently issued as part of *Government Auditing Standards*.[5] The new independence standard has gone through an extensive deliberative process over several years, including extensive public comments and input from my Advisory Council on Government Auditing Standards.[6] The standard, among other things, toughens the rules associated with providing nonaudit services and includes a principle-based approach to addressing this issue, supplemented with certain safeguards. The two overarching principles in the standard for nonaudit services are that:

- auditors should not perform management functions or make management decisions, and
- auditors should not audit their own work or provide nonaudit services in situations where the amounts or services involved are significant or material to the subject matter of the audit.

Both of the above principles should be applied using a substance over form doctrine. Under the revised standard, auditors are allowed to perform certain nonaudit services provided the services do not violate the above principles; however, in most circumstances

[4] *Government Auditing Standard: Amendment No. 3, Independence* (GAO-02-388G, January 2002).

[5] *Government Auditing Standards* was first published in 1972 and are commonly referred to as the "Yellow Book," and cover federal entities and those organizations receiving federal funds. Various laws require compliance with the standards in connection with audits of federal entities and funds. Furthermore, many states and local governments and other entities, both domestically and internationally, have voluntarily adopted these standards.

[6] The Advisory Council includes 20 experts in financial and performance auditing and reporting drawn from all levels of government, academia, private enterprise, and public accounting, who advise the Comptroller General on *Government Auditing Standards*.

certain additional safeguards would have to be met. For example, (1) personnel who perform allowable nonaudit services would be precluded from performing any related audit work, (2) the auditor's work could not be reduced beyond the level that would be appropriate if the nonaudit work were performed by another unrelated party, and (3) certain documentation and quality assurance requirements must be met. The new standard includes an express prohibition regarding auditors providing certain bookkeeping or record keeping services and limits payroll processing and certain other services, all of which are presently permitted under current independence rules of the AICPA. However, our new standard allows the auditor to provide routine advice and technical assistance on an ongoing basis and without being subject to the additional safeguards.

The focus of these changes to the government auditing standards is to better serve the public interest and to maintain a high degree of integrity, objectivity, and independence for audits of government entities and entities that receive federal funding. However, these standards apply only to audits of federal entities and those organizations receiving federal funds, and not to audits of public companies. In the transmittal letter issuing the new independence standard, we expressed our hope that the AICPA would raise its independence standards to those contained in this new standard in order to eliminate any inconsistency between this standard and their current standards. The AICPA's recent statement before another congressional committee that the AICPA will not oppose

prohibitions on auditors providing certain nonaudit services seems to be a step in the right direction.[7]

The independence of public accountants is crucial to the credibility of financial reporting and, in turn, the capital formation process. Auditor independence standards require that the audit organization and the auditor be independent both in fact and in appearance. These standards place responsibility on the auditor and the audit organization to maintain independence so that opinions, conclusions, judgments, and recommendations will be impartial and will be viewed as being impartial by knowledgeable third parties. Because independence standards are fundamental to the independent audit function, as part of its mission, the new independent and statutorily created government body, which I previously discussed, should be responsible for setting independence standards for audits of public companies, as well as the authority to discipline members of the accounting profession that violate such standards.

CORPORATE GOVERNANCE

First, I want to underscore that serving on the board of directors of a public company is an important and difficult responsibility. That responsibility is especially challenging in the current environment with increased globalization and rapidly evolving technologies having to be addressed while at the same time meeting quarterly earnings projections in

[7] Testimony of AICPA Chairman before the House Energy and Commerce Committee (Subcommittee on Communications, Trade and Consumer Protection), February 14, 2002.

order to maintain or raise the market value of the company's stock. These pressures and related executive compensation arrangements unfortunately often translate to a focus on short-term business results. This can create perverse incentives, such as attempts to manage earnings to report favorable short-term financial results, and/or failing to provide adequate transparency in financial reporting that disguises risks, uncertainties, and/or commitments of the reporting entity.

On balance though, the difficulty of serving on a public company's board of directors is not a valid reason for not doing the job right, which means being knowledgeable of the company's business, asking the right questions, and doing the right thing to protect not only shareholders, but also the public's interest. At the same time it is important to strike a reasonable balance between the responsibilities, risks, and rewards of board and key committee members. To do otherwise would serve to discourage highly qualified persons from serving in these key capacities.

A board member needs to have a clear understanding of who is the client being served. Namely, their client should be the shareholders of the company, and all their actions should be geared accordingly. They should, however, also be aware of the key role that they play in maintaining public confidence in our capital markets system. Audit committees have a particularly important role to play in assuring fair presentation and appropriate accountability of management in connection with financial reporting, internal control, compliance, and related matters. Furthermore, boards and audit committees

should have a mutuality of interest with the external auditor to assure that the interest of shareholders are adequately protected.

Responsibilities of Audit Committees

There are a number of steps that can be taken to enhance the independence of audit committees and their working relationship with the independent auditor to further enhance the effectiveness of the audit in protecting the public's interest. We believe that the SEC in conjunction with the stock exchanges should initially explore such actions. Therefore, any legislative reform could include a requirement for the SEC to work with the stock exchanges to enhance listing requirements for public companies to improve the effectiveness of audit committees and public company auditors, including considering whether and to what extent:

- audit committee members should be both independent of the company and top management and should be qualified in the areas related to their responsibilities such as accounting, auditing, finance, and the SEC reporting requirements;

- audit committees should have access to independent legal counsel and other areas of expertise, such as risk management and financial instruments;

- audit committees should hire the independent auditors, and work directly with the independent auditors to ensure the appropriate scope of the audit, resolution of key

audit issues, compliance with applicable independence standards, and the reasonableness and appropriateness of audit fees. In this regard, audit committees must realize that any attempts to treat audit fees on a commodity basis can serve to increase the risk and reduce the value of the audit to all parties;

- audit committees should pre-approve all significant nonaudit services;

- audit committees should pre-approve the hiring of the public companies' key financial management officials (such as the chief financial officer, chief finance officer or controller) or the providing of financial management services if within the previous 5 years they had any responsibility for auditing the public company's financial statements, reports, or other documents required by the SEC; and

- audit committees should report to the SEC and public on their membership, qualifications, and execution of their duties and responsibilities.

Responsibilities of Boards of Directors;
Nominating, Compensation, Audit or
Other Committees; and Management (Officers)

We also believe that the effectiveness of boards of directors and committees, including their working relationship with management of public companies, can be enhanced by the SEC working with the stock exchanges to enhance certain other listing requirements for

public companies. In that respect, the SEC could be directed to work with the stock exchanges to consider whether and to what extent:

- audit committees, nominating committees, and compensation committees are qualified, independent, and adequately resourced to perform their responsibilities;

- boards of directors should approve management's code of conduct and any waivers from the code of conduct, and whether any waivers should be reported to the stock exchanges and the SEC;

- boards of directors should approve the hiring of key financial management officials who within the last 2 years had any responsibility for auditing the public company's financial statements, reports, or other documents required by the SEC; and

- CEOs should serve as the chairman of public company boards.

Also, to further protect shareholders and the public interest, the SEC could be directed to report (1) within 180 days from enactment of legislation on other actions it is taking to enhance the overall effectiveness of the current corporate governance structure, and (2) periodically on best practices and recommendations for enhancing the effectiveness of corporate governance to protect both shareholders and the public's interest.

Analyst Conflict of Interest Issues

and Analyst Independence

We believe that the issues raised by Enron's sudden failure and bankruptcy regarding whether analyst's independence from issuers' of stock is affecting their suggested buy and sell recommendations can be addressed by requiring the SEC to work with the National Association of Securities Dealers (NASD) in connection with certain requirements. Accordingly, the SEC could be directed to work with the NASD to consider whether and to what extent:

- the firewalls between analysts and the business end of their firms should be widened to enhance analyst independence and to report to the Congress on the effectiveness of the regulations;

- disclosure of (1) whether the analyst's firm does investment banking, and (2) whether there is a relationship with the company in question should be improved, and whether to report to the Congress on the effectiveness of the requirements; and

- implementing regulations to be enforced through an effective examination program should be required.

GAO Reporting on the

Above SEC Requirements

The Congress may wish to have GAO evaluate and report to it one year after enactment of legislation and periodically thereafter on the (1) results of the SEC's working relationship with the stock exchanges to strengthen corporate governance requirements, and (2) results of the SEC's working relationship with the NASD in developing independence and conflict of interest requirements for analysts. Accordingly, we suggest that the Congress provide GAO access to the records of the securities self regulatory organizations, such as the New York Stock Exchange and the NASD, that may be needed for GAO to evaluate the SEC's working relationships with these organizations.

FINANCIAL REPORTING

Business financial reporting is critical in promoting an effective allocation of capital among companies. Financial statements, which are at the center of present-day business reporting, must be timely, relevant, and reliable to be useful for decision-making. In our 1996 report on the accounting profession,[8] we reported that the current financial reporting model does not fully meet users' needs. More recently, we have noted that the current reporting model is not well suited to identify and report on key value and risk elements

[8]*The Accounting Profession: Major Issues: Progress and Concerns* (GAO/AIMD-96-98, September 24, 1996).

inherent in our 21st Century knowledge-based economy. The SEC is the primary federal agency currently involved in accounting and auditing requirements for publicly traded companies but has traditionally relied on the private sector for setting standards for financial reporting and independent audits, retaining a largely oversight role. Accordingly, the SEC has accepted rules set by the Financial Accounting Standards Board (FASB)—generally accepted accounting principles (GAAP)—as the primary standard for preparation of financial statements in the private sector.

We found that despite the continuing efforts of FASB and the SEC to enhance financial reporting, changes in the business environment, such as the growth in information technology, new types of relationships between companies, and the increasing use of complex business transactions and financial instruments, constantly threaten the relevance of financial statements and pose a formidable challenge for standard setters. A basic limitation of the model is that financial statements present the business entity's financial position and results of its operations largely on the basis of historical costs, which do not fully meet the broad range of user needs for financial information.[9] Enron's failure and the inquiries that have followed have raised many of the same issues about the adequacy of the current financial reporting model, such as the need for additional transparency, clarity, more timely information, and risk-oriented financial reporting.

[9]The accounting and reporting model under generally accepted accounting principles is actually a mixed-attribute model. Although most transactions and balances are measured on the basis of historical cost, which is the amount of cash or its equivalent originally paid to acquire an asset, certain assets and liabilities are reported at current values either in the financial statements or related notes. For example, certain investments in debt and equity securities are currently reported at fair value, receivables are reported at net realizable value, and inventories are reported at the lower of cost or market value. Further, certain industries such as brokerage houses and mutual funds prepare financial statements on a fair value basis.

Among other actions to address the Enron-specific accounting issues, the SEC has requested that the FASB address the specific accounting rules related to Enron's special purpose entities and related party disclosures. In addition, the SEC Chief Accountant has also raised concerns that the current standard-setting process is too cumbersome and slow and that much of the FASB's guidance is rule-based and too complex. He believes that (1) a principle-based standards will yield a less complex financial reporting paradigm that is more responsive to emerging issues, (2) the FASB needs to be more responsive to accounting standards problems identified by the SEC, and (3) the SEC needs to give the FASB freedom to address the problems, but the SEC needs to monitor projects on an ongoing basis and, if they are languishing, determine why.

We generally agree with the SEC Chief Accountant's assessment. We also believe that the issues surrounding the financial reporting model can be effectively addressed by the SEC, in conjunction with the FASB, without statutorily changing the standard-setting process. However, we do believe that a more active and ongoing interaction between the SEC and the FASB is needed to facilitate a mutual understanding of priorities for standard-setting, realistic goals for achieving expectations, and timely actions to address issues that arise when expectations are not likely to be met. In that regard, the SEC could be directed to:

- reach agreement with the FASB on its standard-setting agenda, approach to resolving accounting issues, and timing for completion of projects;

- monitor the FASB's progress on projects, including taking appropriate actions to resolve issues when projects are not meeting expectations; and

- report annually to the Congress on the FASB's progress in setting standards, along with any recommendations, and the FASB's response to the SEC's recommendations.

The Congress may wish to have GAO evaluate and report to it one year after enactment of legislation and periodically thereafter on the SEC's performance in working with the FASB to improve the timeliness and effectiveness of the accounting standard-setting process. Accordingly, we suggest that the Congress provide GAO access to the records of the FASB that may be needed for GAO to evaluate the SEC's performance in working with the FASB.

The FASB receives about two-thirds of its funding from the sale of publications with the remainder of its funding coming from the accounting profession, industry sources, and others. One of the responsibilities of the FASB's parent organization, the Financial Accounting Foundation, is to raise funds for the FASB and its standard-setting process to supplement the funding that comes from the FASB's sale of publications. Some have questioned whether this is the best arrangement to ensure the independence of the standard-setting process. This issue has been raised by the appropriateness of certain accounting standards related to consolidations, that the FASB has been working on for some time, applicable to Enron's restatement of its financial statements as reported to the SEC by Enron in its November 8, 2001, Form 8-K filing. However, the issue has

previously been raised when the FASB has addressed other controversial accounting issues, such as accounting for stock options. Therefore, the Congress may wish to task the SEC with studying this issue and identifying alternative sources of funding to supplement the FASB's sale of publications, including the possibility of imposing fees on registrants and/or firms, and to report to the Congress on its findings and actions taken to address the funding issue.

THE SEC's ABILITY TO FULFILL ITS MISSION

Over the last decade, securities markets have experienced unprecedented growth and change. Moreover, technology has fundamentally changed the way markets operate and how investors access markets. These changes have made the markets more complex. In addition, the markets have become more international, and legislative changes have resulted in a regulatory framework that requires increased coordination among financial regulators and requires that the SEC regulate a greater range of products. Moreover, as I have discussed, the collapse of Enron and other corporate failures have stimulated an intense debate on the need for broad-based reform in such areas as oversight of the accounting profession, accounting standards, corporate governance, and analysts conflicts of interest issues, all of which could have significant repercussions on the SEC's role and oversight challenges. At the same time, the SEC has been faced with an ever-increasing

workload and ongoing human capital challenges, most notably high staff turnover and numerous staff vacancies.

Our recent report[10] discusses these issues and the need for the SEC to improve its strategic planning to more effectively manage its operations and limited resources, and also shows that the growth of SEC resources has not kept pace with the growth in the SEC's workload (such as filings, complaints, inquiries, investigations, examinations, and inspections). We believe that the SEC should be provided with the necessary resources to effectively discharge its current and any increased responsibilities the Congress may give it. And finally, we believe that the SEC should be directed to report annually to the Congress on (1) its strategic plan for carrying out its mission, (2) the adequacy of its resources and how it is effectively managing resources through a risk-oriented approach and prioritization of risks, including effective use of information technology, and (3) any unmet needs including required funding and human resources.

CLOSING COMMENTS

The United States has the largest and most respected capital markets in the world. Our capital markets have long enjoyed a reputation of integrity that promotes investor confidence. This is critical to our economy and the economies of other nations given the globalization of commerce. However, this long-standing reputation is now being challenged by some parties. The effectiveness of systems relating to independent audits,

[10] *SEC Operations: Increased Workload Creates Challenges*, (GAO-02-3-2, March 5, 2002).

financial reporting, and corporate governance, which represent key underpinnings of capital markets and are critical to protecting the public's interest, has been called into question by the failure of Enron and certain other events and practices. Although the human elements can override any system of controls, it is clear that there are a range of actions that are critical to the effective functioning of the system underlying capital markets that require attention by a range of key players. In addition, a strong enforcement function with appropriate civil and criminal sanctions is also needed to ensure effective accountability when key players fail to properly perform their duties and responsibilities.

Today, I have discussed our suggestions to assist the Congress in crafting needed reforms. We strongly believe that a new independent federal government body created by statute to regulate audits of public companies is needed in order to better protect the public's interest. However, currently we do not believe that it is necessary or appropriate for the government to assume direct responsibility for certain other key areas (e.g., financial reporting and corporate governance requirements). We do, however, believe that the Congress should provide the SEC with direction to address certain related issues as I have discussed. As is usually the case in issues of this magnitude, complexity, and importance, and as the results of the forum we held last month showed, there is no single "silver bullet" to quickly overhaul, or perhaps even replace, the systems supporting our capital markets. In addition, any major changes will involve some degree of controversy. On balance though, as I have discussed today, additional steps are necessary in order to

better protect the public's interest and enhance public confidence in related systems and applicable key players.

In summary, Enron's recent sudden collapse, coupled with other recent business failures and certain other activities, pose a range of serious systemic issues that should be addressed. The fundamental principles of having the right incentives, adequate transparency, and full accountability provide a good sounding board to evaluate proposals that are advanced. A holistic approach is also important as the systems are interrelated and weak links can severely strain their effective functioning. Effectively addressing these issues should be a shared responsibility involving a number of private and public sector parties including top management, boards of directors, various board committees, stock exchanges, the accounting profession, standard setters, regulatory/oversight agencies, analysts, investors, and the Congress. In the end, no matter what system exists, bad actors will do bad things with bad results. We must, however, strive to take steps to minimize the number of such situations and to hold any violators of the system fully accountable for their actions.

Mr. Chairman, this concludes my statement. I would be please to answer any questions you or other members of the committee may have at this time.

CONTACTS AND ACKNOWLEDGEMENTS

For further information regarding this testimony, please contact Robert W. Gramling, Financial Management and Assurance, at (202) 512-6535. Individuals making key contributions to this testimony include Cheryl E. Clark and Michael C. Hrapsky.

(194122)

RICHARD C. BREEDEN & CO.

TESTIMONY OF

RICHARD C. BREEDEN

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

CONCERNING

ACCOUNTING AND DISCLOSURE
REFORM AND OVERSIGHT

April 9, 2002

RICHARD C. BREEDEN & CO.
100 Northfield St. • Greenwich, CT 06830 • Tel 203.618.0065 • Fax 203.618.0063 • rbreeden@breedenco.com

Testimony of

Richard C. Breeden

Before the
Committee on Financial Services

United States House of Representatives

April 9, 2002

Chairman Oxley, Congressman LaFalce, Members of the Committee. It is a great pleasure to appear before you today. I was privileged to serve as Chairman of the Securities and Exchange Commission from 1989-1993. In total I served for nearly ten years in government posts spanning the administrations of Presidents Reagan, Bush (41) and Clinton. Through my own firm I now provide restructuring and workout management services for companies that are experiencing financial distress or crisis, as well as strategic consulting on internal controls, corporate governance and other capital markets issues.

I was honored to work with you, Mr. Chairman, Mr. LaFalce and other members of this Committee to pass the savings and loan reform legislation in 1989, the Market Reform Act of 1990, and the Securities Enforcement Remedies Act of 1990, among other bills. During those years we worked closely together on a wide range of subjects including government securities regulation, market stability and reform, litigation reform, derivatives oversight and accounting and disclosure issues.

During my time at the SEC we completed the most far reaching overhaul of proxy rules in more than a decade, putting in place new rules for disclosing the details of executive compensation

and options grants, and allowing greatly expanded shareholder participation in corporate governance. We handled more than 1,200 enforcement actions, including major enforcement actions against Salomon Brothers concerning corruption in the government bond market, and against Michael Milken for wrongdoing in the market for high yield bonds.

We won vital pay increases for SEC staff, expanded the agency's budget, and improved enforcement and examination resources dramatically in both quantity and quality. We implemented the EDGAR electronic filing system that made disclosure readily accessible to every investor and created the Rule 144A market for raising capital. Rules for small businesses were simplified to help them tap the capital markets more economically.

In these and many other activities I enjoyed great cooperation and support from Republicans and Democrats in Congress, without partisanship. I was proud of my partnership with Congress in trying to enhance the extraordinary traditions of the SEC in enforcing the rule of law in the most important capital markets in the world. Our record then of working together to enact legislation that could command widespread support makes me believe that this Congress and this SEC, under the capable leadership of Chairman Harvey Pitt, can achieve sound and sensible legislation in responding to today's problems and challenges.

Faith in the markets and our system of corporate governance has taken a real pounding from the Enron/Andersen scandals. Because we were successful in encouraging tens of millions of Americans to put a portion of their family savings into the securities markets, more Americans have been harmed financially by the violations of law and craven dishonesty in the whole Enron saga than in any previous single case. Responding to these terrible events requires a measured, careful and

thoughtful response. We should not try to do too much, or allow ourselves to do too little. Certainly the starting point should be to enforce existing law, and then to make further improvements carefully.

While it is easy to condemn the abuses that occurred at Enron/Andersen, the difficult task is to design measures to improve transparency of market information, produce better accuracy in audited financial statements and encourage better governance of both accounting firms and corporations. Also, we need to make any improvements without creating unintended new problems by damaging existing disclosure systems or creating unnecessary costs or overbroad regulation.

The Critical Role of Auditors

The events at Andersen and the issues raised by its indictment are as important for investors and the overall market as the events at Enron. Accountants play a unique role as the scorekeepers of the market economy. While companies in the U.S. don't have to employ a law firm, an underwriter, or other types of professionals, federal law requires a publicly traded company to hire an independent accounting firm to perform an annual audit. In addition to this shared federal monopoly, more than a hundred million investors in the U.S. depend on audited financial statements to make investment decisions. This imbues accounting firms with a high level of public trust, and also explains why there is a vital federal interest in how well the accounting system functions.

Auditors are there to get the numbers right, not to help CEOs or CFOs hide debt, artificially inflate income, and conceal risk. The ultimate objective of the system is for investors, creditors and other participants in the market to have a full and fair picture of the financial condition of the

company and its results. Market participants need to be able to understand a company's risk posture and trends in its results. To do that, they have to be able to see the entire picture of a company's financials, not carefully selected pieces.

Our tools in getting the numbers right include accounting principles that accurately reflect economic substance ("GAAP", or generally accepted accounting principles), auditing standards that detect false numbers ("GAAS", or generally accepted auditing standards), and trained and capable accountants proficient in the application of GAAP and GAAS, backed by firms with sophisticated software, and multiple layers of internal review. The system also relies on the auditor's independence and integrity to apply GAAP and GAAS competently, and irrespective of pressure from the issuer. Enron has exposed weaknesses in every one of these areas.

Part of the problem in Enron was the abysmally poor quality of FASB pronouncements concerning off balance sheet liabilities, and the latitude that exists to "accrue" profits out of mathematical models without adequate safeguards to test the validity of the results. The poor quality of these standards gives wide scope for mischief in their interpretation. Another part of the problem, however, was that those with responsibility for insisting on full and fair disclosure by the company appear to have ignored their duties to the investing public.

Even as accounting firms have steadily consolidated into some of the largest businesses in the world, earnings restatements and blown audits appear to be happening with more frequency, and getting bigger. This suggests that there is something in the internal dynamics of the auditing firms themselves that has gotten in the way of audit accuracy and integrity. Clearly we can do a better job, and everyone should work together toward that objective.

Questions of the Committee

1. Please compare and contrast H.R. 3818 with H.R. 3763 with respect to creating a new accounting regulator. What powers does the new regulatory body need to be effective? Should the regulator be able to establish standards for audit quality, independence, and ethics, rather than rely on the standards set by industry?

At the outset of any discussion of possible change in the regulation of accounting firms, it is important to note what should not change. This concerns the role and responsibilities of the SEC and the Department of Justice ("DOJ") in the oversight system. Historically the SEC has been the only federal agency with oversight responsibilities for the accounting profession and its performance in carrying out audits of publicly traded companies in accordance with both GAAP and GAAS. The SEC's role is generally grounded in its power to define accounting, auditing and disclosure requirements for issuers of publicly traded securities, which it does through Regulation S-X and other rules. The SEC has also had statutory authority to bar accountants from participating in audits of public traded issuers. The SEC also has ultimate authority to approve accounting standards promulgated by the Financial Accounting Standards Board ("FASB"), though it does not have direct oversight over the FASB and its work. The SEC and DOJ have responsibility for investigating violations of law – including the SEC's rules – by accountants or their firms, and for taking appropriate enforcement action. No other federal agency plays a role in this area. Under no circumstances should a third governmental body be created or brought into this system, though any of these basic powers are in doubt, this historic mandate should be renewed and reaffirmed.

There is only one thing about the existing governmental structure described above that in my judgment should be changed. That is that the accounting oversight resources at the SEC and DOJ should be increased substantially. If the total budget of the SEC was doubled – which I

believe should be done – the agency could run for more than 75 years before it would cost as much as investors lost in Enron and Global Crossing alone. That of course doesn't count recoveries by the SEC, which pay more than 100% of its cost anyway. Most of the increased resources should probably go into accounting and examination personnel, though enforcement could use some reinforcements too, though any allocation of resources should best be left for Chairman Pitt to recommend.

The document shredding at Andersen exposes a serious threat to the rule of law in this area that warrants an increase in DOJ's criminal resources as well. The actions of Andersen's management and legal staff were so flagrantly in disregard of Andersen's legal obligations that the SEC brought charges of securities fraud against the entire Andersen firm in the Waste Management case last year, where Andersen consented to a permanent injunction. Similarly, the deliberate acts of Andersen's own personnel appear to have resulted in criminal charges for obstruction of justice in the Enron case. Andersen's legal view appears to have been that it was powerful enough to do what it wished, irrespective of how many people might be hurt.

The impact on Andersen's innocent employees of its collapse, if that occurs, is certainly regrettable, and everything reasonably possible should be done to avoid it. However, we should not learn the wrong lesson here. Firms cannot allow themselves to behave in a manner that ignores their responsibilities to tell the truth, to carry out their audits in conformity with professional standards, and to respect and comply with obligations to protect records of potential wrongdoing where, as in Enron, the rights of large numbers of people may be affected. The leaders of the major accounting firms should play a strong role in placing honesty and integrity above the short term monetary interests of the firm, and in respecting the limits of the law at all times. As a former CEO

myself, I do not believe there is any higher personal responsibility than to ensure your organization is firmly and unequivocally dedicated to integrity and truthfulness.

In the wake of the savings and loan debacle, then President Bush sought and obtained authorization for a special force of 200 dedicated new FBI agents and a similar sized force of prosecutors to pursue white collar fraud cases involving looting of S&L's. I don't know the right number of personnel, but before we pass new laws we should add enough prosecutors to enforce current law effectively. Plainly many people at Enron and Andersen violated the law, and our first obligation is to enforce those laws and put wrongdoers in jail.

A New Oversight Board.

The basic structure and powers of a new oversight body for accounting can of course be debated, and there is not necessarily any "right" or "wrong" answer. Various structures can be made to work, and the most essential element is for a high level of consensus to be developed on the role that such a body should play, and the powers and resources it needs to carry out its missions. It is much better to reach agreement on what should unquestionably be done as first principles than to fail to act because of disagreement on how far to go. HR 3818 and HR 3763 contain many common principles that can form the basis for consensus that should significantly benefit U.S. investors.

My own view is that there is one and only one governmental "regulator" for the accounting industry, and that regulator is now and should remain the SEC. The SEC has the history, the culture and the institutional strength to be able to stand up to any wrongdoer. However, private sector groups working under the SEC's aegis can extend the reach of supervision in a healthy fashion. Therefore, the best model for a new accounting oversight group would be one that parallels the

structure of the NYSE and the NASD. Those organizations have considerable resources and enforcement power, but they exercise private authority delegated by government that is subject to the oversight and review of the SEC itself. The SROs in the securities world play a highly important role, though it is the SEC itself that is the ultimate arbiter of policy, and that brings the toughest cases where its big guns are most necessary.

I would be strongly opposed to see a new accounting oversight body that created even the potential for divided jurisdiction or competing approaches to civil enforcement actions or overall policy. We should not repeat the mistake that was made when the CFTC was created as a separate agency with powers parallel to the SEC, as institutions over a period of decades will develop their own views and seek to expand their resources and mission, and this could lead to unnecessary confusion or interference with the SEC's ability to carry out its proper role of protecting investors and holding audit firms and their personnel accountable for complying with GAAP, GAAS and other requirements of the securities laws. The provisions of HR 3818 dealing with the proposed "Public Auditing Regulatory Board ("PARB") should be clarified to make explicitly clear that the PARB is not a public regulatory body, and that it is explicitly subject to SEC authority in its rules, interpretations or actions. These essential characteristics are set forth more clearly in HR 3763.

Like the NASD, the PARB should be a private sector body, not a government agency. It should not be subject to any government pay or personnel standards, it should not be part of the federal budget process, and it should not in any other manner be treated as part of the government. I believe this will lead to a much stronger organization, and avoid confusion as to role or function. It will be important for any new oversight group to be able to hire top notch people and to seek to retain those personnel for a long tenure. Experience in this field is vital. Therefore, salaries for the

leadership of this body should be comparable to those at the NYSE or the NASD. Over a period of years I would expect the new oversight group would need to build a staff with significant accounting, examination and enforcement expertise, together with the resources devoted to developing both new accounting principles and auditing standards.

Funding for the new body needs to be assured, and various mechanisms have been suggested for doing so. Whatever method is chosen, the organization must have assured funding so that it does not risk loss of resources if it tackles the major firms head on in areas that they do not like. If such a group is to be created, the purse strings must not be held by the accounting industry. I would personally not use the stock exchanges as the mechanism for collecting fees, as this would be administratively complex and could introduce distortions in decisions on where trading would take place. Rather, I would prefer a surcharge on audit fees, with a statutory cap of 5 - 10% of audit fees. The audit firms would collect and remit these fees to the organization, but would not otherwise have any role in the group's budget or spending levels. The SEC should have authority to review the budget and spending of the new group, but not to set these levels.

Many people have suggested that the new body should follow the tradition of the SEC and the former Public Oversight Board ("POB") in having multiple commissioners. The provisions of HR 3818 require seven full time commissioners, who must sever all other business ties, and who would serve four year terms. Personally I believe this structure would be unworkable and undesirable. First, seven commissioners is too many. Even the SEC has only five commissioners, and as the number of commissioners increases, the amount of internal coordination time rises exponentially. A group of seven commissioners would not work nearly as effectively as a smaller group. Second, it would be highly unattractive for board members to sever all other business

relationships and board memberships to accept a four year term with this body. This requirement will make it impossible to attract top caliber board members.

The SEC during its history has had many extremely talented commissioners, who advanced the scholarship and work of the agency considerably, such as the late Al Sommer. However, in recent years it has been more difficult to keep the Commission's five seats filled, and many potential candidates have declined to be considered due to the limited executive role, low salaries, the interruption of their career and other reasons.

Individual commissioners can in fact do considerable damage to the ability of an agency to function cohesively, and the more commissioners there are, the greater the risk that some of those commissioners will seek to undermine the work of the group rather than assisting it. Therefore, the model of the NASD and the NYSE is better. They have a CEO and a strong, full time professional executive staff, with a board of directors who serve part time and have careers elsewhere. Ideally the independent directors of any new oversight group would be paid a substantial director's fee in view of the fact that they should be prepared to meet one or more days each month, and to devote considerably more time to the position than would be true with a corporate board. However, it would be a serious mistake to create full time commissioners for this role.

Subpoena Power.

The new accounting body should not have the power to subpoena either documents or witness testimony, as this is a power of government that should continue to repose solely in the SEC and the DOJ. However, the SEC should have statutory authority to issue subpoenas at the request

of this body, and to provide materials responsive to the subpoena or other compulsory process to the new group.

In order for any person or firm to audit a publicly traded company, they should have to be a member in good standing of the new oversight organization. Thus, failure to provide documents or testimony to the new body could be handled by expelling individuals or firms from the oversight organization, which would end their ability to audit public companies promptly. The new body should have the ability to suspend or expel any individual or firm from its membership, which action would have the effect of an industry suspension. Unlike cases under the SEC's rules, the new body should have the ability to suspend individuals or firms with immediate effect, and the standards for judicial review should be set quite high so that absent manifest abuse such suspensions cannot be overturned. It is a practical reality that in the past the major accounting firms have chosen to expend the resources to litigate suspensions for unlimited periods, including one case that lasted for 17 years in seeking a two year suspension for two accountants. In order for the new body to have a chance of playing a meaningful oversight role, it has to be armed with disciplinary powers that will prevent the Big Four from simply litigating it to a standstill.

Since in my formulation this will be a private sector entity rather than a governmental one, a political appointment process would not be appropriate. The members of the initial board of directors and the selection of the CEO should be worked out between the SEC and the Congressional leadership. The GAO should not play any role in this process as is proposed in HR 3818 for many reasons, not the least of which is that the chances of success for the new board would not be enhanced by embedding in it a Constitutional issue concerning the legitimacy of the appointment of its leadership. This alone could be grounds for litigating any rules or suspensions to

the Supreme Court, and then possibly having to start all over again. The CEO of this body should have a strong background in the investigation and enforcement of securities laws, as well as a strong financial background and a good knowledge of the accounting system. It should not be anyone who formerly ran any of the major accounting firms, as it is terribly important that the public be able to trust that this group will listen to the accounting industry for its point of view, but not be beholden to it.

Setting Accounting Principles.

As the Committee knows, FASB controls the process of developing accounting standards. While FASB has worked hard to develop the best possible standards, the overall process is less than satisfactory for several reasons. The FASB is not accountable to the SEC for which standards are most needed to deal with issues in the marketplace, and to limit undue risks to investors. It sets its own agenda, and it may or may not respond to the SEC's concerns.

Second, the FASB is not accountable to the SEC for the timing of its work. As a practical matter the SEC's choice is to accept or reject standards in whole, but without the ability to modify provisions of the standard even where the SEC believes that a standard will be open to substantial abuse or confusion that could result in unnecessary risks for investors. While the SEC could do the job of developing accounting principles directly, a private sector body similar to the FASB is a better approach for many reasons. However, the SEC should be able to assign the homework and to specify when it must be turned in, as well as having the ability to modify the language of standards however it believes most appropriate. The SEC should also have the power to adopt standards written by any other group, so that it could adopt a specific international accounting standard in

place of a proposed FASB standard, or standards drafted by academic or other professional groups if it believes those standards are superior to ones drafted by the FASB.

This function of developing new accounting standards should ideally be folded into any new private sector oversight body, subject to direct oversight by the SEC. This would maintain a healthy distance from direct government standard-setting, but would at the same time allow the SEC greater input into the establishment of the agenda, setting deadlines for action, and reviewing or modifying final standards. The overall process needs to be able to work faster, and to be much more responsive to producing standards that provide transparency, consistency of application, and resist distortion and manipulation.

Placing the current functions of the FASB into any new body would create advantages in having the professionals who develop accounting principles be part of the same group that oversees cases in which audit professionals are alleged to have misinterpreted such standards. Merging the FASB into the new oversight group would also eliminate the funding issues that have troubled the FASB, as the new body will presumably have a broad-based revenue source that could eliminate the pressure that now exists in FASB funding.

Today auditing standards and practices are codified by the AICPA, rather than the FASB. There is not any particular logic to having one body determining a standard for inventory accounting, for example, and a different body trying to determine how to test compliance with that standard through the audit process. The function of setting and modifying both GAAP and GAAS should take place in the same body, preferably the new oversight group overseen directly by the SEC. As with accounting principles, there would certainly be advantages in having the body that

must judge whether accountants have complied with GAAS also have the institutional knowledge derived from setting those standards.

Independence standards in my view should most appropriately be set by the SEC, as has traditionally been the case. Independence is a core element in the integrity of the financial reporting process, and the rules of the road should be set by the SEC. Certainly day-to-day oversight for independence requirements can be performed by the new body, as well as perhaps interpretations subject to review by the SEC. Here the new body should have the ability to go beyond what is required by the SEC, but not to do less, just as the NASD may establish ethical standards and specific guidelines of behavior that go beyond what SEC rules may require. At the same time, restrictions that are tenuously related to independence could perhaps be revisited as well, making the standards more reasonable in their application where there is no direct connection to an audit team or senior firm management.[1]

2. What limitations on the provision of non-audit services by auditors to their audit clients are appropriate to ensure that the judgment and independence of auditors are not impaired?

The volume of consulting services being provided by auditors to audit clients seems to have risen to the point where there are now many companies whose annual consulting fees to their auditor are a multiple of the annual audit fee. This represents a substantial change since I was at the SEC, and I believe that Chairman Levitt was right to point out the corrosive effect that the volume of such fees is having on auditor independence. As the consulting practices of the major audit firms

[1] For example, if the spouse of an audit firm partner has options or stock in his or her employer, this should not be deemed to violate the independence of the audit firm, so long as this stock was demonstrably acquired as a result of the spouse's employment, rather than through open market purchases, and the family member is not actually on the audit team. Indeed, greater flexibility could in general be shown for situations involving audit firm personnel who are not remotely involved in the audit team or supervision of the audit team, particularly where investments are managed by others such as mutual funds.

have grown, management time has been shifted into selling consulting work rather than finding ways to enhance audit quality. At some point the consulting revenue derived from an audit client may become the principal focus of the relationship, with the audit an afterthought. While the major firms have all announced plans to divest at least a portion of this business, this does not eliminate the issue.

On the other hand, it is important not to overstate the impact that consulting practices may have on independence. Certainly in the case of Enron, had Arthur Andersen not been performing any consulting work, its pure audit fee of $25 million per year would have been more than large enough to create powerful incentives for the managers at Andersen to give the client the accounting treatment it wanted for its SPEs. Unlike consulting fees, which are one time assignments, the audit is generally viewed as a long term engagement. On average, audit engagements at Coopers & Lybrand when I was there lasted nearly twenty years. Thus, the $25 million annual audit fee would have a present value much greater than $25 million in one time consulting business. Therefore, even if firms performed no consulting work whatever, there would still be issues of the willingness of the auditors to antagonize a big client determined to use accounting games to overstate income.

There are at least two separate types of concerns in the debate over restrictions on consulting services by audit firms. First, there are certain types of services that are unhealthy, and should be restricted due to their nature. These include performing internal audit services, along with investment banking, legal services, valuation services relating to assets or earnings that are part of the financials to be audited, product structuring services and perhaps insolvency management services. Each of these types of services creates inherent risks of conflict in subsequent audit decisions that the firm must make, and a real risk that the firm may alter its judgments concerning

appropriate accounting treatment because of positions it may have taken in selling the client the consulting engagement, or in the advice provided by consultants that the audit team will be reluctant to undercut. Financial information system design and implementation, and large software projects, may fall into this category since it is part of the auditor's job to evaluate the integrity of these systems. If staff of the audit firm built the system, the firm's own auditors are unlikely to evaluate it independently. Thus, on this issue I believe HR 3763 may not go far enough.

A second type of concern, separate from issues of inherent conflict, is the issue of the sheer magnitude of consulting services. Here I believe that good practice is to limit the total volume of non-audit fees in any year to a percentage, such as 15-25%, of the audit fee. The audit should be the primary relationship with the client. Thus, the audit firm could sell permissible types of consulting services to an audit client, but only up to a maximum annual dollar limit.

While there is merit in the concern that too much consulting for audit clients can undercut independence, we should not carry accountants too far into the cloister. Investors have an interest in marking sure that in performing the audit, the audit team had available to it a full range of professional competence to enable it to evaluate liabilities accurately and to be certain that the financial statements present a full and fair picture of the corporation's financial results and condition. Thus, I believe that tax services in particular are part of the core competence of any audit firm. An auditor cannot possibly give a full and fair report on a company's results and condition if it is oblivious to the company's tax exposure. Firms typically have a set of GAAP books, and a separate set of tax books, and it is essential to understand specific differences between the tax books and the financial reporting books. Also, there is enormous convenience to clients to be able to have the firm that determined its GAAP income help prepare its tax returns.

Similarly, internal controls consulting contributes to the integrity of reported financial information, and it is also a vital issue of core competence for the audit team. Human resource or benefit plan consulting does not seem to present the same level of inherent dangers of pressure on auditors not to take an independent view of financial reporting issues, though one could argue that issue either way.

Philosophically, I do not believe in restricting businesses from performing lawful services except where there is a compelling reason to do so. A ban on combining auditing and consulting has parallels to the Glass-Steagall Act or the product restrictions that used to limit bank holding companies solely to "banking or services closely related thereto" as designated by the Federal Reserve. In recent years both of these types of structural barriers against "one stop shopping" in financial services have been repealed or liberalized by Congress, yet it is precisely "one stop shopping" that the auditors offer through their consulting divisions.

Though any restrictions will be offensive to some, there is a benefit from having a clearly understood set of limits so that public confidence in the integrity of audit decisions can be restored, and so that we remove undue pressures undermining auditor independence. Absent legislation there is a risk that competitive pressures will push each individual firm to look for ways to enter or reenter specific consulting services ahead of its competitors to try to establish a dominant market position. Backsliding from voluntary action is also a risk, so that there is a benefit to having a set of services that are prohibited by legislation, with the SEC authorized to interpret those restrictions (or perhaps the new oversight group subject to SEC review). At the same time, we should err on the side of

allowing competition, and trusting the SEC to bring particular abuses back to Congress for future action.

3. What are the essential reforms relating to corporate governance? Do you support the notion that audit committees should hire and fire the auditor? Should directors be restricted from serving as consultants?

As the Committee knows, corporate governance is generally a matter of state law, rather than federal. Indeed, during my time at the SEC the D.C. Court of Appeals overturned the SEC's "one share, one vote" rule on grounds that this was beyond the powers of the agency as a matter of corporate governance even though it was contained in rules of SROs under the express oversight of the SEC. Therefore, I am cautious concerning changes in corporate governance that would be appropriate as a matter of federal legislation. Happily, the SEC under Chairman Pitt has already moved forcefully and thoughtfully to enhance disclosure requirements to address major risks demonstrated in the Enron situation.

Perhaps my greatest governance concern is the idea that a CFO could be allowed by any board to hold any financial interests whatsoever that are adverse to the company he or she serves as CFO. The outside audit team, the audit committee and the board itself depend on financial data provided by the CFO and his or her department. Any conflict of interest on the part of the CFO is inherently extremely dangerous, as this is a person who has the institutional capability to circumvent review by the board and the outside auditor.

One remedy for this problem would be to require immediate and prominent disclosure of all separate financial interests contrary to the company held by a CFO or other senior corporate managers, and to require such disclosure to be featured prominently in the company's public filings and to be described in detail in the proxy statement. This disclosure could be enhanced by requiring the audit committee to make an affirmative finding that any such separate interests were in the interest of the company, and to publish this analysis in the proxy statement.

Another area where good corporate governance could be reinforced by enhanced disclosure would be a requirement to disclose immediately any actions by the board of directors of a publicly traded company to suspend the company's code of conduct or conflicts, as took place at Enron, and to include an annual statement regarding conflicts among senior officers and the board's policies on conflicts in the proxy. Of course these steps are undoubtedly among the issues the SEC is now considering, and I am confident that the agency will find the best ways to use disclosure to alert investors to such inherently dangerous situations. Presumably boards of directors will in the future be very reluctant to follow the example of the Enron board. When it comes to allowing conflicts of interest by the officers of a company, "just say no" is certainly the right policy.

Engagement of the Auditor.

As a theoretical matter, the engagement of the outside auditor must be approved by the board of directors, and the audit committee is the board's representative in reviewing any such decision. In practice, however, the engagement of the auditors is frequently a matter that is initially handled by the company itself, and particularly by the CFO, with the board ratifying the company's decision. In my view, the audit committee should in fact control retention and termination of the auditors. The audit committee should also review carefully the proposed audit plan, the number of

hours to be spent and the areas of focus, and interview potential engagement partners proposed by the audit firm. The Chairman of the audit committee should review the bills submitted by the auditors, and the Committee should meet regularly with the engagement team so that there are both formal and informal opportunities for the auditors to communicate issues of concern.

The outside audit team needs to understand that while the audit committee will listen carefully to the views of the CFO and give them substantial weight, the final decision on retention or rotation will be made by the audit committee. At the same time, the company needs to understand that the audit committee will look to purchase the best audit, not the cheapest audit.

There are several corollaries of this view concerning the importance of audit committee control of the audit. One is that the committee must be prepared to devote adequate time to its work, particularly for a large and complex company. Not only must the members of the Committee have the necessary finance and accounting knowledge, they must be willing to use it. Unfortunately, today audit committees are not compensated to spend serious amounts of time in most companies.

Directors as Consultants.

Under the current rules of the NYSE, a director who receives more than $60,000 in consulting fees from the company is not considered to be "independent" in the following year. This restriction seems appropriate to prevent an individual director from having a significant financial reward that is controlled by management while still participating as an independent director on the audit committee. Though the same standard should be applied to contributions to a charity that employs the director, I do not believe there is any need for additional federal legislation on this

point. An absolute bar would seem more restrictive than necessary since a director may have valuable background that would make limited consulting engagements mutually beneficial.

4. What measures can Congress or SROs take to ensure that an analyst is truly independent?

The SROs have recently promulgated new standards in this area that are a definite step in the right direction. Once we have experience under the new standards, it will be possible for the SEC and the SROs to provide better recommendations as to whether more needs to be done. Certainly investors would like to know that analyst recommendations are made on the basis of investment analysis, and that they are not bought and paid for by issuers through their investment banking fees.

5. Do you support mandatory rotation of auditors?

At present, I do not believe that mandatory rotation would be appropriate. For the issuer, there are serious costs involved in changing auditors. More importantly, a change in audit firms also increases the chances of financial risks going unnoticed by a new audit team in the first year or two of an engagement. Institutional knowledge by the audit firm of its client can definitely lead to a better audit plan, and a better audit product. Therefore, I don't believe federal legislation mandating rotation is desirable.

Rather than mandatory rotation, auditor retentions by an audit committee should be made for a longer term, such as three or four years. Today the annual selection of the auditor happens so often that it is treated as a matter of routine. Thus, a very important decision is to a degree trivialized by the frequency it is made.

A better system would be for the audit committee to appoint the auditors to a three or four year contract that could only be terminated by the committee. At the end of this longer engagement, the audit committee should solicit proposals from multiple firms as to the next award of the audit mandate. This would ensure that every four years at least the audit committee would devote serious time to the issue of whether a rotation of auditors would serve the best interests of the shareholders. In considering whether to renew the incumbent auditor, the audit committee should strongly consider a new firm if the company had restated its earnings or been the subject of proceedings relating to inaccuracy of publicly reported financial results, or if the auditors failed to notify the audit committee of the existence of significant audit or accounting issues. These are judgments best left to the board and audit committee, however.

6. How can we best ensure that independent corporate directors are truly independent and that corporate audit committees will effectively take charge of the audit and the relationship with the auditor?

This relates in part to the time commitments that can be expected of audit committees and audit committee chairs. In the typical audit committee, the committee has three or four members, and no staff. The committee is dependent on the company and the auditor for information, and in smaller companies there may not be any internal audit staff or financial analysts to help the committee with analysis. Committees sometimes meet only four times per year to approve the quarterly financials, and some committees do not devote enough time to do the job well. Other committees have highly experienced members and perform a thorough review of financial reporting issues.

One possibility is for the chair of the audit committee to assume a more active role with the finance department, meeting with inside staff and outside auditors much more frequently. Audit

committee chairs could in effect play a role of "lead director" in accounting and disclosure matters. However, most outside directors would probably be unwilling to shoulder the risk or time commitments that would be involved in such an expanded role. Alternatively, the audit committee could hire independent financial advisors more as a matter of routine to help analyze the company's financial statements and all related issues of the selection and application of accounting principles.

"Truly Independent" outside directors.

Certainly there should be a stronger market discipline for companies that do not have a strong board of mostly independent directors with knowledge and experience relevant to the company and its activities. The head of the local cancer hospital may be a great director for a pharmaceutical company engaged in significant anti-cancer drug research, but it is difficult to see what such a background would bring to the oversight of an energy trading company, for example. This does not mean that an individual of basic intelligence and with a good sense of ethics cannot serve effectively as a director, simply that a higher standard of relevant experience might be useful as a market expectation. However, it is difficult to legislate the selection of good directors, and all CEOs have a legitimate interest in wanting to select as directors persons whose judgment they respect. Market participants should carefully consider board quality, and pay less for stocks of companies with directors who do not offer strong and independent capabilities.

7. Do you support a mandate by Congress to the SEC to more systematically review and comment on the disclosure of issuers.

No. I believe the SEC's record here is exemplary, particularly given the systematic underfunding of the SEC that has existed for decades. When I was Chairman I wanted to review more current disclosures of issuers, but we did not have the trained and experienced staff necessary

to review new offerings, '34 Act disclosures, proxy statements and tender offer disclosure documents simultaneously. Adding legislative straight jackets while resources are limited simply forces an allocation of staff that may not be most appropriate given risks to investors at any given time. Markets and their risks change constantly, and the SEC has the expertise to adjust its focus to try to give the maximum protection to investors. Greater oversight of 1934 Act filings would in my view be desirable, but the SEC needs an increase in the number of accountants and disclosure staff so that issuers with the largest market capitalization or most widely held securities can be subjected to regular and thorough reviews. The SEC needs to retain flexibility in how to target its resources.

The provisions of HR 3818 concerning a current disclosure system are in my view too detailed and would create serious issues. However, both bills and recent SEC proposals provide that more rapid disclosure should be fostered by the SEC, and I agree.

Both bills contain similar provisions on improved transparency and disclosure. Enron's disclosures of its SPEs were miserable, and a mandate to the SEC to improve SPE disclosure (which is a complex problem) is certainly warranted in light of Enron. However, I favor the approach of giving the SEC time to review what should be done and how to do it. I believe Chairman Pitt will prove exceptionably capable in leading the SEC in this area.

8. Litigation Reforms. HR 3818 contains provisions that would overturn many limits in abusive shareholder litigation, including restoring joint and several liability, aiding and abetting liability and other measures. I do not believe any such steps would be desirable. Litigation reform was long overdue, and it should not be rolled back. I do support provisions of HR 3818 concerning

document retention by audit firms. I would make any document destruction by an accounting firm unlawful except in accordance with SEC rules.

9. Will the market fix the problems shown by Enron?

The market has certainly already responded to the overall Enron situation. Audit committees are undoubtedly more wary of consulting engagements for the incumbent auditors, and boards will undoubtedly be more wary of proposals to approve conflict of interest waivers for the CFO. Audit firms will hopefully understand that they are not free to destroy documents relevant to criminal or civil investigations, and that audit committees must be notified when the auditor has concerns as to the appropriateness of accounting judgments. Markets have shown they are prepared to penalize companies perceived to have poor transparency or inadequate disclosure. All of these are very healthy signs of market corrections to the abuses at Enron, and these trends will be reinforced if in fact corporate officers or audit firm personnel are convicted of criminal violations and serve time in jail. This is in my judgment the most important part of insuring that investor losses in Enron are not simply ignored in the future.

The market response may or may not prove to be short lived. Sometimes memories of such events can be short, and lessons may not be truly learned. Only time will tell if lasting changes in behavior will result from the Enron events. However I am optimistic that this situation has been so disgusting to so many people, and so intensely covered in the press, that there will be a lasting beneficial effect on market behavior.

At the same time, there are many issues, particularly involving Andersen and its activities, that the market cannot solve alone. For example, the SEC does not have sufficient tools to oversee

the accounting industry or to provide strong accountability for audit failures. It doesn't have enough people, and the law allows essentially endless litigation over cases of auditor malpractice. The DOJ also has a very important role to play, and I believe that it needs more dedicated criminal resources to enable it to pursue cases of individuals or firms that have engaged in criminal wrongdoing. The POB was never an effective body, and has now been disbanded. Thus, absent legislative change, I believe that there is a gap in the practical ability of the overall system to provide meaningful enforcement and accountability for accounting problems.

While there were corporate governance and other issues at Enron, had the accounting system done its job the problems would have come out much sooner, and devastating losses could have been prevented. Without ignoring the importance of putting all the corporate lawbreakers in jail, it is important to remember that the heart of this problem was failure of the auditors to do their job, coupled with woefully inadequate disclosure by Enron itself.

There are other areas in which modest legislation would improve the overall system, some of which are contained in each of HR 3763, HR 3818, and the President's proposals. For example, we should consider areas in which disgorgement of profits from executive stock sales should occur. Using the model of section 16(b) of the 1934 Act, which recaptures short swing profits on sales by officers, directors or 10% holders, Congress may wish to consider legislation that would recapture for the estate of a bankrupt corporation all profits from sales of stock by such persons within a defined period such as six months prior to a bankruptcy filing. This would eliminate the incentive of officers to conceal bad news while they frantically try to unload their own stock. Congress could decide to limit such disgorgement to cases where the SEC finds evidence of sales that occurred when there was not adequate disclosure of the Company's problems.

Finally, it is always the case that an argument can be made that market response has cured the need for legislation. However, most often the companies that don't need the reforms adopt better practices, while companies that may pose the greatest risk to investors will not change their policies. Our laws in the accounting and disclosure area have to be updated in light of our experience in order to keep them relevant to current issues, and to maintain their vitality over time. If we ignored the catastrophe that Enron represents for investors across the country, we would be sending a message of insensitivity that could harm confidence in the broader market and damage the ability of companies to raise capital in the future. This case demands a reasoned and measured response, but a response nonetheless.

TESTIMONY OF PROFESSOR DONALD C. LANGEVOORT, GEORGETOWN UNIVERSITY LAW CENTER, BEFORE THE COMMITTEE ON FINANCIAL SERVICES, UNITED STATES HOUSE OF REPRESENTATIVES, 107TH CONGRESS, 2D SESSION

April 9, 2002

The last few months have brought public attention to bear on the seriousness of a problem of which we have known, or should have known, for years – that economic forces have increased the temptation for company executives to be dishonest with the investing public, and that this temptation has translated into an unacceptable level of corporate fraud, misrepresentation and concealment. The forces that have produced this are many, including weaknesses in the system of corporate governance, otherwise well-intentioned forms of stock-based executive compensation, compromises in the integrity of the accounting profession, the pace and profitability of financial innovation for both risk shifting and tax avoidance and, sadly, the sometimes too-easy willingness of investors to believe what they are told by both issuers and Wall Street when promises of riches are dangled in front of them. I commend members of this Committee, on both sides of the aisle, for your commitment to addressing many of these issues and establishing a higher level of accountability and transparency in our markets.

Without slighting many of these specific and important issues in the bills before you, my purpose today is to focus solely on private securities lawsuits and their role in this restoration of investor protection. As this Committee is well aware, the issue of private securities litigation is contentious and polarized. Securities fraud class actions are portrayed either as pure public-regarding mechanisms for championing investor rights or lawyer-driven sinkholes of opportunism and strike suit abuse. But the truth is neither of

these. Securities class actions do present an opportunity for abuse through the filing of low-merit complaints with the expectation of settlements that are profitable mainly for the lawyers, and there probably are too many weak claims. At the same time, however, there are – as recent events have amply demonstrated – many meritorious cases that dearly deserve redress. Especially given the under-funding of the SEC's oversight and enforcement capacity, private lawsuits play a necessary role in policing fraud in the markets. What is needed from the law, simply, is balance. I believe that portions of H.R. 3818 dealing with private rights of action are crucial to restore balance that has been lost in recent years in a number of key respects.

The Need for Legislation

Much has been said and written recently about private securities litigation and the efficacy of the Private Securities Litigation Reform Act of 1995. The most commonly publicized statistical evidence is that there has not been a sustained drop in the filing of lawsuits in the years following the legislation. From that, it is tempting to infer that neither the PSLRA nor the underlying case law has prejudiced plaintiffs unduly, and that therefore no reform is needed to restore any balance.

To be sure, cases can and do get brought: nothing in the law has been a death-knell for the fraud-on-the-market lawsuit. But the years prior to the legislation that serve as the baseline for these statistics do not provide a useful comparison. Both the economic risks of investing and the temptations and opportunities to engage in fraud have accelerated in recent years, such that it might fairly be said that there are many more

meritorious causes of action now than before. In fact, it is possible that precisely because of the deterrence lost as a result of both judicial pruning of the securities laws and legislative reforms, the incidence of fraud (and hence the number of good lawsuits) has risen.[1] In other words, current law could still be preventing too many good claims even if we observe no drop-off in the overall rate of litigation. These aggregate statistics don't tell us enough to make a judgment one way or the other.

I suggest that we not speak in generalities. Instead, in the aftermath of Enron, Global Crossing, Waste Management, Cendant, Sunbeam and so many less visible examples of real abuse – certainly circumstantial evidence, if nothing else, that the deterrence to fraud in inadequate – Congress should examine the *specific* roadblocks that might stand in the way of legitimate securities lawsuits, and decide whether current law is sensible, fair and balanced. If not, that rule should be changed. H.R. 3818 is an important, focused step in this direction.

Restoration of Aiding and Abetting Liability

In 1994, the Supreme Court surprised nearly everyone in the legal and business community by holding that private plaintiffs were no longer able to sue "aiders and abetters" of securities fraud for damages under Rule 10b-5.[2] Whatever the merits of its statutory construction methodology or policy musings, the Court's basic holding was

[1] It should be clear that the PSLRA was merely the culmination of a decade in which the courts created many roadblocks of their own to open-market securities fraud cases. The key provisions in many respects simply codified what most courts were already doing. If so, then a reduction in claims would not be likely except in geographic areas where certain courts had not as restrictive as others.

[2] Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

clear. If this kind of secondary liability is appropriate (as the Court conceded it may be), the job of creating it is for Congress, not the judiciary. I urge this Committee to accept the Court's invitation.

As I testified shortly after the *Central Bank* decision,[3] as a policy matter it is extraordinarily difficult to argue seriously that true aiders and abetters – that is, those who intentionally render substantial assistance to a securities fraud – should not be responsible to the victims for the harm they help cause. The common law has long imposed tort liability on aiders and abetters, reflecting the basic wisdom of this norm. And Congress has accepted the severe wrongfulness of aiding abetting, long ago making it a federal crime generally and more recently making clear the SEC's ability to bring enforcement actions based on it. If this kind of conduct is wrongful, why would we ever deny the victims, who often are unable to recover fully against the primary wrongdoers, their just compensation?[4]

There is no good reason at all, except for the supposed fear of litigation abuse. But even if (as I believe) that fear is well-founded to a limited degree, the right response is to control abuse through a carefully-tailored set of restraints on the cases that are brought rather than throwing out a good doctrine in its entirety. There are good ways of controlling unduly speculative claims against secondary actors, including certain of the steps taken in the PSLRA, which was enacted shortly after *Central Bank*. Once a healthy

---

[3] Statement of Donald C. Langevoort Before the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs, United State Senate, 103d Cong., 2d Sess., May 12, 1994.

[4] It bears noting that in suits where the issuer and its executives are the only defendants remaining, the *issuer* (directly or indirectly, though its D&O insurance carrier) funds on average more than 99% of any settlement. The practical effect, then, is that one group of innocent investors (existing company shareholders) pays damages to another (the class of traders).

balance has been achieved, courts should be authorized to impose liability when there truly was intentional and substantial assistance.

Even a brief survey of the kind of conduct that escapes responsibility under current law underscores the gap in investor protection that it creates. Imagine, for example, an investment bank that assists an issuer in financing an off-books entity used to fraudulently manipulate earnings. Or the accounting firm that helps structure it to avoid taxes that would otherwise be owed. Assuming that these firms knew of or recklessly shut their eyes to the issuer's fraud on investors, they bear responsibility to the victims. I would not want any legislation restoring aiding and abetting liability to be lax in defining substantial assistance. Mere proximity to a fraud is not enough. But when a person adds substantial value to a fraudulent course of conduct – in other words, contributes in a substantive way to its success – then liability is necessary and appropriate to achieve both deterrence and compensation. In cases such as the ones I have described, the professionals may well have provided not only technical assistance but aggressively advocated the desirability and efficacy of the strategies, reaping considerable consulting or banking fees in the process. If in so doing they intentionally furthered a fraud, they surely owe compensation to the victims.

Post-*Central Bank* developments in the law underscore the need for reform here. The Court's decision quickly generated confusion in the lower courts on the question of when a person or entity becomes "primarily" liable for a violation of the securities laws. There is one line of authority – perhaps now the most common approach – that absolves even those who participate directly in the formulation of deceptive publicity, financial

statements or SEC filings unless they are somehow *publicly identified* as responsible.[5] Read strictly, this test would mean that "behind the scenes" actors, no matter how central their role in the deception, avoid all responsibility to the victims under the securities laws, except where they are controlling persons. Whether we call such persons "primary participants" or aiders and abetters is unimportant: the important thing is that they be made liable if their involvement was both intentional and substantial in causing harm.

Statute of Limitations

When the Supreme Court resolved the question of the appropriate statute of limitations for Rule 10b-5, it had legislative guidance to work with, drawing from other provisions of the Securities Act and the Securities Exchange Act by analogy. And so the Court determined that the short statute of limitations found occasionally in the securities laws' express liability provisions – one year after discovery, and in no event more than three years after the fraud – was appropriate.[6]

Putting aside the correctness of this as a matter of statutory construction, the short statute of limitations is wholly ill-suited to the job of policing securities fraud in today's complex markets. When Congress wrote the other sections' statutes of limitation in 1934, it was addressing a world that pre-dates the modern class action. Rule 10b-5 didn't even exist. And certainly the size and breadth of today's investment marketplace could hardly be foreseen.

[5] See Wright v. Ernst & Young LLP, 152 F.3d 169 (2d Cir. 1998)(statement must be "attributed to that actor at the time of dissemination").

[6] Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991).

Once again, Congress should use common sense as its guide. In a fraud-on-the-market case, one year is too little time to prepare an effective and well-grounded suit, especially if the clock begins running – as some courts insist – as soon as there is some basic notice of the likelihood of fraud.[7] As recent events have demonstrated, many large frauds unfold gradually: the first hints may be troubling, but do not clearly indicate either the nature or the extent of the wrongdoing. The realization that a lawsuit is necessary and appropriate does not come immediately. The one-year rule has much potential for mischief, including forcing unduly rushed pleadings when the need for a lawsuit is late in coming.

The three year "cap" is even more pernicious and archaic. With today's complex capital structures, delays in the discovery of fraud for more than three years are readily foreseeable. A firm that fraudulently hides liabilities off-books may sustain the illusion for some time. There is no reason to let a securities wrongdoer free simply because that short a period of time has elapsed.

For these reasons, I strongly endorse extending these periods to three and five years respectively, which corresponds more closely to the more modern statutes of limitation found today in analogous settings such as common law fraud and state blue-sky law.

[7] E.g., Whirlpool Fin. Corp. v. GN Holdings, 67 F.3d 605 (7th Cir. 1995). Fortunately, some other courts have been more forgiving.

Discovery Stays and Other Reforms

H.R. 3818 would reverse the rule established in the PSLRA that stays discovery pending a motion to dismiss for failure of adequate pleading under Section 21D(b) of the Securities Exchange Act, albeit only with respect to suits against auditors. As you know, this is a piece of a very big issue – the pleading standards generally in securities fraud actions. Without belaboring the broader issue here, I believe that the pleading standard requires revisions in two respects. First, Congress should make clear that the "strong inference" standard is to be construed with balance in mind. In many cases, investors lack the information necessary to present a strong case of intentional misconduct at the time they file their complaint. Although I am not uncomfortable with the approach taken by some courts that this standard can be met by showing such things as a sufficiently strong motive and opportunity, I think that the standard can be formulated better while still allowing courts to weed out speculative claims. I would set the bar simply at whether plaintiffs presented particularized facts giving rise to reasonable grounds to believe that a securities fraud violation has occurred. I would also give the trial court the discretion to allow a limited and supervised period of discovery, and allow dismissal thereafter if plaintiffs had not uncovered additional facts that give rise to a reasonable likelihood of success on the merits. I would not limit either reform to suits involving auditors.[8]

[8] I believe that one additional change in the reforms created by the PSLRA would be desirable. The so-called "safe harbor" for forward-looking information today protects statements that are either accompanied

Conclusion

I make no claim that the beneficial reforms to private securities litigation proposed by H.R. 3818 will themselves restore integrity to the process of financial reporting and issuer disclosure. The threat of litigation, public or private, can only go so far in causing good behavior to occur instead of bad.

Presumably, the market will react to Enron and similar examples of corporate dishonesty by demanding better governance mechanisms and penalizing companies that do not offer high-quality disclosure. This will be a necessary and healthy discipline if it lasts past the next round of investor exuberance. But no one can argue seriously that marketplace discipline is enough to deter fraud. For one reason or another, corporate executives will find themselves tempted to lie if only to cover-up a streak of bad fortune and hold on to their jobs and perquisites long enough to try to gamble their way out of trouble – to me the single most common explanation for financial fraud. Indeed, there is reason to believe that increased marketplace demands are precisely the reason we are seeing more corporate frauds.

If recent financial frauds have taught us anything, in other words, it is that the temptation to be dishonest is strong, and existing corporate governance mechanisms that we would like to trust – e.g., independent directors and audit committees, "reputational intermediaries" like investment banks and accounting firms, marketplace demands for candor – operate with less force than we would like. The real work of reform (which I suspect should not rest heavily on increased threats of liability) must be in these areas,

---

by meaningful cautionary language or made without actual knowledge of their falsity. I believe that when plaintiffs can create a strong inference of deliberate fraud (i.e., actual knowledge), the safe harbor based on cautionary language should disappear.

and will take time and cooperation between public and private forces. But that reform will take time and will never be perfect; inevitably corporate managers will find the means to cheat. Hence, it is essential that the law establish a clear baseline for tolerable behavior: those who intentionally participate in schemes to defraud the investing public should be liable for the harm they cause, and should be prevented from causing comparable harm again.

Rules of conduct mean nothing, however, unless someone is able to enforce them vigorously and effectively. Increased SEC funding is a must, so that the resources are there to make public enforcement operate as a much more powerful deterrent. Inevitably, private securities litigation will always have to assume a large part of the burden of both enforcement and the search for compensation. I urge this Committee to take the balanced, reasonable steps to restoring the effectiveness of private securities actions proposed by H.R. 3818.

TESTIMONY OF DAMON A. SILVERS

ASSOCIATE GENERAL COUNSEL

AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

TESTIMONY BEFORE THE HOUSE FINANCIAL SERVICES COMMITTEE

APRIL 9, 2002

Good afternoon, Chairman Oxley and Ranking Member La Falce, my name is Damon Silvers, and I am an Associate General Counsel of the American Federation of Labor and Congress of Industrial Organizations. The AFL-CIO believes today's hearing on H.R. 3818, the Comprehensive Investor Protection Act of 2002, is an essential part of a much needed effort at comprehensive reform of the capital markets and is grateful to the Committee for the opportunity to participate in this hearing. We note that this Committee was the first to address the issues raised by Enron in December of last year, and we would like to thank the Committee for giving the AFL-CIO at that time the opportunity to brief the Committee on the impact of Enron's collapse on both Enron workers and America's working families more generally.

Enron is a window into a set of pervasive conflicts of interest that defeat the purposes of corporate governance and threaten the retirement security of America's working families. At Enron the management, the board of directors, the outside auditors and the Wall Street analysts all failed to protect investors. Similar events have occurred on a smaller scale at

Global Crossing, Cendant, Waste Management, McKesson and other public companies. The source of these failures lie in the unregulated conflicts of interest that permeate the relationships between the management of these companies and the people who were supposed to be protecting investors.

This Committee has heard in prior hearings from those who still would have you believe what Enron used to preach – that unregulated markets will solve all problems. Now that may be the view from the K Street offices of those who do the heavy lifting for the Big Five. But it is not how things look for thousands of working families in Houston and Portland, Oregon and Rochester, New York who have lost their retirement savings and in some cases their jobs and their health care because they believed what they were told -- by their employers, their employers' accountants and the analysts that interpreted the accountants' numbers.

H.R. 3818 is the most comprehensive legislation introduced in this Congress in response to the conflicts of interest in the capital markets and in the boardrooms of America's public companies. However, I would note however, that H.R. 3818 and H.R. 3673, the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002, both reflect what appears to be an appropriate consensus in this Committee that the structure of our markets needs reform – that doing nothing is not an option.

Let me then review the areas where Congress needs to act and the provisions of H.R. 3818 that respond to the need.

Corporate governance starts with boards of directors. Public company boards need strong independent directors who are accountable to investors. Part of the problem at Enron was that Enron touted directors as independent who really had significant ties to Enron management, ties that Enron did not have to disclose. So investors first need complete disclosure of all ties between board members, the company and company management. H.R. 3818 requires just that, while H.R. 3763 has no such requirement.

While this provision in H.R. 3818 is a very important part of the bill, we would encourage the bill be further strengthened to require that this higher standard of independence be the relevant standard for measuring the independence of auditor and compensation committees. Furthermore, with genuine independence from management must come genuine accountability to shareholders. Shareholders should have access to management's proxy, not just for shareholder proposals on a handful of subjects, but for director candidates that a substantial number of shareholders want to see on the board of the company they invest in. Investors also deserve the right to bring before the annual meeting through management's proxy any proposal that is legal and can be shown to enjoy significant shareholder support. We would urge these corporate governance provisions be added to any reform package.

The second area in need of reform is the practice of public accounting. There are three issues here -- independence, oversight, and the process by which the accounting rules are made. On independence, the simple fact is that you cannot be a public auditor with an obligation to get the numbers right for a public audience and also be a consultant whose aim is to advise executives on how to optimize the numbers. The tension between those goals is too severe and the rewards for compromising the public audit responsibility are too great. It's just too easy for an auditor seeking to blend those roles to end up like Arthur Andersen at Enron, structuring SPE's as a consultant and auditing those same structures as an auditor.

The Big Five now to be arguing that if they can't earn the big money as consultants they won't be able to attract top people. From an investor perspective, we would say the opposite is true-- that unless audit and consulting functions are separated, the Big Five will not be able to attract anyone with any integrity to their audit practices, and integrity is what worker funds want in an auditor.

Here H.R. 3818 takes the right approach by giving the SEC the authority to ban a wide range of consulting by auditors, and requiring that the audit committee or the full board approve in advance the provision of by the company's audit firm of any consulting services allowed by the SEC. By contrast H.R. 3673 bars only certain types of consulting. It would still allow the involvement of auditors in creating Special Purpose Entities of the sort at issue at Enron. The result is auditors passing on the accounting

treatment in the public audit of the very entities they helped create, as Anderson did at Enron.

H.R. 3818 also requires rotation of audit firms and limits the revolving door between audit firms and their clients. H.R. 3673 has no such provision. The AFL-CIO requested the SEC adopt mandatory audit firm rotation in our December 11, 2001 rulemaking petition to the SEC. We believe the formulation in H.R. 3818, which ties the period after which a change in auditor is required to oversight by a public oversight board, is an appropriately flexible way to prevent public audit firms from becoming captive to their client companies.

The next issue after independence is oversight of auditors. Former SEC Chair Arthur Levitt has outlined in testimony before the Senate Governmental Affairs Committee what we believe are the key characteristics of an much needed auditor oversight body -- members independent of the Big Five, full investigative and disciplinary powers, and independent funding. H.R. 3818 creates a Public Accounting Regulatory Board that meets these three tests. H.R. 3763 envisions a Public Regulatory Organization which does not meet these tests.

Finally, there is the rulemaking process. Anyone familiar with the political pressures brought to bear on FASB around accounting for executive stock options in the mid-1990's, not to mention the decade long paralysis on SPE accounting knows that FASB is

too open to pressures from issuers and those beholden to issuers. Here there are a variety of options available for how to make FASB more independent -- ranging from merging with a public auditor oversight body to closer ties with the SEC. Because of jurisdictional issues, neither bill under consideration addresses the structure of FASB. However, ultimately we would urge the House to include in any final bill the provisions reforming FASB in Representative Dingell's Truth and Accountability in Accounting Act of 2002 (H.R. 3970).

Then there are the Wall Street analysts. These people play a vital role in our markets--they interpret the numbers. But analysts have become captive to the investment banking side of their firms. That's why part of a comprehensive package of reforms would be a provision banning basing analyst compensation not just on specific investment banking transactions, but also barring tieing analyst compensation to investment banking performance generally. H.R. 3818 requires the SEC to ban analyst compensation tied to investment banking performance. H.R. 3763 goes no further than requiring a study.

All these reforms are of little benefit if there is no enforcement. The Securities and Exchange Commission has been underfunded for years, and has not been able to pay enough to attract and retain the experts they need to do their job. Congress has passed pay parity for the Commission, but has not yet funded it. H.R. 3818 both provides adequate resources to fund pay parity and allows the Commission to expand its oversight and enforcement activity. The Commission needs this kind of increase in resources to

take up the needed work of expanding its review of issuer disclosure. H.R. 3763 has no such provision.

Finally, I want to address the ultimate accountability measures available to shareholders -- recourse to the courts. The AFL-CIO and worker funds view litigation as part of a continuum of tactics for holding the management of the companies we invest in accountable and for recovering money fraudently taken from us. As such, we strongly believe that the current immunity from civil suits in the law for those who aid and abet securities fraud is outrageous -- and directly connected to the rise in accounting restatements and accounting fraud since the Central Bank of Denver case in 1994. We are thus particularly supportive of H.R. 3763's restoration of investors' right to sue those who aid and abet securities fraud and its restoration of the doctrine of joint and several liability in private securities cases. In contrast H.R. 3763 has no such provisions.

The AFL-CIO believes a comprehensive approach to capital markets reform is needed to address the problems that led to Enron's collapse. While H.R. 3818 still could use some strengthening in the area of corporate governance, on the key issues of auditor independence, auditor oversight, analyst independence and investors' right to recover for losses due to fraud, the bill gets at the heart of the problem. In contrast, while H.R. 3763 has a number of positive provisions, it avoids dealing effectively with each of the central conflicts of interest at work in our capital markets.

In closing, the labor movement does not view what happened at Enron as the product of a few bad people at Enron or any other company, for that matter. While those individuals who have been given the responsibility to manage workers' and the public's money need to be held to a single high standard, we believe at the heart of what happened at Enron are systemic problems that need systemic solutions. These solutions will offend powerful interests, but they will protect America's working families. H.R. 3818 contains within it many of these necessary solutions, and has our strong support. The AFL-CIO is grateful for the opportunity to share our views with the Committee on these bills and welcomes the opportunity to continue to work with the Committee as you move forward in addressing these issues. Thank you.

Damon A. Silvers

Damon A. Silvers is an Associate General Counsel for the AFL-CIO. His responsibilities include issues involving corporate, securities and bankruptcy law, benefit fund investment policy, and mergers and acquisitions. Mr. Silvers has represented the AFL-CIO and the Trade Union Advisory Committee to the Organization for Economic Cooperation and Development at the OECD's Corporate Governance Taskforce. Mr. Silvers has testified before the Senate Commerce Committee on the collapse of Enron, before the Senate Banking Committee on corporate governance reform, before the House and Senate Judiciary Committees on bankruptcy law, the House Subcommittee on Capital Markets on securities analysts' independence, and before the House Pensions Subcommittee on ERISA reform. He was a member of the Advisory Committee on Analyst Independence to the House Capital Markets Subcommittee. He is also a member of the American Bar Association's Subcommittee on International Corporate Governance.

Prior to working for the AFL-CIO, Mr. Silvers was a law clerk at the Delaware Court of Chancery for Chancellor William T. Allen and Vice-Chancellor Bernard Balick. Mr. Silvers has previously worked in the Mergers and Acquisitions Department at Credit Suisse First Boston, for the law firm of Cravath, Swaine & Moore, the Enforcement Division of the United States Securities and Exchange Commission, Monitor Company, a management consulting firm, and in the General Counsel's office at the International Brotherhood of Teamsters. Mr. Silvers has also been the Assistant Director of the Office of Corporate and Financial Affairs for the Amalgamated Clothing and Textile Workers Union, and the Research Director for the Harvard Union of Clerical and Technical Workers, AFSCME.

Mr. Silvers received his J.D. with honors from Harvard Law School. He received his M.B.A. with high honors from Harvard Business School and is a Baker Scholar. Mr. Silvers is a graduate of Harvard College, summa cum laude, and has studied history at Kings College, Cambridge University.

Mr. Silvers is the primary author of "Challenging Wall Street's Conventional Wisdom: Defining a Worker-Owner View of Value," published in *Working Capital: The Power of Labor's Pensions*, Fung, et al. eds, Cornell University Press (2001).