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EXAMINING ENRON: THE CONSUMER IMPACT OF ENRON'S INFLUENCE ON STATE PENSION FUNDS

HEARING

BEFORE THE

SUBCOMMITTEE ON CONSUMER AFFAIRS, FOREIGN COMMERCE AND TOURISM

OF THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

MAY 16, 2002

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ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

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EXAMINING ENRON: THE CONSUMER IMPACT OF ENRON'S INFLUENCE ON STATE PENSION FUNDS

THURSDAY, MAY 16, 2002,

U.S. SENATE,
SUBCOMMITTEE ON CONSUMER AFFAIRS, FOREIGN COMMERCE AND TOURISM,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:30 p.m. in room SR–253, Russell Senate Office Building, Hon. Byron L. Dorgan, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF HON. BYRON L. DORGAN, U.S. SENATOR FROM NORTH DAKOTA

Senator DORGAN. This hearing will come to order. I'll be joined momentarily by my colleagues, Senator Nelson—I believe Senator Boxer will join us as well. But in light of the hour, I want to proceed.

I will necessarily have to absent myself for a leadership meeting, at which time Senator Nelson will take the chair, in about 40 minutes, but—Senator Nelson has just joined us, as you see.

This hearing is a continuation of a number of hearings that we have been holding discussing issues that surround the Enron Corporation. This hearing is at the request of my colleague from Florida, Senator Nelson, who, quite properly, wants an explanation about how the pension fund of Florida lost some $329 million in Enron's stock issues, more than any other public pension fund in the country, I understand.

This is a long and tortured subject. We began hearings dealing with Enron matters in—last December, I believe it was, and we'll continue to hold some hearings into June. One of the issues that has arisen is the purchase of Enron stock, even as the Enron stock was collapsing, and the cost of those purchases to the Florida pension fund and other pension funds around the country, but the largest purchase, I think, and the biggest loss was to the Florida public employee's pension fund.

Let me say that I don't have any preconceived notions or judgments about today's hearings. We're trying to understand and learn from the hearings. And I agree with my colleagues that Florida's public employees deserve to try to get some answers, and my hope is that this hearing will shed some light on some of these vexing and troubling issues.

Let me call on my colleague, Senator Nelson.

STATEMENT OF HON. BILL NELSON, U.S. SENATOR FROM FLORIDA

Senator NELSON. Mr. Chairman, what we would like to accomplish here as we have responsibility for crafting legislation to try to protect the public for the future, and here we have—the public has been harmed in the course of this whole saga, because public servants in investing their funds in a public retirement fund, those funds having severely diminished under conditions that we're going to explore. In Florida's case, taxpayers were not harmed because the Florida retirement system was, in fact, fully funded. But it was only a few years ago that the retirement fund was not fully funded, and, had the same circumstances occurred, the losses would be being borne by taxpayers not by the pensioners of the state of Florida. So that adds another dimension that is considerably important for us as we are examining what is the legislative solution to this.

So what we want to do is to get to the bottom of this and to prevent it from happening again by virtue of coming forth with legislation that would make it a lot less likely that this kind of scenario would occur again.

Thank you, Mr. Chairman.

Senator DORGAN. Senator Nelson, thank you. And the long-term goal, of course, is for us to evaluate what we're learning form this scandal. And, yes, the Enron matter is a scandal involving, in my judgment, substantial dishonesty and grand theft, in some cases.

Yesterday, for 4 hours, we heard of price fixing in California, which I expect will be the subject of a substantial criminal investigation. It appears to be not just the Enron Corporation, but they were neck deep in it. And so this issue has many tentacles, one of which deals with the losses to pension funds. And the question is: How do we legislate, or do we legislate, in ways that can provide some protection that this sort of thing will not happen again?

We have a number of witnesses today. I indicated, Senator Nelson, that I will not be able to stay for the entire hearing, but you will be chairing when I have to depart.

Mr. Glassman, welcome.

Mr. GLASSMAN. Thank you.

Senator DORGAN. Is that Dow still going to hit $30,000? Didn't you have a book—all right, then one of these days I'm going to start buying again then. I don't have a lot of money to buy with, but we'll consult privately, I guess, about that. It's nice to see you again. I haven't seen you for some while.

Others of you on the panel, thank you for being with us. I would like to begin by asking Mr. Tom Herndon, from the Florida State Board of Administrators, the executive director. He will give testimony. And I believe two of his colleagues are here, as well, to answer questions, Mr. Coleman Stipanovich and Mr. Trent Webster. Coleman Stipanovich is Florida State Board of Administrator's deputy executive director, and Trent Webster is portfolio manager of Florida State Board of Administrators.

Following that, we will hear from Mr. Bruce Calvert, CEO of Alliance Capital Management, Alfred Harrison, account manager, Alliance Capital Management, and then we will have Mr. Glassman.

And then we will have a second panel of three people: Michael Musuraca—I hope I've got that name right—American Federation of State, County, and Municipal Employees, AFSCME, Travis Plunkett, Consumer Federation of America, and Sarah Teslik, Council of Institutional Investors.

So why don't we proceed, Mr. Herndon? Your entire statement will be made a part of the record, and you may summarize for us, if you would.

STATEMENT OF TOM HERNDON, EXECUTIVE DIRECTOR, FLORIDA STATE BOARD OF ADMINISTRATION; ACCOMPANIED BY C. COLEMAN STIPANOVICH, DEPUTY EXECUTIVE DIRECTOR, FLORIDA STATE BOARD OF ADMINISTRATION; AND TRENT WEBSTER, PORTFOLIO MANAGER, FLORIDA STATE BOARD OF ADMINISTRATION

Mr. HERNDON. Thank you, Mr. Chairman, Senator Nelson. It's nice to see you. With me this afternoon, as you pointed out is Coleman Stipanovich, the deputy director of the State Board of Administration, and Trent Webster, portfolio manager on the staff of the State Board of Administration in our Domestic Equities Division. I have a brief statement, and I'd like to work through that very quickly for all three of us.

The opportunity to comment on the Enron disaster is not one that we really take any relish in. Unfortunately, Florida has the distinction of losing more money on Enron stock than any other known organization, but that is definitely not a distinction that we enjoy or we relish. Unfortunately, approximately 90 percent of the Enron losses were realized in an account managed by Alliance Capital Management. So for us at the State Board of Administration, the current situation could be more aptly called the "Alliance Disaster."

Let me give you a brief background on who we are and how we operate. The Florida State Board of Administration is the investment arm of Florida State Government, with $125 billion under management. We are governed by three trustees: the Governor, the state comptroller, and the state treasurer. We invest funds on behalf of approximately 25 government clients, with the largest being the Florida retirement system at approximately $100 billion.

We're a broadly diversified investment organization with assets in the U.S. stock market, the U.S. bond market, the international stock market, real estate, and private investments, and serve approximately 600,000 active members and approximately 200,000 retirees. Under our defined benefit plan, payments to retirees, as Senator Nelson has pointed out, are guaranteed by the employers regardless of the gains or losses in the investment portfolio.

As a quick aside, Mr. Chairman, I might add that we're currently in the midst of transitioning to a defined contribution program, 401(a), for all of our members, and that might be of some interest to the Committee at a future date when you talk about social security.

Now, back to the main issue, Alliance's Enron investments for the Florida Retirement System. Our Enron experience started in November of 2000 when Alliance first began to acquire a position in Enron. Our domestic equities unit has 14 outside managers who

are charged with exercising their expertise to select sound investments for our portfolio. Alliance is one of those 14 managers. These investment firms are given full discretion by contract and are paid a handsome fee for the diligent deployment of their resources and expertise. In this case, the lion's share, by far, of our Enron position was acquired by Alliance Capital Management, and specifically their Minneapolis-based large-cap growth investment team headed by Mr. Harrison.

Alliance's contract with the Florida SBA recognizes Alliance's fiduciary duties and committed it to certain investment protocols, including the obligation to perform rigorous company-specific research. In this case, however, Mr. Harrison and Alliance failed to meet their obligations under our investment advisory agreement. Alliance's Enron purchases ultimately caused a principal loss of $280 million to the Florida Retirement System, and we believe Alliance was negligent in its job performance. As a result, we have filed litigation against Alliance to recover our losses, and a copy of that complaint has been furnished to the Committee.

We've all read stories about the inadequacy of Enron's financial disclosures and conflicts of interest at Enron as well as the conflicts that exist generally in the financial markets. While these subjects are worthy of your investigation, any investigative action you undertake should not allow financial professionals such as Alliance to shift the blame for their own negligence to the corporations in which they invest. As detailed in our complaint, sufficient Enron information as publicly available to inform a sophisticated investment manager such as Alliance of the extreme risks of Enron investments. Remember, before Alliance even invested in Enron, the footnotes of Enron's financial statement disclosed the supposedly, quote/unquote, "secret partnerships" controlled by Andrew Fastow. Sadly, Mr. Harrison has admitted, quote, "nobody ever really dug into the footnotes," unquote.

Our concerns about Alliance's investments in Enron coincided with our broader concerns about Alliance's performance for the Florida Retirement System. Alliance had suffered a period of poor performance unrelated to and before Enron investments began. In calendar year 2000, we had put Alliance on a watch list where they stayed until terminated in December of 2001. Throughout this period, in spite of continuing red flags that were raised associated with Enron's death spiral, the Alliance investment team continued to buy Enron stock in an accelerated fashion. And all of this is detailed in the court complaint.

You will note that Alliance kept buying, even though the Enron news was getting worse and worse. As we've observed the Enron investments being made, we assumed, to our detriment, that Alliance was conducting the, quote, "rigorous company-specific research" they had promised. When we questioned Alliance about the Enron purchases, we were assured of this fact. It is now clear to us that Alliance was buying Enron on faith, not on research.

However, this hearing is not the place to try the case. That'll be done later on in the court. Rather, the Committee's invitation to this hearing stated that the scope of your inquiry is focused on the practice of Enron officials contacting pension funds or institutional investors in order to tout Enron stock. We have no information to

offer on that subject. We at the Florida State Board of Administration we were never contacted by Enron officials. We were informed by Mr. Harrison that he and members of the Alliance team met with high-ranking Enron officials, and we understand that such contacts are routine between money managers and corporate officials. They're certainly not unique to Enron or Alliance. However, we at the State Board of Administration have no direct knowledge about what was discussed between Enron and Alliance or if these discussions were in any way different than those which commonly take place in the industry.

Much has been written about the conflicts of interest that surround Enron and Alliance, most notably, Mr. Frank Savage, who was an Enron board member and, in fact, on the finance committee that approved the off-balance-sheet partnerships and waived the conflicts of interest, and also served as a senior officer and board member of Alliance. We've been assured by Alliance that this was a conflict without consequences. Because the effects of Mr. Savage's conflicts are unclear to us at this time, our lawsuit against Alliance currently makes no claims relating to Mr. Savage's conflicts of interest.

We understand that this committee or others in Congress are investigating conflicts in the investment industry. While we encourage a thorough review of this conflict practices, as a governmental body, the Florida SBA does not engage in the types of practices now under investigation. But clearly one lesson that needs to be learned from this experience is that conflicts of interest in the public financial marketplace should be at least fully and openly disclosed. And some conflicts of interest should be prohibited altogether. Investment firms should install and enforce policies that prohibit investment firm employees from serving on boards of directors of firms they analyze. Just as it is inappropriate for accounting firms to be auditors and consultants, or for investment bankers to not public analytical reports on firm clients, it is inappropriate that the board members of investment firms be on the boards of companies whose stock they are recommending and buying. There is simply too much opportunity for the wrong kind of alignment of interest.

In closing, I've tried to highlight what happened to us as a pension fund as a result of the negligence on the part of Alliance Capital Management. As long as pension funds have active portfolio management, the pension industry must be able to rely on and fully trust expert outside financial advisors to exercise their fiduciary duty based upon independent research which is not compromised by conflicts of interest. Any actions you can take to ensure the integrity of the research and investment activities from Wall Street firms like Alliance Capital would be most worthwhile.

Thank you for your attention, and we'll be happy to answer any questions.

[The prepared statement of Mr. Herndon follows:]

PREPARED STATEMENT OF TOM HERNDON, EXECUTIVE DIRECTOR, FLORIDA STATE BOARD OF ADMINISTRATION; ACCOMPANIED BY C. COLEMAN STIPANOVICH, DEPUTY EXECUTIVE DIRECTOR, FLORIDA STATE BOARD OF ADMINISTRATION; AND TRENT WEBSTER, PORTFOLIO MANAGER, FLORIDA STATE BOARD OF ADMINISTRATION

Thank you for this opportunity to comment on the "Enron disaster" and its implications for Florida State Board of Administration ("Florida SBA") and other pension funds. The Florida SBA has a unique distinction in this situation, namely, that we lost more money on Enron stock than any other known organization. I can assure you that this is not a distinction that we relish. Approximately 90 percent of our Enron losses were realized in an account managed by Alliance Capital Management. So, for us at the Florida SBA, the current situation could more aptly be called "the Alliance disaster."

Let me give you a brief background on who we are and how we operate. Briefly, the Florida SBA is the investment arm of Florida State government, with $125 billion under management. The Florida SBA is governed by three members of the Florida Cabinet—the Governor, the Comptroller and the Treasurer. We invest the funds of approximately 25 government clients, with the largest being the Florida Retirement System at approximately $100 billion. We are a broadly diversified investment organization with assets in the U.S. stock market, U.S. bond market, international stock market, real estate and private investments. The Florida Retirement System serves approximately 600,000 active members and 200,000 retirees. Under our defined benefits plan, payments due to retirees are guaranteed regardless of the gains or losses in the investment portfolio.

As a quick aside, I might add that we are currently in the midst of transitioning to a new Defined Contribution program, which might be of interest to the Committee members at the point in time that you discuss privatizing Social Security.

Now, back to the main issue at hand—Alliance's Enron investments for the Florida Retirement System. Our Enron experience in Florida started in November, 2000 when Alliance first began to acquire a position in Enron. Our Domestic Equities unit has 14 outside money managers who are charged with exercising their expertise to select sound investments for our portfolio. Alliance was one of those 14 managers. These investment firms are given full discretion by contract, and are paid a handsome fee for the diligent deployment of their resources and expertise. In this case, the lion's share, by far, of our Enron position was acquired by Alliance Capital Management, and specifically their Minneapolis based large cap growth investment team headed by Al Harrison. Alliance's contract with the Florida SBA recognized Alliance's fiduciary duties and committed it to certain investment protocols, including the obligation to perform "rigorous company-specific research."

In this case, however, Mr. Harrison and Alliance failed to meet their obligations under our investment advisory agreement. Alliance's Enron purchases ultimately caused a principal loss of over $280,000,000 to the Florida Retirement System. We believe Alliance was negligent in its job performance. As a result, we have filed litigation against Alliance to recover our losses. A copy of our Complaint has been furnished to this Committee as an attachment to a copy of this statement.

We have all read stories about the inadequacy of Enron's financial disclosures, conflicts of interest at Enron as well as conflicts, which exist generally in the financial markets. While these subjects are worthy of your investigation, any investigative action you undertake should not allow financial professionals such as Alliance to shift the blame for their own negligence to the corporations in which they invest. As detailed in our Complaint, sufficient Enron information was publicly available to inform a sophisticated investment manager such as Alliance of the extreme risks of Enron investments. Remember, before Alliance even invested in Enron, the footnotes of Enron's financial statements disclosed the supposedly "secret" partnerships controlled by Andrew Fastow. Sadly, Mr. Harrison has admitted, "nobody ever really dug into the footnotes."

Our concerns about Alliance's investments in Enron coincided with our broader concern about Alliance's performance for the Florida Retirement System. Alliance had suffered a period of poor performance unrelated to and before the Enron investments began. In 2000, we had put Alliance on a "watch list" where they stayed until terminated in December 2001. Throughout this period, in spite of continuing "red flags" that were raised associated with Enron's death spiral, the Alliance investment team continued to buy Enron stock in an accelerated fashion. All of this is detailed in the Court Complaint, which we have furnished to you. You will note that Alliance kept buying, even though the Enron news was getting worse each day.

As we observed the Enron investments being made, we assumed, to our detriment, that Alliance was conducting the "rigorous company specific research" they had promised. When we questioned Alliance about the Enron purchases, we were

assured of this fact. It is now clear to us that Alliance was buying Enron on "faith"—not on research. However, this hearing is not the place to try our case; that will be done later in court.

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Much has been written about the conflicts of interest that surround Enron and Alliance, most notably, Mr. Frank Savage, who was an Enron Board Member (in fact on the Finance Committee) while also serving as a senior officer and board member of Alliance. We have been assured by Alliance that this was a conflict without consequences. Because the effects of Mr. Savage's conflicts are unclear to us at this time, our lawsuit against Alliance currently makes no claims relating to Mr. Savage's conflicts of interest. We understand that this Committee, or others in Congress, are investigating conflicts in the investment industry. While we encourage a thorough review of these conflict practices, as a governmental body, the Florida SBA does not engage in the types of practices now under investigation.

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In closing, I've tried to highlight what happened to us as a pension fund as a result of negligence on the part of Alliance Capital Management. As long as pension funds have active portfolio management, the pension industry must be able to rely on and fully trust expert outside financial advisors to exercise their fiduciary duties based upon independent research which is not compromised by conflicts of interest. Any actions you can take to ensure the integrity of the research and investment activities from Wall Street firms like Alliance Capital would be most worthwhile. Thank you for your attention, and I am happy to answer any questions.

Senator DORGAN. Mr. Herndon, thank you very much. I understand Mr. Stipanovich and Mr. Webster are here to answer questions, but you do not have a statement.

Let me ask to have the testimony from Alliance next, and then we will ask some questions and then have the testimony of Mr. Glassman from this panel.

Mr. Calvert, how would you like to proceed? Do you and Mr. Harrison both have a statement, or do you have a statement on——

Mr. CALVERT. Yes, Mr. Chairman, we do.

Senator DORGAN. All right. Why don't you proceed, and your entire statement will be made a part of the permanent record.

STATEMENT OF BRUCE W. CALVERT, CHAIRMAN AND CEO, ALLIANCE CAPITAL MANAGEMENT

Mr. CALVERT. Thank you, Mr. Chairman, Senator Nelson. Would it be all right if we just switched chairs here for——

Senator DORGAN. Let me note that the Ranking Member of the full Committee has just joined us, Senator McCain, and I've asked if he has an opening statement. He does not. So we will proceed, Mr. Harrison, with your testimony.

Mr. CALVERT. Good morning. My name is Bruce Calvert, and I'm the chairman and chief executive officer of Alliance Capital Management, which is an investment management company. With me today is Al Harrison, vice chairman of Alliance Capital Management.

Mr. Harrison is among the most highly regarded and well-respected managers in the industry. Over the last 30 years, he has developed a superb investment record and also a well-deserved reputation for honesty and integrity. As many of you know, Mr. Harrison purchased Enron stock on behalf of a number of Alliance clients. He will address some of the reasons why he made these investments, including his reliance on the statements made to him by Enron's management, statements that we now know to be untrue. But first, some background.

Alliance is one of the world's largest investment managers. Investment management and research is our only business. We manage approximately $450 billion for a global clientele: institutions and individuals directly and through a family of mutual funds. For example, we manage money for 45 of the Fortune 100 companies, and we manage money for public retirement systems in 43 of the 50 states.

Our interests are directly tied to the interests of our clients. Alliance is paid advisory fees based on the assets it manages for each account. Simply stated, when we buy securities or make investments that appreciate in value, our revenues increase. Conversely, if we make investments that decline or depreciate in value, our revenues decline proportionately. We do not earn investment banking fees, nor do we trade for our own account. We prosper when our clients prosper.

Alliance offers a broad range of investment services to meet the diverse needs of our clients. Today I'm going to focus on our large-cap growth product, Al Harrison's team, which consists of 25 portfolio managers, each of whom manages accounts in accordance with the team's philosophy and investment process. Each of these managers is also involved in researching potential investment candidates. The team is supported by Alliance's investment research organization. Some 320 analysts cover companies throughout the world. Each analyst is assigned a limited number of companies in the same or related industries so that they can develop a focused expertise.

I would now like to turn to our investment in Enron. The decision to invest in Enron was based on extensive research into Enron's business, its growth prospects, and the company's fundamentals, importantly, always in relationship to the price of the shares. I believe the judgment of Alliance's investment professionals with respect to Enron was entirely reasonable based on the information available to them at the time. Of course, we would have acted differently based on the information that we have today, but this information was hidden from us.

While we deeply regret having invested in Enron, the root problem rests not with the judgment of our portfolio managers, but with Enron itself. I believe that the blame for the collapse of Enron and the resulting loss to countless investors lay with Enron's management and its officers who we now—and I emphasize "now"—

know were on a course to deliberately mislead the investors, analysts, rating agencies, and others.

I believe that meetings with management are a crucial part of the investment decisionmaking process. At Alliance, these meetings are serious and substantive. Our researchers and portfolio managers had many such meetings with Enron. During these meetings, senior members of Enron management misrepresented numerous material facts. Mr. Harrison can elaborate on some of these misrepresentations, and I will leave that subject matter to him.

But we also know that others were misled. For example, a representative from Standard and Poor's testified that far from providing anything like complete, timely, and reliable information, Enron committed multiple acts of deceit and fraud, just as it did to many others with whom Enron dealt. Significantly, under federal securities laws, Standard and Poor's enjoys preferred access to Enron's books, access that investment advisors, such as Alliance, do not enjoy. Despite this preferred access, Standard and Poor's were still unaware of Enron's fraud and continued to rate Enron's credit investment grade until November 28th, 2001, more than 2 weeks after Alliance's last purchase of Enron.

Many other investors were similarly deceived. Press reports have confirmed that a number of money managers invested in Enron in October and November. Moreover, hundreds of millions of shares—hundreds of millions of shares—traded in October and November. As Alliance's purchases represented only a very tiny fraction of these trades, it is clear that many others were buying Enron at what they perceived to be very attractive prices.

It has been reported in the press that, excluding Florida, at least 5 state pension funds lost more than $100 million in Enron stock. Alliance did not make the Enron investments for these funds. Other investment managers had been similarly misled.

The truth is this. If a management of a corporation is bent on deceiving the investment public, and if they are vetted by a major auditing firm in that enterprise, it is very difficult for investment professionals to discern the truth. This is the case even where those investment professionals performed extensive research, as Alliance did with Enron.

If I may, I'd like to just address one final issue relating to Frank Savage, a director of Alliance Capital. Until July, Mr. Savage was also an employee of Alliance with responsibility for sales and marketing in the Middle East and Africa. He did not have investment responsibilities. Mr. Savage also served on the board of directors of Enron, beginning in mid October 1999.

Mr. Savage joined the Enron board at Enron's request and his service was personal to him. Alliance did not ask Mr. Savage to serve on the Enron board, nor did he so as a representative of Alliance. Alliance permitted him to join the board only after he had agreed to comply with our policies governing employee service on unaffiliated boards which, among other things, required that he be walled off from any discussion with Alliance personnel concerning investments in Enron. Mr. Savage re-certified his compliance with these policies annually thereafter.

To be perfectly clear, Mr. Savage never participated directly or indirectly in any decisions by Alliance to buy, hold, or sell Enron

stock, and his membership on the Enron board had nothing to do with those investments. There was, in fact, no conflict.

Thank you.

[The prepared statement of Mr. Calvert follows:]

PREPARED STATEMENT OF BRUCE W. CALVERT, CHAIRMAN AND CEO, ALLIANCE CAPITAL MANAGEMENT

Good morning Mr. Chairman and Members of the Subcommittee. My name is Bruce Calvert and I am the Chairman and Chief Executive Officer of the investment management firm Alliance Capital Management ("Alliance Capital"). I have been with the firm for nearly thirty years, during which time I served as Chief Investment Officer, Director of Equity Research and an active equity portfolio manager. I would like to thank the Subcommittee for the opportunity to appear before you to discuss Alliance Capital's investments in Enron Corporation ("Enron").

I am appearing with Alfred Harrison, a Vice Chairman of Alliance Capital and its most senior portfolio manager. Mr. Harrison is not only one of Alliance Capital's best managers, he is among the most highly regarded and well-respected managers in the entire industry. Over the last thirty years, he has developed one of the most successful investment track records, and also a well-deserved reputation for honesty and integrity. As many of you know, Mr. Harrison purchased Enron stock on behalf of a number of Alliance Capital's clients, and he can address some of the reasons why he made those investments, including his reliance on the statements made to him by Enron's management—statements that we now know to have been untrue.

Alliance Capital is one of the world's largest investment managers. Investment management and research is our only business. Alliance Capital provides a wide range of investment management services to a diverse group of investors worldwide, including U.S. pension plans, institutional investors and high-net-worth individuals. For example, Alliance Capital has been selected to manage money for 45 of the Fortune 100 companies, public retirement systems in 43 of the 50 states, as well as by foundations, endowments, central banks and other global institutions. Alliance Capital is also one of the largest mutual fund sponsors, with a diverse family of globally distributed mutual fund portfolios. As of March 31, 2001, Alliance Capital's total assets under management were approximately $452 billion.

Significantly, Alliance Capital's revenue is directly tied to achieving positive performance for its clients. For its investment management services, Alliance Capital is paid advisory fees based on a percentage of the net assets it manages for each account. This fee structure is important in looking at Alliance Capital's incentives with respect to the investments it made in Enron on behalf of its clients. Because its investment management revenue is based on a percentage of assets under management, if Alliance Capital invests in a company whose stock drops in value, its advisory fees will drop proportionately.

You should also know that Alliance Capital offers its clients multiple products. Our clients have greatly varying needs, and in response to those needs, we offer a full range of investment disciplines. In broad terms, we offer growth equities, value equities and fixed income. Within these broad categories, we offer more specific services. In growth equity, we offer such products as large-cap growth, mid and small-cap growth, international growth and others. A product wheel identifying these many offerings is attached to my statement as Exhibit A.

Of the broad spectrum of investment disciplines Alliance Capital offers, I am going to talk today about our Large Capitalization Growth product. Alliance Capital's large cap growth team is headed by Alfred Harrison. The team consists of portfolio managers and investment professionals based in Minneapolis, Chicago and Cleveland, all of whom are responsible for managing accounts pursuant to a large capitalization growth investment strategy. Collectively, these managers use their independent knowledge and experience to research potential investment candidates. These portfolio managers work as a team, and very often, but by no means always, invest in the same securities. Although there will typically be a broad degree of overlap in the holdings of the large cap growth portfolio managers, each portfolio manager does have a meaningful degree of individual discretion with respect to portfolio composition, and it would be unusual to see two portfolio managers have identical holdings in their portfolios.

It is critically important to understand that Alliance Capital is a research-driven organization. We have more than 320 analysts covering a broad universe of companies throughout the world organized into growth, value and fixed income teams. The number of analysts is important because it permits us to assign each analyst to a specific industry sector with a limited number of companies to follow so that the

analysts can develop a depth of knowledge about the companies they follow. We often assign multiple analysts to cover a single company from different viewpoints, such as equity and fixed income. The sole purpose of these analysts is to assist in improving performance of client accounts. That is how we grow our revenues. We do not earn investment banking fees, nor do we engage in trading for our own account.

With that background, I would like to turn to Alliance Capital's investments in Enron. The decision to invest in Enron was based on extensive research by the Alliance Capital research and portfolio management team into Enron's business, its growth prospects, and the company's fundamentals in relation to the price of its shares. Without question, I believe that the judgment of Alliance Capital's investment professionals with respect to Enron was entirely reasonable based on the information available to them at the time. We at Alliance Capital deeply regret having invested in Enron, but the root of the problem rests not with the judgment of our portfolio managers, but with Enron itself. That is, I believe the blame for the collapse of Enron and the resulting loss to countless investors lay with Enron's management and its auditors, who now appear to have been on a course to deliberately mislead investors, analysts, rating agencies and others.

I understand that Alliance Capital's research and portfolio management team had many meetings and conversations with Enron management to discuss Enron's business. Based on my years of experience, I believe that meetings with management are a very important part of the investment decision-making process. These meetings tend to be serious and substantive.

In the course of Alliance Capital's meetings with Enron, senior members of Enron management misrepresented numerous material facts. Mr. Harrison can elaborate on some of those misrepresentations, and I will leave that subject matter to him. But we do know, based at least in part on the testimony before this Subcommittee and other Senate Committees, that many others were similarly deceived by Enron and its management.

For example, a representative from Standard & Poor's testified that Enron failed to disclose that certain Enron insiders had a financial stake in Enron's off-balance-sheet partnerships and failed to disclose the nature of compensation that was paid to Enron's CFO in connection with these partnerships. Specifically, he testified that "far from providing anything like complete, timely and reliable information to Standard & Poor's, [Enron] committed multiple acts of deceit and fraud on Standard & Poor's, just as it did to many others with whom Enron dealt." Significantly, under federal securities laws, Standard & Poor's enjoyed preferred access to Enron's books, records and financial condition—access that investment advisors such as Alliance Capital do not enjoy. Despite this preferred access, Standard & Poor's was still unaware of Enron's fraud and continued to rate Enron's credit as investment grade until November 28, 2001, almost two weeks after Alliance Capital's last purchase of Enron stock.

Similarly, an analyst for Credit Suisse First Boston stated that the "inaccuracies and lack of information in Enron's financial reporting affected [his] conclusions and ratings on Enron." He explained that "[i]f the information a company provides is incomplete, incorrect or misleading, [his] analysis will be undermined." Obviously, we concur with this statement.

As I have said, it is plain that many institutions and private investors relied on the statements of Enron management and the company's audited financials. At this point, it is not clear which institutions were investing in Enron in the fourth quarter of 2001, but certainly many firms bought Enron stock during this time. Press reports have confirmed that a number of money managers invested in Enron in October and November on behalf of public pension funds. Moreover, there were many millions of shares being traded each day in October and November, and in some cases, hundreds of millions of shares. As Alliance Capital's purchases represented only a minor fraction of these trades, it is clear that many others were buying Enron in large quantities at what they believed to be bargain prices. And many investors who did not buy Enron during this time period still owned substantial quantities they previously purchased, but did not sell. It has been reported in the press that, excluding Florida, at least 5 state pension funds each lost more than $100 million in Enron stock. (Alliance Capital did not make the Enron investments for those funds.)

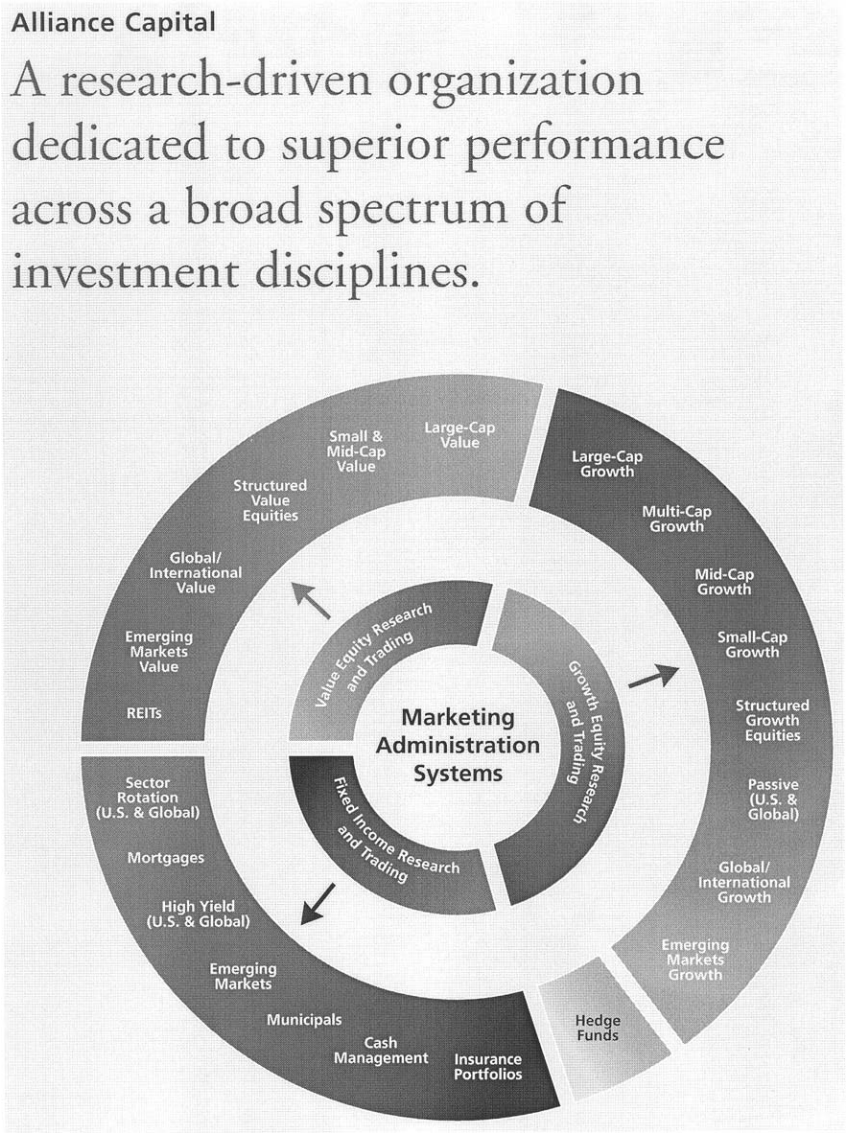
These large and widespread losses underscore one unfortunate fact—that as a general matter, if management of a corporation is bent on deceiving the investing public, and they are abetted by a major auditing firm, it is very difficult for investment professionals to discern the truth. This is the case even where those investment professionals perform extensive research into the company's business, as Alliance Capital did with Enron.

I would also like to take the opportunity to address one final issue relating to Frank Savage, a director of Alliance Capital Management Corporation, the general partner of Alliance Capital. Until the end of July of 2001, Mr. Savage was an employee of Alliance Capital, with responsibility for sales and marketing in the Middle East and Africa.

Mr. Savage also served on the board of directors of Enron beginning in mid-October 1999. Mr. Savage joined the Enron board at Enron's request, and his service was personal to him. Alliance Capital did not ask Mr. Savage to serve on the Enron board, nor did he do so as a representative of Alliance Capital. Alliance Capital permitted him to join the Enron board only after he had agreed in writing to comply with Alliance's policies governing employee service on unaffiliated boards, which among things required that he be "walled off" from any discussion with Alliance Capital personnel concerning investments in Enron. Mr. Savage re-certified his compliance with those policies annually thereafter. To be perfectly clear, Mr. Savage never participated directly or indirectly in any decisions by Alliance to buy, hold or sell Enron stock, and his membership on the Enron board had nothing to do with those investments.

Thank you, Mr. Chairman. I appreciate the opportunity to answer any questions the Subcommittee might have.

Exhibit A



Senator DORGAN. Mr. Calvert, thank you very much.

Mr. Harrison, you may proceed.

STATEMENT OF ALFRED HARRISON, VICE CHAIRMAN, ALLIANCE CAPITAL MANAGEMENT

Mr. HARRISON. Good afternoon, Mr. Chairman and Members of the Subcommittee, and thank you for the opportunity to appear here today to discuss events related to Enron. My name is Alfred

Harrison, and I'm a vice chairman of Alliance Capital Management. I also lead the large capitalization growth team, which has over $50 billion in assets under management.

For 17 years, I have been responsible for managing the Florida State Board of Administration account. During that time, the account grew from an initial funding of $50 million in 1984 and subsequent contributions of $294 million to more than $3.6 billion in assets, a total return of over 1500 percent, versus comparative returns for the S&P 500 of 978 percent, the Russell 1000 growth index of 863 percent, and 843 percent for a benchmark unique to Florida. Even allowing for the $280 million loss on Enron and all fees paid to Alliance Capital by the SBA, this means that we added more than $1 billion to the account than would have been achieved by indexing in any benchmark. I believe the pensioners of Florida would be very pleased with this result.

Our investment philosophy centers on using intensive research to find the correct balance between a company's fundamentals, on the one hand, and using judgment to assess its price. We call this the "V factor." It sometimes means buying a stock into a price period of weakness if we believe it underprices a company's long-term core earnings power. We've followed this buy-low/sell-high methodology on many successful occasions benefiting the fund by several hundreds millions of dollars.

If I could just interject here, painful though it is, I bought the airlines stocks immediately—the market opened after September the 11th and made a very strong recovery in price as a result of that.

My original investment in Enron was in November 2000. Its reported annual earnings were growing at 25 to 35 percent at a time when technology stocks were beginning to collapse. Enron's reported growth stood out by comparison.

I have been asked how I viewed Jeff Skilling's departure on August the 14th. My colleagues and I considered the return of Ken Lay and the promise of openness and a commitment to get rid of non-core assets as a positive. We met with Ken Lay and colleagues in Minneapolis on August the 21st and intensively questioned them all. On October the 16th, the company took a one-time charge in writing off its investment in failed entities such as broadband, but noted that its quarterly recurring earnings increased by 26 percent on the core business. They also took a $1.2 billion equity writeoff for losses incurred in a partnership, but took back from Enron shares that had been pledged as collateral to that partnership. The next day, I and six members of Alliance Capital from Minneapolis and New York on both the equity and fixed income sides met with the entire Enron team in New York. We concluded that Enron's core business was still intact.

Senator DORGAN. Excuse me. What date was that?

Mr. HARRISON. That was October the 17th, sir.

We concluded that Enron's core business was still intact and that Ken Lay was doing what he had promised in terms of acknowledging past investment mistakes and clearing the decks.

Senator DORGAN. Mr. Harrison, excuse me for interrupting again. Did that include Mr. Lay and Mr. Fastow?

Mr. HARRISON. No. Mr. Fastow was not there at that meeting. Just Mr. Lay, CEO Greg Whalley, Executive Vice President Mark Koenig, Jeff McMahon, the treasurer, and Paula Rieker, investor relations.

Senator DORGAN. Thank you.

Mr. HARRISON. Enron's management insisted that it had completely unwound its relationship with the partnership and that everything was now out in the open. He insisted that no further negatives would be revealed. Based in part on the false reassurances directly from the most senior levels of Enron management, we continued to add to our Enron positions in the ensuing price weakness.

On November the 9th, Dynegy made a bid for Enron, which seemed to validate our confidence in its core operations. The bid was backed by $1.5 billion from Chevron Texaco, who owned 27 percent of Dynegy. This was like Avis making a bid for Hertz.

We met with Dynegy management, who had seen Enron's book. We met them in New York, Chicago, and Minneapolis in the next few days and were convinced that the resulting company could be a powerhouse, assuming regulatory approval. We bought more Enron stock, around $9 a share. Since the SBA gets daily electronic transmission of all of our trades, they are aware of these purchases. Unfortunately, Dynegy withdrew their offer in late November when the rating agencies downgraded Enron's debt two notches to junk status and bankruptcy was imminent, as we sold our shares.

Let me stress that only a little over 10 percent of my dollar investments in Enron took place in October and November before this bankruptcy. Throughout our ownership of Enron, our analysts on my team researched the company extensively, met with management over a several-year period. We talked with Wall Street energy traders, suppliers, and the rating agencies, amongst many others. Unfortunately, we know now that Enron was a massive fraud. Its audited financial statements were misleading and grossly incomplete. We, along with other investors, suffered greatly as a consequence.

Before closing, let me also address the subject of Frank Savage, who served on the board of Alliance Capital's general partners and who, until the end of July 2001, was an Alliance Capital employee. Let me say emphatically that I did not discuss Enron with Mr. Savage, and he played no part in my decisions on Enron.

I would be happy to answer your questions.

[The prepared statement of Mr. Harrison follows:]

PREPARED STATEMENT OF ALFRED HARRISON, VICE CHAIRMAN, ALLIANCE CAPITAL MANAGEMENT

Good morning Mr. Chairman and Members of the Subcommittee, and thank you for the opportunity to appear here today to discuss events related to Enron Corporation ("Enron").

My name is Alfred Harrison and I am the Vice Chairman of Alliance Capital Management ("Alliance Capital"). I also lead the large capitalization growth team at Alliance Capital with over $50 billion in total assets under management.

For seventeen years, I have been the portfolio manager with ultimate responsibility for managing the account of the Florida State Board of Administration ("SBA"), the state agency charged with responsibility for managing Florida's public pension fund. During the 17 years that I managed the SBA portfolio, we grew the account from $344 million in contributions to more than $3.6 billion in assets—a

total return of approximately 1,500 percent versus comparative returns for the S&P 500 Index of 978 percent, the Russell 1000 Growth Index of 863 percent and the benchmark selected by Florida itself of 843 percent—even allowing for the approximately $280 million loss on Enron and all fees paid to Alliance Capital by the SBA.

This means that Alliance Capital achieved a return for the SBA account of more than $1 billion more than would have been achieved by investing in any index benchmark during that period. I believe the pensioners of Florida should be very pleased with this result.

Our investment philosophy, which has been consistently applied, involves finding the correct marriage between Fundamentals as they relate to each company—which is a product of intensive research—and then applying a Price judgment in relation to the facts we ascertain. We call this the "V factor".

Enron appeared to have many of the qualities we look for in a growth stock. For example, when I originally invested in Enron in November 2000, it was the seventh largest U.S. company, with a dominant market position in the newly deregulated area of gas and electricity distribution and trading. It had reported annual earnings growth of 25 percent–35 percent. Enron's management had been widely heralded as among the brightest and most visionary management teams in the world.

Although market opinion is never unanimous about a company's business and prospects, Enron, because of its dominant position, was widely held by institutional investors, including many of the largest fund managers in the country. That notwithstanding, some have criticized my additional purchases of Enron stock in the months before Enron's bankruptcy. Overall, a little over 10 percent of my dollar investment in Enron on behalf of the SBA took place in October and November of 2001 before Enron declared bankruptcy.

A key element of our "V" factor" investment philosophy is to opportunistically add to a position in a stock that is declining in price if the company's core earnings power is projected to remain intact. This philosophy is clearly stated in the investment advisory agreement between Alliance Capital and the SBA, and has worked with enormous success for the SBA and many other clients over the years.

When Enron's stock came under price pressure but its fundamental business appeared to remain intact, the stock appeared to be attractive consistent with the "V" philosophy. That is, Alliance Capital's purchases were based on the belief that the magnitude of the adverse developments was more than discounted in the stock price and that Enron's assets and long-term earnings power were undervalued. Again, this is a time-tested investment strategy that Alliance has applied consistently over the last two decades to achieve the outstanding results it has for the SBA and its other clients.

I have been asked how I viewed the August 14, 2001 resignation of Enron's then-CEO Jeffrey Skilling. At the time, we viewed Kenneth Lay's return as CEO to be a positive development given his promise of openness and a commitment that Enron would shed non-core assets and focus upon its core business lines. Upon learning of Skilling's departure, I and my colleagues immediately arranged for a meeting with Lay, which was held in Alliance Capital's Minneapolis offices on August 21, 2001. At that meeting, we had a very detailed discussion about Enron's business, and our questions appeared to have been answered in a complete and satisfactory manner.

On October 16, 2001 Enron reported its third-quarter results and a surprising $1.2 billion reduction in shareholder equity. The very next day, I and my colleagues, including a number of portfolio managers, our equity analyst, our fixed income analysts and our oil analyst, met in New York with Ken Lay, COO Greg Whalley, Treasurer Jeff McMahon, Executive Vice President Mark Koenig and Paula Rieker, from Investor Relations. The Enron group represented to us that the reduction of shareholder equity was offset by Enron's buyback of stock pledged to a partnership, and that the write-off was equivalent to the company's repurchasing the shares in the open market. Enron's management insisted it had completely unwound its relationship with the partnership and that everything was now out in the open. As we now know, these and other representations were patently false. Even with the few special purpose entities that did come to light, crucial facts were withheld about the structure and insider relationships with Enron management.

Based in part on the false reassurances directly from the most senior levels of Enron management, in the four weeks following October 16, Alliance Capital added to the SBA's Enron position.

Some of these additional purchases were made shortly after November 9, when Dynegy, with a $1.5 billion dollars cash commitment from ChevronTexaco, announced its intention to merge with Enron. Based on the fixed exchange rate stipulated in the proposed merger agreement between Dynegy and Enron, Enron was trading at a large discount to its indicated exchange value. Moreover, we saw the

new combined entity as offering strong appreciation potential. Before investing, Alliance Capital discussed the proposed deal with Dynegy management in the week following the merger announcement. We met with Dynegy management in New York, Chicago and Minneapolis. Dynegy stated that it was confident that the merger would be completed. Specifically, Dynegy's management stated that, based on their due diligence and their extensive experience in the business, Enron's books appeared to be in order and confirmed that Enron's core energy business was very strong. Market analysts around the country also generally believed that the deal would close, and that the deal presented a strong upside for Enron shareholders. Again, consistent with the "V" philosophy, I added to the Enron position around $9 per share.

Alliance Capital's research was critical to all these decisions. Typically, I select stocks for investment using judgment, experience, and research by our analysts and my team of portfolio managers. In the case of Enron, that research included many meetings and calls with Enron's senior management. It included a review of Enron's public filings, audited financial statements and press releases. It included detailed discussions with Enron's suppliers, customers and competitors. It included following Enron's credit ratings, discussing Enron with the credit rating agencies, following energy industry developments, attending major industry conferences, utilizing the expertise of sell-side analysts that followed Enron, and analyzing Enron's apparent debt load.

In my experience, one of the most crucial aspects of Alliance Capital's research and evaluation process is speaking with a company's management team. The last year's events notwithstanding, I have found that management almost invariably provides an accurate picture of the company's business. They are of course obligated by law to do so. Unfortunately with Enron, this was not the case. As I have said, I and other portfolio managers and analysts on the Alliance Capital team met and spoke with Enron management repeatedly throughout 2001, and their answers to our questions were false and misleading in significant respects.

We now know, of course, that Alliance Capital was not the only investment advisor or investor misled by Enron. Based upon published reports, it appears that the SBA lost as much as $50 million as a result of other investment advisers' investments in Enron, or in index funds managed by the SBA itself. Many thousands of other investors suffered losses in Enron, ranging from a few dollars to well over $150 million dollars. Indeed, it has been reported that apart from the SBA, 5 state pension funds each lost at least $100 million in Enron. (Alliance Capital did not make those Enron investments).

And while we never rely uncritically on the opinions of sell-side analysts affiliated with other firms, often the substance of the information they convey, as well as their opinions, are helpful to our analysis. It is interesting to note that throughout October and November 2001, many sell-side analysts continued to rate Enron a buy or strong buy. Goldman Sachs, J.P. Morgan, Lehman Brothers, Salomon Smith Barney, UBS Warburg, Merrill Lynch, CIBC Oppenheimer and CS First Boston were among the major firms that continued to recommend Enron as an attractive stock. We consulted a number of these institutions whose analysis of Enron appears to have been wrong-footed by Enron's misinformation.

Alliance Capital also consulted Standard & Poor's regarding its credit ratings of Enron. Credit rating agencies can serve as a significant source of information about a company, as the agencies enjoy unrivalled access to a company's books and records under the securities laws that investment advisers such as Alliance Capital do not have. Unfortunately, Standard & Poor's has publicly confirmed that, despite its privileged position, it too was deliberately misled by Enron.

I have managed money for institutional and private investors for forty years, and I have always taken my responsibilities very seriously. Part of this responsibility involves exercising judgment in selecting stocks for my clients. In the case of Enron, that judgment was impaired by false and misleading information from Enron and its auditors Arthur Andersen. The truth is, Enron may be the single largest, most far-reaching episode of corporate fraud of this century, and a great number of portfolio managers around the country were likely misled, just as Alliance Capital was.

Finally, I want to address a question that has been raised concerning Frank Savage, who served on the board of Alliance Capital's general partner and who, until the end of July 2001, was an Alliance Capital employee. Let me say emphatically that I have never discussed Enron with Mr. Savage, and he played no part with my Enron decisions.

I welcome any questions the Subcommittee may have regarding these matters.

Senator DORGAN. Mr. Harrison, thank you very much.

I'm not quite sure where to start here, except that the public employees pension fund in Florida lost $300-and-some million, and I think, Mr. Herndon, you say it really wasn't your fault. Mr. Calvert and Mr. Harrison, you say it wasn't yours. And I think what you're saying is that you were lied to and misled by the Enron Corporation. You did due—you say you did due diligence, but the deception by the Enron Corporation caused you to do things. The result is that caused the Florida pension fund to experience a rather substantial loss.

Senator McCain, I indicated I was going to ask a couple of questions of Alliance and then call on Mr. Glassman, if that's all right with you.

Senator MCCAIN. I see. All right.

Senator DORGAN. Let me try to understand this just a bit more, if I can. Does the Florida pension management know of the general positions that are taken and the purchases made when they are made? Did you know, for example, that as Enron stock was collapsing and pancaking, that additional purchases were being made by Alliance, in your behalf, of Enron stock?

Mr. HERNDON. Yes, sir, Senator. We knew that those activities were taking place and, in response to our queries of Alliance, were reassured that the rigorous company-specific research they promised us was also being undertaken by Alliance, so we continued to place our trust in them and may have been misguided, in retrospect.

Senator DORGAN. But you trusted them. Was there internal difficulties? Did you have discussions amongst yourselves, amongst the three-member board, of whether this was a good decision or whether you should continue to allow this to happen?

Mr. HERNDON. We discussed it at some length. Remember, it's important to put in perspective the fact that we had put Alliance on our watch list almost a year before, because their performance had been deteriorating overall. So the Enron situation was a specific example of concern that we had in that broader context.

We did discuss it. We discussed it with Alliance. They reassured us that everything was OK, that they knew what they were doing. We don't second guess our managers' stock decisions. We make decisions about whether to hire or fire managers. We don't have the resources or the capabilities—nor does any other pension fund, for the most part, in this country—have the capability to do individual stock research. That's what we hire the experts for.

Senator DORGAN. I understand that. But if you don't second guess those who purchase your stocks, then why do you put them on a watch list?

Mr. HERNDON. Well, we asked them questions to try and discern whether or not they are confident in their view that they are, in fact, in possession of the facts, that they can express their discipline and their professional opinion in a sound fashion. And we were hearing comforting noises from Alliance that were intended, at least, to reassure us that they were doing the homework. We don't know that.

Senator DORGAN. And my question, I guess, is that the entire country was selling Enron—that's why its stock was collapsing—and you were discovering that you were buying more of it through

your relationship with Alliance, and I was trying to understand if, internally, you were having second thoughts about that and having a discussion about whether you ought not to see that that's discontinued.

Mr. HERNDON. We did have those discussions.

Senator DORGAN. Mr. Stipanovich, can you describe those discussions for me?

Mr. STIPANOVICH. What we look at with a manager, and as Mr. Herndon related, when we put a manager on a watch list, it's really performance based. It's not really their—it's a byproduct of their stock selection. But because we don't have the expertise, nor do we exercise the discretion to get into individual stock selection, we really look at overall performance over periods of time, and that period of time is typically 1-, 3-, and 5-year periods and then since inception and that kind of thing, but the—more of the emphasis on the 3- and 5-year period. So it was for overall performance that really was the overriding problem. Enron was really the straw that broke the camel's back.

Senator DORGAN. Let me just—an initial question about Enron and your meetings with them. Mr. Calvert, you and Mr. Harrison both indicated that the top officials from Enron just lied to you, misrepresented the company. You used the word "fraud" a good many times in your presentation. We had Mr. Lay sitting at the table that you're now sitting at, and he took the Fifth Amendment. And we had Mr. Skilling, and he talked from here to Europe, but we really didn't understand much of what he was saying, at least he never admitted to very much. And Mr. Fastow is nowhere to be found. And so we're struggling to try to determine what Enron represented to people like you.

Tell me again, if you can, with more specifics, how do you believe Enron lied to or deceived Alliance Capital, and who did that?

Mr. HARRISON. In retrospect, I think we can see that we not only had misleading information that came out in a very parsimonious fashion, but it was grossly incomplete. What has come out subsequently, in terms of literally hundreds, maybe thousands, of partnerships would have given a totally different picture, both as it relates to the gains and losses, and particularly the debt position of Enron.

So I think that the key thing here is that, notwithstanding face-to-face meetings, looking them in the eye, asking all of the questions that we have done over the years that have led to our successful performance, the answers that were given, in retrospect, were just not adequate.

Senator DORGAN. Mr. Harrison, were you aware of an SPE called "Braveheart"?

Mr. HARRISON. Was I aware at the time? No.

Senator DORGAN. You are now?

Mr. HARRISON. No. I am now, yes.

Senator DORGAN. Would an analyst or someone in your position expect to be knowledgeable about Braveheart? I mean, would you expect the corporation to have disclosed sufficient footnotes and information on their financial statements to allow one to understand what a Braveheart is and how they use the money?

Mr. HARRISON. If the auditors had considered something to be material, it very definitely should have been right out there in front of investors, rating agencies, and everybody else.

Senator DORGAN. So do you believe you were lied to by the auditors with respect to this company, as well?

Mr. HARRISON. Clearly, the failure to provide information on something such as this would point to at least inadequacy on their party.

Senator DORGAN. Senator McCain?

Senator MCCAIN. Mr. Herndon, in March of 2002, the Tampa Tribune quotes you as saying, "I can probably give as many examples on the upside as I can on the downside of investment managers of ours who have taken relatively large positions on companies on bad news, where the price got driven down only to have it rebound." It continued, "I'm not sure we would do anything different today than we did last fall."

Mr. Herndon, given those statements, why do you now believe Mr. Harrison was negligent by investing in Enron?

Mr. HERNDON. My view hasn't changed much, Senator, since last fall, and that is that the process by which Alliance makes its investments, we believe is sound if its rigorously applied and done in the utmost of fiducially responsible fashion. We don't believe that occurred in this case.

Senator MCCAIN. You wouldn't have done anything different than you did last fall?

Mr. HERNDON. If we had been able to rest confidently that Alliance had, in fact, done the homework, Senator, I don't believe we would have done anything different, but we don't believe Alliance did the homework. They've never been willing to share that with us. So, consequently, we have no other position to take except that they didn't do it.

Senator MCCAIN. In the summer of 2001, SBA personnel visited Harrison's group in Minneapolis. After the meeting, Mr. Webster wrote in a memo to the SBA, "My opinion of Alliance as a first-class organization is only enhanced by our visit. The depth and breadth of the knowledge within Alliance is impressive." It continued, "We discussed a wide range of operational market issues with Al Harrison. He gives me no reason to believe we should be at all concerned about Al's ability. I continue to believe that Al is one of the best money managers employed by the state board."

Mr. Webster, how does the SBA reconcile the statements with their claim now that Alliance was negligent?

Mr. WEBSTER. Our trip up to Minneapolis was to better understand the process by which Alliance picked stocks. Our observations made us believe that the process was sound.

Senator MCCAIN. Well, were you fooled, Mr. Webster?

Mr. WEBSTER. Well, I would probably think so, yes, in this case.

Senator MCCAIN. And, Mr. Herndon, you were not deceived?

Mr. HERNDON. Senator, we have no quarrel with the fact that Alliance has been an outstanding investment manager on behalf of the state board for many years. But just as I have a clean driving record for 17 years, and then if I plow into a crosswalk and kill a bunch of children, the fact remains that I have been negligent in that specific instance. And that's exactly what we think happened

in this case. And Alliance has made no effort to help us understand why, in fact, that didn't occur.

The process is sound. We don't have any quarrel with that, if it's diligently applied. In this case, we believe there was negligence afoot on the part of Alliance, and we'll ultimately let a court of law make that determination.

Senator MCCAIN. Mr. Calvert, there have been suspicions raised regarding a possible conflict of interest by Mr. Savage, who sits simultaneously on the Alliance and the Enron boards of directors. Do you believe that Mr. Savage's dual roles give, at a minimum, an appearance of impropriety? And I'd ask you to take the microphone, if you don't mind.

Mr. CALVERT. We don't believe that there was, in fact, a conflict. We believe it was well covered by our policies. And, on the other hand, we do understand that perception is a different issue, and we think people have been entirely entitled to question at great length, and to question that relationship to see if there was impropriety, and I believe we have said there was not, and I believe people have concluded——

Senator MCCAIN. Do you believe there was an appearance of impropriety?

Mr. CALVERT. I do not believe that, no.

Senator MCCAIN. Should corporate board members be required to disclose potential conflicts, in your view, Mr. Calvert?

Mr. CALVERT. Yes, they should. And our 10–K discloses that Mr. Savage was on the Enron board.

Senator MCCAIN. Don't you think average citizens, when seeing the very large amounts of money Mr. Savage directed toward investments in Enron would say, "Wait a minute. He's a member of the board of directors of this company. Wouldn't that give him some bias?"

Mr. CALVERT. Mr. Savage didn't direct any investments for Enron. He was not involved in any way, shape, or form at any time, in any discussions, or any decisions that were made about our investments in Enron.

Senator MCCAIN. He had no involvement in the decisions made by Mr. Harrison's team in Florida.

Mr. CALVERT. Absolutely not.

Senator MCCAIN. I thank you. I thank the witnesses, and I thank you, Mr. Chairman. I thank the witnesses. Mr. Glassman, welcome.

Senator NELSON [presiding]: Mr. Glassman, we'll take your testimony, and then we'll continue the questioning.

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

Mr. GLASSMAN. Thank you, Senator Nelson and Senator McCain. My name is James K. Glassman. I'm a resident fellow at the American Enterprise Institute and host of the Web site texcentralstation.com. I'm also a syndicated financial columnist for the Washington Post and author of two books on investing. I devoted much of my professional career to educating small investors. I am deeply concerned about the effects of the Enron scandal on these investors, and I congratulate you for holding this hearing today.

Currently, more than half of U.S. families own stock, compared with just 15 percent in the mid 1960's and 20 percent in the early 1990's. This is an enormously beneficial development. The Enron disaster has been costly and shameful, but it provides a valuable educational opportunity for these investors. It is important that Members of Congress help them draw the right lessons.

But I worry that, in hearings like this one, investors can get a dangerous message, that they are not personally responsible for their investments. For example, many Florida officials have, unwittingly or not, given the public the impression that the way the stock market works is that you keep your gains and sue to recover your losses since they must be someone else's fault. Indeed, the most important lesson of the Enron collapse should be that investors assume risks when they invest in stocks, and that they need to protect themselves.

A smart investment strategy, then, is one that harnesses risk, dampens it, tries to control it. But eliminating risk in the stock market is impossible. The best way to harness risk is through diversification. That is owning lots of stocks in different sectors so the inevitable losers will be offset by winners. Well-run pension funds typically hire several managers with different, often uncorrelating investment styles. Each of the managers is responsible for a portion of the fund's assets. And one thing tell my readers is that stock investing is a long-term endeavor. There will be rotten years and great ones. The only way judge a portfolio manager is over the long-term.

As someone who follows investment managers, I can only say that Mr. Harrison's long-term record has been exceptionally good. Mr. Harrison can defend his own record, and he has, although if I were Mr. Harrison, I would certainly respond to the comments about his investment style being equated to a drunk driver who kills children.

But let me just emphasize what I think is the relevant information about his long-term record—his record. Long-term records are what count. And from 1984 to 2001, according to published reports, even with the Enron losses, he increased his share of the Florida account from $345 million to $3.7 billion, beating the S&P and other benchmarks. His investing style was well known to Florida officials, or it should have been. He buys, in an often very risky way, beaten-up stocks that are solid but he believes are underpriced. For example, according to the New York Times, he made a, quote, "quick large gain," end quote, by buying Continental Airlines stock after the tragedy of the terrorist attacks of September 11th, which went down and then went back up.

Overall—and I think this is a point that has not been made and should be—Enron represented, according to my calculations, 0.3 percent of the total Florida pension fund. If the Florida pension fund had been invested in the Standard & Poor's 500 stock index, which is generally perceived as a good way and not overly risky way to invest in stocks, it would have represented 0.5 percent. So, in a sense, Florida was actually under-invested in Enron.

Let me just address a couple of specifics. Mr. Harrison was faulted for buying Enron as the price fell. The New York Times quoted Tom Gallaher, the Florida State Treasurer and one of the state

pension fund's trustees, as saying, quote, "Only fools buy on the way down," end quote. In fact, good investors, who believe in the companies in which they put their money, prefer to buy stocks at low prices rather than high.

Second, Enron's value in the stock market fell sharply when, on October 16th, 2001, it announced a reduction of shareholder equity of $1.2 billion because of partnership losses. Then came the further shocks of October 22nd and November 8th, the overstatement of profits.

Between October 22nd and November 16th, Mr. Harrison bought, according to published reports, $35 million worth of Enron at prices ranging from $9 to $23 a share. The question is whether this investment was reckless. A little math is in order. This investment represented less than 1 percent of his total Florida portfolio under management and less than four-one-hundredths-of-one-percent of the entire Florida pension fund. Specifically, the New York Times cited the $12 million he invested between November 13th and November 16th and called it, quote, "a huge bet that the company's prospects would turn around," end quote. In fact, it was not a huge bet. It represented one-three-hundredths of Mr. Harrison's Florida portfolio, and about one-ten-thousandth of the entire pension fund. Clearly, in hindsight, Mr. Harrison did make a mistake, but it appears to me that he didn't do anything that was reckless.

Were Mr. Harrison's investing practices bizarre, as Senator Nelson, you, yourself are quoted as saying? Not in my opinion. It is important to remember humility in viewing the workings of markets. The price of a stock is the considered judgment of thousands of investors. For every seller, there is a buyer. After the adverse revelations, the fact that Enron stock was plummeting, for example, doesn't mean that it's a bad investment. For example, by definition, $10 a share was the best—that is to say, the most informed—price for Enron on November 14th, one of the days on which Mr. Harrison made his purchases. Yes, it was a mistake. It was a bad purchase, in hindsight. But Mr. Harrison has also made many good ones.

The Enron collapse has unfortunately generated a kind of hysteria. In fact, what is bizarre is not so much the behavior of portfolio manages like Mr. Harrison, but the behavior of many journalists and public officials. Enron was a costly episode, but I fear that the search for scapegoats will end up not merely smearing the reputations of talented and dedicated professionals, but will send small investors—that is, your constituents—a disastrously wrong message.

We should not frighten people away from investing. Whether we like it or not, for most Americans, stock market investing represents not just the best, but, in fact, the only way to build a large enough nest egg for a comfortable retirement. Yes, we need to protect and nurture investors, but we should not treat them like fools or children. We need to give them the tools, including accurate reporting and good financial education, which is an important role for Congress to play, to make their responsible choices.

I thank you.

[The prepared statement of Mr. Glassman follows:]

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

Bizarre Behavior? The Story of Enron Stock Losses in the Florida State Employee Retirement Fund

Mr. Chairman and Members of the Subcommittee:

My name is James K. Glassman. I am a resident fellow at the American Enterprise Institute and host of the website TechCentralStation.com. I am also a syndicated financial columnist for the Washington Post and author of two books on investing. I have devoted much of my professional career to educating and advising small investors. I am deeply concerned about the effects of the Enron scandal on these investors and congratulate you for holding this hearing today.

Currently, more than half of all U.S. families own stock, compared with just 15 percent in the mid–1960s and 20 percent in the early 1990s. This is an enormously beneficial development. Americans primarily own shares of individual companies, mutual funds run by professionals, or index portfolios, which are baskets of stocks, maintained by computer programs, that reflect broader markets. The Enron disaster has been costly and shameful, but it provides a valuable educational opportunity for investors. It is important that members of Congress help them draw the right lessons.

I worry that in hearings like this one, investors get a dangerous message—that they are not personally responsible for their investments. For example, many Florida officials have, unwittingly or not, given the public the impression that the way the stock market works is that you keep your gains and sue to recover your losses—since they must be someone else's fault. In this view, investing is an endeavor that always produces winners, so, if there are losers, they someone must have cheated.

Instead, the most important lesson of the Enron collapse should be that investors assume risks when they invest in stocks, and they need to protect themselves. This hearing asks witnesses to comment on how losses such as those in the Enron case could be "avoided in the future." They cannot. Some stocks will always fall in value. The market as a whole has fallen in 22 of the past 76 years. Investors need to know that short-term losses are part of investing. Stocks are risky.

However, the risk that a company will use deceptive or illegal accounting practices is a highly unusual one. Share prices of America's very best companies, with good managers, good products, good employees and good ideas, will fall from time to time—with no chicanery or lawbreaking involved.

In early 2000, for example, the stock-market value of Procter & Gamble, a sound corporation with great brand names like Tide and Crest, dropped by 54 percent in just two months. Volatility is inherent in stock investing. And volatility means that some stocks can rise by 7800 percent in a decade (as Dell Computer has done) while others, like Enron can go from $80 to a few cents in a year.

Stocks Are Risky, But Rewards Are High

In fact, the way to understand why stocks have been such a great investment over the past two centuries in the United States is to recognize that investors get compensated for taking risks. Since 1926, a portfolio the 500 stocks of the Standard & Poor's benchmark index (or its predecessor) has returned an annual average of 7.6 percent after inflation, compared with an annual average of just 2.2 percent, also after inflation, for medium- and long-term U.S. Treasury bonds. In other words, over 30 years, an investment of $1,000 in stocks rose, on average, to $8,000, while a similar investment in bonds rose to less than $2,000.

A smart investment strategy, then, is one that harnesses risk, dampens it, tries to control it. But eliminating risk in the stock market is impossible.

The best way to harness risk is through diversification—that is, owning lots of stocks in different sectors, so that the inevitable losers are offset by winners. Well-run pension funds typically hire several managers with different, often uncorrelated investing styles; each of the managers is responsible for a portion of the fund's assets. Small investors can get the same effect by owning different kinds of mutual funds: a growth and income fund, for example, that concentrates on large-company stocks that pay dividends, might be balanced by a small-cap aggressive-growth fund, whose manager looks for smaller firms that are often ignored by the public and by analysts, or by a fund that concentrates in Asian-based companies.

One thing I tell my readers is that stock investing is a long-term endeavor. There will be rotten years and great ones. Bonds are short- or medium-term investments; stocks are not. The only way to judge a portfolio manager is over the long term.

The Alliance Losses

It is with this approach that I have analyzed the events I first saw described in an article that appeared on March 3, 2002, in the New York Times. It reported that Alfred Harrison, a money manager for Alliance Capital, had lost $328 million through his investments in Enron Corp. on behalf of the Florida State Pension Fund.

The article asked why Mr. Harrison had bought Enron at the "11th hour"—that is, as late as two weeks before Enron filed for bankruptcy. The clear implication was that Mr. Harrison had done something terribly wrong, unprofessional, even corrupt.

I had heard of Mr. Harrison since I write about mutual funds, and knew he had an excellent reputation for his management of Alliance Premier Growth, a fund that had consistently beaten its peers. As I read the entire article and did some research on my own, a different picture emerged. It became clear that Mr. Harrison's critics lacked a basic understanding of how markets work and that they were making him a kind of scapegoat for some reason, perhaps political. But, more important, I worried that the way the story was treated might lead small investors—the people for whom I write—to draw the wrong conclusions about their own investment strategies.

Let me be specific . . .

1. The loss of $328 million in Enron stock came in a pension fund portfolio of $95 billion. In January 2001, Enron represented about 0.53 percent of the S&P 500 index, a good proxy for the market as a whole. A quick calculation finds that Mr. Harrison's peak holding of Enron represented about 0.3 percent of the Florida pension fund. In other words, if anything, Enron appeared to be underweighted in the Florida portfolio.

2. Mr. Harrison had been managing a piece of the Florida pension fund since 1984, presumably with annual reviews. Why hadn't Florida fired him earlier? Very simply because Mr. Harrison had increased his initial stake from $345 million to as much as $6 billion in about 15 years, according to published reports. When his contract was terminated, the stake had fallen to $3.7 billion—but that was still a 10-fold increase in 17 years, for an average annual return of 16 percent, considerably above the returns of the market as a whole.

3. Mr. Harrison is well-known for a particular style of investing. He takes extra risks and generally achieves extra rewards. Morningstar Mutual Funds, a research firm, calculates that, for the public fund he has managed since 1992, his investments have been about one-third riskier than the market as a whole. It is hard to believe that the Florida authorities were unaware of that style. Money managers operate in public; their records and strategies are well-known. Mr. Harrison, in fact, has a reputation for trying to find undervalued companies whose price, he believes, will rise. A well-run pension plan balances a manager like Mr. Harrison with other managers who might specialize in income-producing stocks or mid-caps or bank stocks.

4. Mr. Harrison was faulted for buying Enron as the price fell. The New York Times quoted Tom Gallagher, the Florida State Treasurer and one of the state pension fund's three trustees, as saying, "Only fools buy on the way down." In fact, good investors, who believe in the companies in which they put their money, prefer to buy stocks at lower, rather than higher prices. Most smart investment analysts would generalize the opposite way: "Only fools sell on the way down—and buy on the way up." If you have found a good company in which to invest, and have bought its shares at $50 each, then it makes sense to buy more of those shares at $10 each. The question with Enron was its soundness as an investment, not the fact that its price had dropped. Indeed, Mr. Harrison frequently invested in stocks that had dropped in price, and, if Mr. Gallagher thought this something "only fools" do, then it is hard to understand why Mr. Harrison was retained for 17 years. In the right hands, Mr. Harrison's approach is a very effective strategy. For example, according to published reports, Mr. Harrison made a profit in the Florida fund by investing in Continental Airlines last year. He bought the stock after it fell shortly after the terrorist attacks in New York and Washington in September. Not long afterwards, it rose strongly, and Mr. Harrison made what the Times called "a quick large gain."

5. Enron's value in the stock market fell sharply when, on Oct. 16, 2001, it announced a reduction of shareholder equity of $1.2 billion because of partnership losses. Then came further shocks: the announcement on Oct. 22 of an SEC inquiry and the announcement on Nov. 8 of an overstatement of profits over the previous 5 years. Between Oct. 22 and Nov. 16, Harrison bought $35 million worth of Enron at prices ranging from $9 to $23 a share. The question is wheth-

er this investment was reckless. A little math is in order. This investment represented less than 1 percent of his total Florida portfolio under management and less than four-one-hundredths of one percent of the entire Florida pension fund. Specifically, the New York Times cited the $12 million he invested between Nov. 13 and 16 and called it "a huge bet that the company's prospects would turn around." In fact, it was not a huge bet—it represented one-three-hundredth of Mr. Harrison's Florida portfolio and about one-ten-thousandth of the entire pension fund. Clearly, in hindsight, Mr. Harrison made a mistake. He evidently believed that Enron's assets remained substantial and that the company would be bought out by Dynegy, a competitor. The Dynegy deal fell through on Nov. 30, and Harrison liquidated his Enron holdings that day. Two days later, Enron filed for bankruptcy protection.

A "Bizarre" Decision?

Let me be clear. I certainly would not have invested in Enron in October, nor would I have advised my readers to do so (and many of them asked). The reason, very simply, is that for small investors I advocate a strategy of buying companies with solid long-term (meaning 20 years and more) prospects. But was Mr. Harrison's decision "bizarre," as Sen. Bill Nelson is quoted as saying? Not in my opinion. It is important to remember humility in viewing the workings of markets. The price of a stock is the considered judgment of thousands of investors—for every seller, there is a buyer. After the adverse revelations, the fact that Enron stock "was plummeting," in Sen. Nelson's words, did not make it an imprudent investment. For example, by definition, $10 a share was the best (that is, the most informed) price for Enron Nov. 14, one of the dates on which Mr. Harrison made one of his purchases. Yes, it turned out to be a bad investment, but Harrison also had many good ones, including, according to press reports, MBNA, Motorola and Cisco Systems. These stocks were bought according to the strategy that had produced good results for his clients—a strategy that his promotional literature calls "V investing"—that is, buying companies whose shares had fallen beyond what he believed to be reasonable levels and then selling them when they recovered, as many did.

Overall, Mr. Harrison not only beat the S&P with his Florida-fund portfolio but, with his public mutual fund, also beat the large-cap growth group and the Russell 100 Growth index, according to Morningstar. In addition, from 1994 to 1999, his fund beat the S&P in four out of five years. It returned 46 percent in 1995, 23 percent in 1996, 32 percent in 1997, 48 percent in 1998, and 28 percent in 1999.

A Kind of Hysteria

The Enron collapse has, unfortunately, generated a kind of hysteria. In fact, what is bizarre is not so much the behavior of portfolio managers like Mr. Harrison but the behavior of many journalists and public officials. Enron was a costly episode, but I fear that the search for scapegoats will end up, not merely smearing the reputations of talented and dedicated professions, but will send small investors—that is, your constituents—a disastrously wrong message.

Mr. Harrison was not the only money manager or analyst who was impressed by Enron's historic results, its business strategy, its management and its story. The company was lauded by Fortune magazine for many years as America's most innovative. In late September 2001, after Enron's stock price had fallen by two-thirds, the Value Line Investment Survey, an independent research firm with an excellent reputation, gave the company an "A" rating for financial strength and a "2" (above-average) rating for "timeliness." The Value Line analyst wrote, "We think fears are overdone . . . and . . . markets for both wholesale and retails services are still growing strongly." After all, revenues had risen from $14 billion to $100 billion in 10 years, and earnings had gone from 9 cents a share in 1989 to $1.47 a share in 2000.

Janus, one of the biggest mutual fund houses in the country, owned 5.6 percent of the company's shares by itself, and the Fidelity sector fund that specializes in energy made Enron its largest holding. Alliance and Mr. Harrison were not alone in their admiration of the company. Like the entire business press and the entire investment establishment, they were duped by what we have learned were aggressive misrepresentations of the company's financial condition.

The bulk of Mr. Harrison's investment in Enron—approximately 90 percent by my calculation from published reports—occurred before the company's restatements of assets and earnings. The relevant issue is not his investment in a particular stock that lost money; it is, instead, the structure of his portfolio. Was he dangerously overweighted in Enron? In other words, did he have too much stock in that one company in relationship to his other holdings? Not at all. Did his losses in Enron seriously impair his overall performance? Again, no. An average annual return of 16

percent over 17 years is exceptional. Imagine one of your constituents at age 31 turning over $10,000 to Mr. Harrison to invest for retirement at age 64. At a 16 percent rate of return, the constituent would have a nest egg of well over $1 million.

Does Congress have a legislative role here? Again, no. The Florida state pension fund and similar funds should select and oversee their own managers without federal interference. They are fully capable of deciding who should manage their money. It is a shame, however, that the trustees have handled this matter in the politically and emotionally charged way they have. If they don't like the way particular managers perform, then they can fire them. If laws are broken, they can ask for prosecution.

So what are we doing here?

Promote Financial Education

Congress can serve a constructive function in the aftermath of the Enron scandal. That function is educational. It is a fact and a blessing that the majority of Americans now own stock. Many of them, however, do not understand the basics, let along the intricacies, of investing. Teaching them is what I try to do in my columns and books, but government leaders can also play an important role. Let me close by listing what I believe are the lessons to small investors from the Enron collapse:

Diversify. If a stock like Enron is among only five or 10 stocks you own, then you're in big trouble, but if Enron is part of a widely diversified portfolio—as it should be—then you can pick yourself up, take your tax loss and move on.

Be skeptical of the experts. Wall Street has a herd mentality. Not only do analysts have a bullish bias, but, worse, they have a sheepish bias. They don't want to stand out from the flock. So if a few top analysts start buying a story, then practically every analyst buys the story. In the case of Enron, it was a famous short-seller, James Chanos, who started asking questions about the company's financial statements. Chanos, of course, had an ax to grind himself because, by selling short, he made money if the stock fell. But he proved an important point for small investors: Often, in the market, as in life in general, it is better to listen to non-conforming argument than to the conventional wisdom.

Recognize that bad things happen to good investors. Events such as the Enron debacle are part of the risk inherent in investing. They'll always occur. Mr. Harrison said of Enron, "On the surface it had always seemed to be a fairly good growth stock." It did, but it wasn't. However, investment professionals who bought the stock for their clients' portfolios were not venal or corrupt. They simply took at face value what the company reported in its official filings, and they were deceived. Mr. Harrison and others bought Enron stock after adverse revelations, but they too believed that the company still had valuable assets. This was a mistake but not an outrageous one. Through diversification, he protected the bulk of his account. That's a key lesson for small investors.

Take Personal Responsibility. Finally, all investors need to understand that their choices in financial investing are their own responsibility, just as their choices in home-buying are their own responsibility. They should not expect to be bailed out by lawyers or politicians. Thanks to the incredible financial democracy and diversity that has developed in the United States, small investors can take advantage of professional management and analysis at low cost, or, at even lower cost, they can simply own index funds that reflect the entire market. Investors who have proceeded in this way, with clear-headed, long-term strategies, have done very well. Over the past 20 years, an investment in the 30 stocks of the Dow Jones Industrial Average, with dividends re-invested, has increased about 20-fold.

We should not frighten people away from investing. Whether we like it not, for most Americans, stock-market investing represents not just the best way, but the only way, to build a large enough nest egg for a comfortable retirement. Yes, we need to protect and nurture investors, but we should not treat them like fools or babies. We need them to give them the tools—including accurate reporting and good financial education—to make their own responsible choices.

Thank you.

Senator NELSON. Thank you, Mr. Glassman, and thanks to all of you for your testimony. I think the chairman will be coming back after he finishes this interview that he's doing. In the meantime, I've got a few questions. First, for Mr. Herndon.

Mr. HERNDON. Yes, sir.

Senator NELSON. In your experience with Florida and the knowledge of public funds across the country—and by the way, I think we ought to state that you've headed this Florida retirement system, otherwise known as the State Board of Administration, for, what, about 5 or 6 years?

Mr. HERNDON. 5½ years.

Senator NELSON. And is it true that you've been—that you have decided to retire?

Mr. HERNDON. Yes, sir.

Senator NELSON. And who is to be your replacement?

Mr. HERNDON. The board has not made that decision yet. I hope it's my colleague, Mr. Stipanovich, but that remains to be seen. The trustees will make that decision.

Senator NELSON. Well, in your experience with Florida and your knowledge of the public funds—and I might point out here that, as I understand it, this Florida pension fund is the fourth-largest pension fund in the country.

Mr. HERNDON. Yes, sir.

Senator NELSON. Then with that kind of knowledge, give me an estimate of the percentage of funds invested in index funds versus fixed investments like bond funds and versus a percentage of actively invested through money managers.

Mr. HERNDON. I'd be happy to, Senator. And maybe Mr. Glassman might want to pay attention to this as well since over 60 percent of our equity investments are in index funds, we hire 14 different outside managers, all of whom possess different styles so that we are a very diversified fund. It's never been our intention to try and send a message to the public or anyone else that they're not responsible for their losses, provided the investment manager that they hire conducts themselves in a responsible fashion and does the homework that they contract for.

In this case, we don't believe that happened. In this case, we believe Alliance was negligent. And in that case, it's incumbent on institutional investors like us and any investor to hold them responsible for the misdeeds that they conduct. And in this case, that's what we're trying to do.

Senator NELSON. All right. Now, what I'm trying to find out is a relative amount of the fund that's in the index funds and other kinds of investments and then what percentage of your stock portfolio is handled by outside money managers. You have some internal managers, as well.

Mr. HERNDON. About 40 percent, approximately, of the stock portfolio is handled by outside money managers. About 60 is indexed by both internal and external money managers. And overall, about 60 percent of the entire pension fund is in indexed products, both bonds, international, and U.S. equity. And I'm setting aside, for the moment, real estate and private investments since they're really quite a bit different investment.

Senator NELSON. All right. Let me see if I understand. So 40 percent of your stock portfolio is handled by outside money investors——

Mr. HERNDON. Right.

Senator NELSON.—money managers. And 60 percent is handled internally or by——

Mr. HERNDON. Or by external index funds.

Senator NELSON.—by the index funds.

Mr. HERNDON. Correct.

Senator NELSON. All right. You state in your testimony that Alliance was put on an internal watch list for poor performance.

Mr. HERNDON. Yes, sir.

Senator NELSON. Tell me when that occurred, and describe to our Committee the nature of a watch list.

Mr. HERNDON. It occurred in the fall of 2000, late in the fall of 2000, as we saw Alliance's performance for the overall portfolio deteriorate. And I might add—Mr. Glassman has made this comment, as well—that, at its peak, Mr. Harrison's portfolio on behalf of the State Board of Administration was close to $6 billion. When he was terminated, it was $3.7 billion. So they lost $2.3 billion for the State Board of Administration, of which $280 million was Enron investments. So it's not exactly as if we were acting in a capricious fashion. We were very cognizant of his long track record with us.

But to the point, we tried to accelerate our monitoring of Alliance from the quarterly process that we currently do to a monthly review, where our analysts and our staff talk to the staff in Minneapolis, or vice versa, every single month so that we keep a close eye on what's going on. And we ask them, "Why are you doing some of the things that you're doing? We want to be assured that you're doing it in full possession of the facts." And they kept assuring us that they were. I'm not so sure about that, but——

Senator NELSON. And you said that they were put on this so-called watch list, which is the terminology that you've described——

Mr. HERNDON. Yes, sir.

Senator NELSON.—from the fall of 2000.

Mr. HERNDON. That's correct. November or so of 2000.

Senator NELSON. Now, is—you talked about the frequency of the meetings as a result of being on a watch list. Does this, then, suggest—for example, in a New York Times article of March the 3rd, they make reference to the fact that Mr. Harrison was meeting with representatives of the Florida fund some 31 times last year. Would that have caused the increased frequency of these meetings?

Mr. HERNDON. I'm not sure about that story, Senator. We certainly didn't meet with Mr. Harrison 31 times. We did talk with his office or his staff or Mr. Harrison on a number of occasions. I don't have the count in front of me, but it was a couple of dozen times over the course of 2001. I don't know about 31, but——

Senator NELSON. All right. Once I get to Mr. Harrison, I'll ask him these kinds of questions, and I'd like the Committee to have an understanding of this. We wanted to understand what watch lists are. Do other funds have watch lists?

Mr. HERNDON. Yes, sir. It's a fairly common practice in the industry. When an investment manager's performance deteriorates, all of us increase our scrutiny, we increase the attention that we're giving to the investment manager to try and understand what's going wrong, what do we attribute the poor performance to. In this case, that's exactly what we were trying to do. We were trying to understand what was accounting for the poor performance on the part of Alliance.

Senator NELSON. And so if other funds have this—do they have that same kind of criteria as you do for putting them on watch lists?

Mr. HERNDON. Essentially they do. I mean, we're all watching manager performance. That's what we do is hire and fire managers, not invest in individual stocks. And most all of the large pension funds follow a similar pattern. They may use a slightly different screen, but they all follow a similar pattern.

Senator NELSON. Since we're talking about the time from the fall of 2000 until the winter of 2001, how many other money managers were on that watch list for the State of Florida?

Mr. HERNDON. As I recall, during that period of time—I don't recall that there was anybody else that was on that watch list at that particular time. I could stand corrected, and I'd be happy to get that information for you, Senator.

Senator NELSON. So Mr. Harrison was on the watch list for—somewhere I've picked out the time—it was approximately 17 months.

Mr. HERNDON. That sounds about right.

Senator NELSON. What kind of action—with him being on a watch list for that long and him being—as you have just testified, being the only one on the watch list for the state of Florida, what kind of specific action, other than the meetings being accelerated from quarterly to monthly, would occur—did occur?

Mr. HERNDON. Increased communication, visits to Minneapolis, bringing the Alliance staff down to Florida to visit with us, watching their purchases with a closer degree of scrutiny than we did prior to that time, trying to get more of an explanation of just exactly what was underlying their investment decisions.

Senator NELSON. Well, maybe you can help me understand this, then. You know, one of the sources, as I've prepared for this hearing, was this New York Times article of March the 3rd, and it says, "As Enron edged toward bankruptcy, Mr. Herndon said communication from Alliance ground to a halt. 'There was an abysmal lack of communication,' he said." Given the fact of this increased communication, how does that square with this?

Mr. HERNDON. What I was referring to in that particular quote was the decisionmaking process that Alliance went through to sell the stock that we owned. They, without notice to us, blind-sided us, in spite of repeated discussions, visits in our office. A day after we received an e-mail from them highlighting the value of the Enron stock, they sold the entire position out in a sale in a private placement overseas without telling a sole and never did tell us even til after the fact. We found out about it on our own volition. Alliance never did tell us until several days later that they had, you know, bailed out and left us holding the empty sack.

Senator NELSON. Well, with this particular scenario, what corrective action was taken in the course of the watch list, and what was not taken, that led to the present situation?

Mr. HERNDON. Well, we fired Alliance, first and foremost, for a variety of reasons, many of which we've discussed here this afternoon. We've also made an effort to implement a variety of screening tools to more closely monitor the investment decisions of our managers. But bear in mind, Senator, as you heard the Alliance of-

ficials represent, they had 25 analysts on their team in Minneapolis, 300 research folks around the world. The State Board of Administration and no pension fund in this country has that kind of resources. We don't have the capability to monitor individual stock decisions on the part of our managers when they're managing a $50 billion stock portfolio.

So what we are doing is trying to understand and trying to develop screens that help us understand exactly how focused and disciplined that investment process on the part of the managers, and reassure us that the reason we hired them is still a valid one.

Senator NELSON. As I said at the outset, what—the purpose of this hearing is for us to get to the bottom of this so we can understand what happened and why it happened and what we should do about it from the standpoint of reforms at the federal legislative level. How long would you suggest to us that we should consider, as we consider this whole matter, that someone should stay on a watch list before corrective action should be taken?

Mr. HERNDON. Our general rule of thumb is approximately 3 years, assuming that there are not consequential events, material events, that are at play that shorten that watch list, as is the case with Enron. We didn't originally put Alliance on the watch list because of Enron. It became a more profound problem as we moved further and further into the watch list period. But, generally speaking, I think 3 years is the industry benchmark. That's a sufficient time to determine whether the individual manager is skillful or not, and that is the practice that the board generally applies, is 3 years.

Senator NELSON. Is that the practice that other states use, as well?

Mr. HERNDON. Well, that's my impression, Senator. I can't speak for all of them, obviously, but my impression certainly is that 3 years is a pretty common benchmark for watch list activity.

Senator NELSON. In light of this activity, are you still comfortable with 3 years?

Mr. HERNDON. I think we're comfortable with 3 years, again, recognizing that there are critical events that could happen. Had we known, for example, that Mr. Savage was on the board of Enron, we might very well have done something different, but that was never disclosed to us. And, in fact, I think—I could certainly stand to be corrected—but I think it's even against Alliance's own corporate policy, but they made an exception in this case for Mr. Savage. That's the kind of material event that we might very well have dealt with differently had we known that, but we didn't know that. And those kind of events can shorten a watch list cycle.

Senator NELSON. You know, someone would know that if they just read the annual report of the company.

Mr. HERNDON. Well, that's perhaps the case, Senator. I'm not at all sure that it's always the case, but we would hope that that's the case.

Senator NELSON. Let me ask you about a reform. The Florida State Board of Administration had a standard beyond which an outside money manager was not to go, and that was that, of that outside money manager's total portfolio, they were not to invest in

more than 6 percent of that portfolio in a single stock. It's my understanding that that was exceeded in this case. Is that accurate?

Mr. HERNDON. It may have been, on limited occasions. I don't know that they were consistently above that standard throughout the period of time that they were investing in Enron, but there may have been some instances where they pierced that level.

Senator NELSON. Would that have been a matter of discussion as a benchmark that would trigger certain actions in the course of being on this watch list?

Mr. HERNDON. Yes, sir.

Senator NELSON. And should that be, as part of the reforms that we're looking at?

Mr. HERNDON. It should be something that you take into consideration, Senator, no question about it.

Senator NELSON. And in looking at reforms, what could you suggest to us might give some signals with regard to someone on a watch list with regard to index funds, as compared to the performance of an outside money manager? Is there something in the lingo of the trade that would be helpful to us there?

Mr. HERNDON. Well, in most cases, outside money managers or active managers have a benchmark against which they're measured. It may be an index-style benchmark, like an S&P 500, or it may be a custom benchmark that was in place, for example, for Alliance. Anybody should be gauging the performance of the investment manager against that benchmark. And if they consistently underperform that benchmark over a long enough period of time, going back to our 3 years, then they should be dealt with. Whether they are de-funded to some degree or terminated is up to the individual investment firm—investment fund.

Senator NELSON. Tell me your recommendation with regard to reforms that—in many states, I understand that the governing board—in this case, as you have described it, the State Board of Administration board of trustees are the Governor, the treasurer, and the comptroller—in many states, I understand that there is a representative of the participants in the fund, such as a retiree who is drawing from the fund or a state worker that is paying into the fund, instead of just elected officials. What is your observation there?

Mr. HERNDON. I count ourselves as one of the fortunate organizations, in that we have a board of, as you say, statewide elected officials that are ultimately accountable to not only the members of the pension fund, but to the taxpayers, ultimately. And, as you observed early on in the testimony in the hearing today, ultimately the taxpayers are the ones that are responsible for the pension fund in some respects.

So I think the form that we currently have is a good one. It's very effective. It is a well-managed organization, from the standpoint of the trustees. We have an advisory council. In fact, we have two advisory councils that have representatives of the various labor unions and so forth on them, and I think that gives everybody a very rational way to communicate their interests and concerns.

Senator NELSON. Has there been any concern for you, as we consider this legislation, that you could advise us about potential conflicts of those elected officials? For example, either by law or rule,

I don't know which, anyone participating as a member of the Florida cabinet in the capacity as the Division of Bond Finance cannot receive contributions from any bond company. Do you think that there should be similar kinds of prohibitions with regard to elected officials being the trustees on any kind of the investments that are in that state retirement fund and/or the money managers and the principals of those money managers? What is your advice to us there?

Mr. HERNDON. This issue was considered, I believe, two or 3 years ago by the SEC. At the time, there was discussion about prohibiting investment managers, investment companies like Alliance, from making campaign contributions to trustees of various pension funds. For whatever reason, that idea didn't ever quite get implemented, to the best of my knowledge, but I think it's one that is worth considering, Senator.

Senator NELSON. Well, thank you for your testimony. I may come back, so thank you. What we're trying to do is to see if we can put things in place here to get to the heart of the issue.

Mr. Stipanovich, let me ask a couple of questions of you. And thank all of you for your time and your patience. We'll take as long as we need to get this whole issue aired, and then we'll be looking forward to going on to the second panel, as well.

The statement was made, and I don't remember who—it may have been you, Mr. Calvert; it may have been you, Mr. Herndon, I don't know—but, for the record, have any of the three of you had any conversations with anyone from Enron?

Mr. STIPANOVICH. I'll answer for myself, Senator. I have not had any conversations with anyone from Enron. And——

Senator NELSON. We're talking basically in this 2-year period.

Mr. STIPANOVICH. Right.

Senator NELSON. We're talking about 2000 and 2001.

Mr. STIPANOVICH. That's correct.

Senator NELSON. Or representatives of people from Enron specifically about the Enron stock.

Mr. STIPANOVICH. I have not. We did learn this morning that our—Trent Webster had a marketer call on him in mid 1999 from Enron, and that was before—well before we owned Enron or even knew what Enron was. And he had a fairly brief meeting with her. And that's—it's fairly standard for them to go out around the country and talk up their stock. And we just learned about that this morning from Trent, who said that he had never had any conversations subsequently, with Alliance or otherwise, about this meeting or making any kind of recommendations about Enron.

But we did learn for the first time—we had actually thought no one had ever had any contact with Enron at the board, and we really went to great lengths to try to ascertain that, if there was anybody that possibly had contact with Enron, and we learned of this development this morning, which we think is inconsequential. It's not an official. It's a marketer that basically promotes their stock, and this was, like, in mid 1999, and we did nothing with the information or made no recommendations or did not buy the stock, internally or otherwise, except in certain portfolios which we have no control over.

Senator NELSON. Mr. Stipanovich, who would have made the decision to put Enron on—correction.

Who would have made the decision to put Alliance on the watch list?

Mr. STIPANOVICH. That would have been the chief of domestic equities, Senator.

Senator NELSON. And is that someone that reports to you?

Mr. STIPANOVICH. That's correct, Senator.

Senator NELSON. And is that someone that Mr. Webster works for?

Mr. STIPANOVICH. Yes, it is.

Senator NELSON. And what is that person's name?

Mr. STIPANOVICH. That would be Susan Schueren. Susan Schueren.

Senator NELSON. Susan Schueren.

Mr. STIPANOVICH. Yes, sir.

Senator NELSON. And when that decision to make a particular company put on the watch list, then is that reported to you from Mrs. Schueren, and how does it go through the pecking order?

Mr. STIPANOVICH. At that point in time, Senator, it was not a formal, formal process. It was more of an informal process. We now are implementing, as you were talking about earlier, these watch list monitoring guidelines, which there will be protocol as to how that's reported, but there was no process in place that necessarily there was a list, an authentic list, produced of managers on this watch list that they would actually produce in hard copy and distribute to Tom or myself. It was an informal kind of watch list. This came about with deterioration in Alliance's performance that began late August. And unofficially they went on this watch list, as Tom said—it was late December 2000 or early 2001.

And to kind of digress here a moment in this context of answering your question, Senator, this watch list—we spent considerable time, post–Enron, trying to refine how we developed a watch list and better monitoring procedures for the managers. And these major consultants around the country have a lot of expertise in the industry counseling with all of the major funds in the country, and we have come up with and adopted a monitoring list that has actually been adopted and been implemented that we are now formally using. And so there's very specific criteria that we look at that would then produce managers on the watch list.

We went back and back-tested that watch list against Alliance, and actually did this as an afterthought. This monitoring watch list was not developed around Enron—you know, around Alliance; it was really developed based on consultants', you know, expert advice in what the industry is doing and what we might best do to better monitor managers and increase communications. And in that back-test thing, they actually would have gone on the watch list officially about the same time that they did unofficially, but in stone there's some very specific criteria, Senator, and it's not quite so—note quite as simple as, like, a 3-year period. It's a combination of things where the three kind of standards that we look at are extraordinary events, which would deal with organizational issues, and that was part of what Trent's objective was in going up there, where you would look at changes in the ownership or control of the

manager or revisions of the business plan of the manager, or a key decisionmaker in the organization leaves, like the portfolio manager to my right, or a rapid increase or decrease in assets and that kind of thing.

The other thing would be a short-term performance in relation to an appropriate index or peer group, and there's two ways that we look at that. We look at that versus an index, and that's the benchmark that you've heard us talk about here today. And in addition, we are now using a universe peer analysis called TUCS, Trust Universe Comparative Service, is the major type of service like that in the country. And because we're such a big firm, as you know, the fourth largest in the country, we are in this universe where it's large funds. So in this universe, you would be looking for a fund manager that significantly underperforms the appropriate peer group over four consecutive quarters—and this is on a short-term basis, and you're just looking at a 1-year snapshot. And then on a longer-term basis, you would be looking at under performance for 3- and 5-year periods, and we get into so much of that time being under median or so much of that time being in bottom quartile. And so the three kind of variables begin to kind of interrelate.

And this is not a science, Senator. This is an art, and it will always be an art. And so it's those kind of factors that would come into play, but it is at least quantifiable enough now that it would trigger an official watch list. And at that point, it's really up to our discretion for about a 6-month period whether or not we would terminate that manager immediately or maybe keep him on another 6 months or so.

Senator NELSON. Since Mrs. Schueren would report to you, what role did you play as the deputy director to oversee the watch list?

Mr. STIPANOVICH. Let me qualify that, if I may, Senator. I serve Mr. Herndon as a full deputy executive director. In our organization, we do not have a, quote/unquote, "chief investment officer." When I was moved into this position in June of 2001, it was to—my primary responsibilities were to assist the executive director, who was the closest thing to a CIO that we have, but we, in fact, do not have a CIO, with the asset classes. And in addition to that, I do do some other things in terms of initiatives and projects and some operational things.

So, to answer your question, Senator, she actually reports to both of us.

Senator NELSON. I see. And what was the role that you would play, back then, up until the end of 2001 with regard to the watch list? Is that part of your responsibility to see that the watch list is watched?

Mr. STIPANOVICH. At this point in time, over the last few months, I have been very directly involved in the development of an official performance monitoring watch list. Earlier on, because it was such an earlier period, with me not coming onboard until June, I was not as involved in the, you know, watch list and what it might look like at that point in time, but I was certainly aware that there was a watch list, and that the Alliance was put on this watch list. They would discuss it with me, in terms of what, you know, my thoughts

were and was I in agreement or disagreement. And so I was certainly involved, Senator.

Senator NELSON. And did you say earlier that there was no written procedure for monitoring companies on the watch list?

Mr. STIPANOVICH. Not in terms of something that literally had gone before the board and been approved and been adopted and become part of the contract for the investment manager. This now is part of contracts for the investment managers where they have these performance monitoring guidelines, but there was certainly something in writing internally in terms of just kind of—you know, loose kind of common practices that took place.

Senator NELSON. And there is now a—written procedures?

Mr. STIPANOVICH. That's correct, Senator.

Senator NELSON. As Mr. Herndon had referred to a series of meetings and teleconferences concerning Alliance, I have some notes from a teleconference that occurred on September the 17th, 2001, and also October the 30th, 2001. And the participants were Stipanovich, Menke, Hurdle, Campbell, McKnight, Davis, Robinson, Webster, Lathum, and Al Harrison and Elizabeth Smith, from Alliance. On this teleconference, what did you go over? And how did that work into the decisions that you all made to allow Alliance to continue to keep purchasing shares?

Mr. STIPANOVICH. Yes, sir. The way that normally occurs, in terms of Mr. Herndon's role and my role, the—as you know, we have probably in excess of 40 active managers and, with quarterly meetings, there is literally numerous meetings that take place throughout the year. And it's my practice that when there are issues or a manager is on a watch list—and even as informal as it was, it was a watch list—I then began—I would attend meetings and participate. Mr. Herndon would do that on a much more limited basis, less so than myself.

At this particular meeting, I was attending because of performance. It really was more—had more to do with Alliance's performance. As you can see in the memo, there is some mention of Enron, but we did not spend a great deal of time talking about Enron at that point in time, but we certainly were concerned about Enron. We did talk about Enron, and it was literally the—following the interim and next—the following meeting that took place on October 30th and thereafter, but certainly September, that we really began to zone in on Enron.

Because, Senator, even with everything that we're doing now in creating these screens and trying to identify early warnings for stocks that we can heighten communications with managers about these stocks, at the end of the day, we give these managers full discretion, and we pay them well—and some would disagree with that—but we pay them well to exercise their discretion. We are not stock pickers. And right now, with Enron and everything that's behind us, we still do not plan to be stock pickers. That's what we hire them for.

So we're going to do a better in getting this information, but there's still, you know, a challenge as to what we're going to do with this information, because we're not going to tell them what to buy and sell.

Senator NELSON. Well, we're trying to figure out how to protect the public through legislation in the future to avoid this kind of thing. Would you bring that up here and put it on the easel? Bring it up over here, please, close to me where I can point to it.

Now, this—have you got a pointer? See if you've got a longer pointer. But this is a graphic that depicts the price and the date starting at October the 17th, when the stock price was at about $32. And here's the first signal, right here, SEC investigation is announced when the price is at $22, 311,000 shares are bought. And then as the stock goes on down, you see the picture, prices keep coming down, the stock keeps being bought. And here's the date that we're talking about right now. October the 30th is when you have this telephone conference call with Alliance on the watch list. And so the stock now has come down to $12.23.

And this is what the notes say of the teleconference, "Enron was a big part of the recent under-performance. Alliance had a couple of face-to-face meetings with the company last week. The reality is that the core trading business is in fine operational shape." Now, that's the notes that you all have of this teleconference.

And can you comment about that since—and I'll ask Mr. Webster, too, when we get to him. They just called a vote, so I'm going to have to call a recess in a minute, but go ahead, please, Mr. Stipanovich.

Mr. STIPANOVICH. Yes, Senator. As you—if you look at the longer time line, there are many, many flags such as this on the time line that, again, heightened us and we began to ask these questions. But there's probably no one sitting at this table that can answer that question, hopefully, better than Alliance, because we don't—we didn't understand it. As much as we tried, we did not understand why they were still buying it after all of the—everything that even my mother was reading in the paper about Enron, and they were continuing to purchase the stocks. We were at the point that we felt they were on the wings of a prayer and wish in this thing either stabilizing or going back up, but we—it was incumbent upon us, as fiduciaries, to continue to ask these questions, knowing that we were not going to give them—tell them to sell or buy, and they're the people that need to answer that question, Senator.

Senator NELSON. And, as a matter of fact, you just used the word "flags." I noticed that that was the statement that you had made in a New York Times article on January 27th, of which you were quoted, quote, "We had a fair amount of discussions with Alliance about what was happening with our Enron shares," Mr. Stipanovich said, "There were plenty of red flags, and we would talk about them." Who is the "we" in this particular case?

Mr. STIPANOVICH. That would be the domestic equity staff under the leadership of Ms. Schueren. And you can see, as we take these meeting notes, we always record who are attending these meetings—but from the executive director through myself down to the domestic equity staff, including Trent Webster and a number of other people, again, with the chief of domestic equities.

Senator NELSON. And what were the red flags?

Mr. STIPANOVICH. Well, Senator, I've got a—you know, I can go through the list here, but it was certainly the fact that—it really kind of began on August 14th, when Skilling left, is when the ma-

jority of the red flags really began to, you know, wave red. But it was just things, in terms of the new partnerships that we were finding off balance—off the balance sheet and so on and so forth.

Senator NELSON. Well, of those red flags—you know, on that same day—October the 30th, the same day that you had that particular telephone conference call, they went out, and they bought another 317,000 shares, and that was on October the 30th. November the 8th, Enron admits that it overstated its profits by over a half a billion dollars. And then another 581,000 shares are bought on November the 13th; and another 478,000 were bought on November the 14th; and another 209,000 shares bought on November the 16th. And I'm curious—the Committee would want to know why were the red flags ignored?

Mr. STIPANOVICH. Senator, that's a question that Alliance would have to answer. We kept asking the same question you're asking, "Why are you ignoring these red flags? You bought this stock for $79.25 in November of 2000, and it's now down in in the single digits." There had been red flags literally starting since almost January 2001—or some flags were out there, in terms of people leaving the firm. But certainly, come August, there were more red flags than you could shake a stick at.

Senator NELSON. As you all went through the discussions, once you'd hang up, for example, or when you'd have just regular discussions among your staff about the watch list—and in this case, only one company, you've testified, was on the watch list—did you ever talk about, did you ever ask, whether or not this company should be de-funded?

Mr. STIPANOVICH. We absolutely were talking about de-funding Alliance at that point in time. We had actually been talking about de-funding Alliance for several months prior to that, because, again, at that point in time, when you get on the watch list, you have to start considering what your alternatives are in terms of any de-funding. Your options are you de-fund them or you fire them or you fund them, and they certainly weren't—they were on the de-funding—under discussion for de-funding and, again, possible termination, because they were on this watch list.

And, you know, there were a number of things we'd ask. For example, the statement was made awhile ago that Mr. Glassman said something about their weighting compared to S&P 500. In September 2001, they had 4-percent weightings. Senator, that was 20 times the weight of what the S&P 500 had in Enron. I don't know—he said something about reading it in the paper, and that kind of leads us to believe maybe you can't always believe what you read in the paper, but this is off Bloomberg, and they were 20 times the weight of Enron.

So these were the kind of questions that we would ask about. You know, why the overrating? Do you really have that much belief in the stock with this kind of, you know, warning signals.

Senator NELSON. Well, what were some of the other red flags? Help us to understand. Specifics would help us very much.

Mr. STIPANOVICH. OK. January 2001, highly respected short-seller shorts Enron. They continue to buy stock. Analysts, Skilling values Enron stock at $126. Skilling becomes CIO. Janus becomes—Janus Fund, one of the most successful funds in the country—be-

comes a net seller of Enron. Also a lack of disclosure and transparency in Enron financials reported by Goldman Sachs analysts. This is March of 2001. March 5th, Enron accounting again arises material red flags. Skilling, "People want to throw rocks at us." Enron in blockbuster, cancel video and demand on deal. Enron vice chairman, Cliff Baxter leaves after complaining of Enron partnerships. And fiberoptics collapse of $180 million charge, May 21st. Enron's power and generating venture in India falters. Power contracts fail. In June, S&P credit review, concern over international assets. Skilling abruptly resigns in August. September, Lay announces Enron would divest $4.5 billion in assets to restructure and emphasize trading options. September 19th, Enron claims India calls $5 billion in damages in violating their power agreement which caused part of their reasons for losses. Crude oil futures were falling to the lowest level in 2 years. Release of earnings, analyst calls, $618 million lost, shareholder equity written off. Also 13 or 14 analysts downgraded Enron after October 16th earnings report at a press conference. Crude oil falls to lowest level in 1999. October, SEC opens an inquiry. We're still buying the stock. Lay defends CFO Fastow, and CFO Fastow resigns a week later. Egan Jones downgrades Enron debt to junk. Enron—Alliance is talking to their creditors who do the credit analysis in the fixed income, which is fairly—I'm not too sure it's that usual. Enron creates special committee on partnership. November 8th, former—reflects additional details of accounting partnerships and restates earnings from 1997 to 2001, reduced by $586 million, largely due to these partnerships that are out there with all the previous red flags. Dynegy merger officially announced. And then that's all we begin to hear about is Dynegy, and that's the answer. Lay, Enron made billions—says, "Billions of very bad investments were made at Enron." This is a quote from Lay in November 15th. November 19th, Enron announces Enron may take additional $700 million pre-tax charge. November 20th, Enron warns of continuing credit worries, asset restatement, and reduced trading activity. November 28th, S&P downgrades Enron to debt, to junk, and triggers a billion dollar debt payment. Dynegy calls off the merger. Crude's at $12.50 a barrel. Enron file bankruptcy. Alliance sells.

Senator NELSON. And what in the discussions that you all had did you decide to do about all of those red flags? Was it as you said earlier, that you decided to keep hands off and let the money manager do it, despite the red flags?

Mr. STIPANOVICH. What we decided to do was fire Alliance. Unfortunately, we didn't fire them soon enough.

Senator NELSON. Earlier you had said that folks would ask you whether you agreed or disagreed with the actions. And I can't remember the specific quote, but you remember what I'm referring to. And I would like to ask you, was there any specific matter that you were consulted about when people would ask you if you agreed or disagreed with actions on overseeing the watch list? As we are doing this reform legislation, you said folks would ask you whether you agreed or disagreed. Is there anything in those actions that we should know about as we craft this legislation?

Mr. STIPANOVICH. Actions, as in—I'm sorry, Senator.

Senator NELSON. When people—as I understand your testimony, you said that folks would ask you whether you agreed or disagreed with actions of a particular investor—in this case, Alliance.

Mr. STIPANOVICH. Well, unfortunately, we're not in the position to really make those kinds of decisions, which are really what I think you're referring when you say "agree or disagree," and that is the purchase of the stocks. We are not in a position to make stock-selection decisions. We don't have the resources, Senator, or the staff to make those type of decisions. That's why we hire external managers and pay them for them to make those decisions.

What we do do is, we do serious performance monitoring, in terms of trying to make sure that they're providing the type of performance in the aggregate that we're looking for to reach our investment objectives at the board.

Senator NELSON. I'm going to miss this vote if I don't get up and go right now. So the Committee will stand in recess, subject to the call of the chair, and it will take me about 7 minutes to go over and vote and get back. The Committee is in recess.

[Recess.]

Senator NELSON. All right. Well, thank you very much, Mr. Stipanovich, and excuse me for having to stop here and go vote, but that's the way it goes around here.

Mr. STIPANOVICH. Thank you, Senator.

Senator NELSON. All right. Mr. Webster, why don't you describe for the Committee your position at the SBA?

Mr. WEBSTER. Yes. I'm a portfolio manager of domestic equities within the State Board of Administration, and I have two roles at the board. The first—my primary role is that I run the special situations fund, which is the only internally actively managed fund at the board. And I would say probably 80 or 90 percent of my job, or at least until the Enron debacle, was managing money. The other part of my job is facilitating the information flow of market to other staff members within the board so that we can make a decision about whether to fund, de-fund, terminate, hire managers. And that was the capacity that I had when I went out to visit Alliance in June.

Senator NELSON. And who do you report to in the pecking order?

Mr. WEBSTER. My direct boss is Ken Menke, who is the assistant chief of domestic equities, and ultimately to Susan Schueren, who is the chief of domestic equities.

Senator NELSON. All right. And the lady that was referred to earlier——

Mr. WEBSTER. Susan Schueren?

Senator NELSON. Is that one and the same?

Mr. STIPANOVICH. Yes, sir.

Mr. WEBSTER. Yes.

Senator NELSON. OK. Then I did not understand the pronunciation of her name. It's Schueren.

Mr. WEBSTER. Schueren.

Senator NELSON; Schueren.

Mr. WEBSTER. Yes.

Senator NELSON. I see. And then she reports to Mr. Stipanovich.

Mr. WEBSTER. That's correct.

Senator NELSON. OK. Now, can you describe the Florida SBA internal review process, in terms of putting individual money managers on a watch list?

Mr. WEBSTER. I don't really actually think I am the one to answer that question. What I do is give the information about the stocks that are in the portfolio to the people who make that decision on what managers go on or off the watch list.

Senator NELSON. You give information about the stocks.

Mr. WEBSTER. Yeah. Well, for example, because I manage a portfolio, I'm in the stock market every day buying and selling stocks. So I am probably the most connected to the stock market at the board. And so, because of that, I have a role in overseeing the manager's portfolio, the list of stocks in their portfolio, to see if what they're buying and selling makes sense relative to their strategy.

Senator NELSON. And so you'd be involved in bringing up any of these red flags that were testified to earlier.

Mr. WEBSTER. That's correct.

Senator NELSON. OK. And I suppose that some of the other red flags that maybe we didn't even mention here was—you'd be seeing different lists, like Forbes and newspapers or publications like Forbes. You'd be looking at other analysts and seeing what they would say you ought to buy or sell and a commentary on it and whether or not they would give a downgrade or an upgrade—you'd see all of that.

Mr. WEBSTER. Well, I'd see, you know, some—the majority of it.

Senator NELSON. All right. I'm going to put in the record an analyst's history of the Enron Corporation over that period of November and October 2001 with regard to analysts like Warburg, Goldman Sachs, A.G. Edwards, Merrill Lynch, Solomon Smith Barney, Prudential, Bank of America, so forth, all of which had a downgrade through that period of time.*

Now, is that something that you would have considered at the time?

Mr. WEBSTER. Well, yes. Yes and no. In my decisionmaking process, when I buy and sell stock, the analyst ratings have some informational content, but it would certainly be one of the things we'd be looking at.

Senator NELSON. And having seen this kind of stuff, what did you say at that particular time about Enron and the portfolio with Alliance?

Mr. WEBSTER. Well, what we were inquiring about was—we were trying to determine the decisionmaking process that Alliance was undertaking to buy Enron. And so we would ask Alliance about, you know, the issues surrounding Enron—for example, the chargeoffs, the resignations, things like that, specific issues relating to Enron and if they had taken that into account and if their decisionmaking process was consistent and logical with what they had—you know, what they were supposed to be doing.

Senator NELSON. And as a portfolio manager, what did your analysis tell you about Enron as a company?

Mr. WEBSTER. Well, I never looked in depth at Enron to make a buy or sell recommendation. I read the press reports, and I had

*The information referred to was not available at the time this hearing went to press.

listened to the analysts, but I never made—I never spent, for example, 2 weeks learning about Enron. It was more an amalgamation of news over time that made me familiar with the events at Enron.

Senator NELSON. Well, you offered some commentary, did you not?

Mr. WEBSTER. Yes. I mean, I understood the basic issues, but—and I was making my superiors aware of those basic issues, but I did not take the—I did not undertake a sufficient amount of research to at least make a buy decision on Enron.

Senator NELSON. There has been a widely quoted memorandum. Why don't you tell us about that memorandum that you wrote?

Mr. WEBSTER. Which memorandum is that, Senator?

Senator NELSON. October 24.

Mr. WEBSTER. Yeah, the reason why I had written that memorandum was to make my superiors aware of what was happening in the Alliance account. We knew that Alliance had purchased Enron and it was in their account. And as we watched the stock fall, I decided, as a means of communication, to let the people who are on—you know, who are on the memo aware of what was happening in the Alliance account concerning Enron.

Senator NELSON. If I recall, you had some pretty strong quotes in that memo. You want to share those with us?

Mr. WEBSTER. Well, if you refer to them, I'll perhaps comment.

Senator NELSON. Well, how about, "A stock that is falling when a company has accounting problems is almost always a bad time to buy," Webster wrote. "Alliance buying Enron since August has clearly been a mistake," Are those your words?

Mr. WEBSTER. Yes. And I think the subsequent events, at least in this case, were borne out to be true or consistent with what I said at that time.

Senator NELSON. Can you pull that back over here? That was on October the 24th, over here.

Mr. WEBSTER. Uh-huh.

Senator NELSON. And it's trading at about sixteen bucks a share, and it continues to go down. Did you share that memo with anybody?

Mr. WEBSTER. Oh, yes. I distributed it on October 24th to Susan Schueren and Ken Menke and to Martha Hurdle, and I assumed it went up to Coleman and Tom eventually.

Senator NELSON. Did you expect this kind of buying to continue in light of what you said?

Mr. WEBSTER. I guess I would say that I don't expect managers to buy or sell at any time. It's just—they either buy or they sell.

Senator NELSON. Well, you had the—you had a concern, did you not, when you wrote those words?

Mr. WEBSTER. That's correct, yes. And the reason for my concern was merely to communicate to my superiors what was happening in the Alliance portfolio so that they were aware of what was occurring in the Alliance portfolio.

Senator NELSON. Do you know—did the board of trustees receive your concerns or your memo?

Mr. WEBSTER. Well, they did eventually, but I don't—I have no idea if it was passed on to them at the relevant time.

Senator NELSON. Well, in those pretty strong words, what was your concern? Why don't you restate that for the record?

Mr. WEBSTER. My concern was the stock was falling on the issues that were in the press at the time that were being reported. And some of the—and the issues were that, in retrospect now, we find out that the accounting was a fraud at Enron, and the issues were trickling out into the market causing, or at least contributing to, the fall of Enron stock.

Senator NELSON. The previous spring, the spring of 2001, Alliance sold Enron stock on April the 17th, sold 112,600 shares. Do you have any knowledge of that?

Mr. WEBSTER. Yes.

Senator NELSON. Tell us about it.

Mr. WEBSTER. I actually—well, I think for a more accurate explanation, you probably should ask Alliance. My understanding, though—and, you know, I don't want to put words into Alliance's mouths, but it's my understanding that they were executing a V strategy where they'd buy as it fell and then sold it as it rose. But, again, I'm not the person who can give you the exact explanation for that.

Senator NELSON. In your capacity, did you participate in this teleconference that I have the notes of from September the 17th?

Mr. WEBSTER. No, sir.

Senator NELSON. How about October the 30th?

Mr. WEBSTER. Yes, sir.

Senator NELSON. OK. And you want to tell us something about that teleconference meeting?

Mr. WEBSTER. On October 30th?

Senator NELSON. Right.

Mr. WEBSTER. It was part of our increased oversight of Alliance, and we had questioned them about the purchases of Enron and why they were continuing to purchase.

Senator NELSON. And what was your feeling at the time of that teleconference?

Mr. WEBSTER. I guess what we were just trying to understand was what was the thought process and the decisionmaking process that Alliance was undertaking in making the purchases. At the time, we didn't know if it was correct or not. We just knew that it was falling, and they were buying it as it was falling, but we had—at least I certainly did not know what the outcome of Enron would have been.

Senator NELSON. As I read some of your quotes in other publications, it seems to me that you had some misgivings about Enron for quite awhile. For example, you stated in a March 24th St. Petersburg Times article, quote, "Enron was a stock that we had watched for years, and we couldn't understand why it kept going up," end of quote.

Mr. WEBSTER. Uh-huh.

Senator NELSON. Why don't you explain what you meant by that?

Mr. WEBSTER. Well, I'd like to first preface that with saying there are thousands of stocks in the stock market, and on some of them, we're right, and some of them, we're wrong. And fortunately, on Enron, as it turned out, we were correct on it. We had—we had an idea of what Enron's basic business plan was, and we viewed

it more as an arbitrage house, if you want to say it. And that's not necessarily a bad thing, but rather, you know, the valuation that you'd pay for something like that was what was curious to us.

Senator NELSON. Well, that was back at a time that Enron was still flying high in its stock price.

Mr. WEBSTER. And we were—yeah, in money management for that time period, we were wrong, because the stock kept going up.

Senator NELSON. And so your comment, "Enron was a stock that we had watched for years, and we couldn't understand why it kept going up," is that a statement that you had confidence in it or that you did not have confidence in it?

Mr. WEBSTER. I think that that's actually taken a little bit of—out of a little bit of context, because we did understand why it was going up. And the reason why it was going up was because its earnings were growing. What we didn't understand about it was how it grew its earnings. It just—we didn't understand it. But we understood why the stock was rising, because earnings were rising.

Senator NELSON. Since Alliance was on the watch list at that point, having gone on the watch list in the fall of 2000, was there any sharing of your statement, your concerns, as you had these monthly meetings?

Mr. WEBSTER. We—to my recollection, we first—we brought it up in October—in the October meetings. Enron—even though Enron was a stock that we didn't understand the fundamental business model, we also didn't necessarily believe it was a house of cards, either. And so, for example, in 1999 or 2000, there may not have been a reason necessarily to flag it as a potential bankruptcy. It was only after the charges—the charge-offs from the company and the resignations and the other red flags that Mr. Stipanovich had mentioned earlier, when it became a real issue for us.

Senator NELSON. All right. Thank you very much, Mr. Webster. I appreciate it.

Mr. HERNDON. Senator, do you mind?

Senator NELSON. Yes, Mr. Herndon?

Mr. HERNDON. I apologize, but I wonder if it's possible, if you're going to move away from us, if I could be excused. I have a commitment that I'd like to try and make, if that's feasible.

Senator NELSON. Certainly.

Mr. HERNDON. Thank you.

Senator NELSON. All right. Let's move to Mr. Harrison.

Mr. CALVERT. Senator?

Senator NELSON. Yes?

Mr. CALVERT. Pardon me. Before we begin the questioning, would you mind if we just corrected a couple of points for the record. Some statements have been made that are not factual.

Senator NELSON. Please, Mr. Calvert. We'll recognize you.

Mr. CALVERT. OK, thank you very much. First, I'd just like to correct a statement. We did not make an exception to our policy for Mr. Savage. We followed that policy to the letter. Second, we never owned a 6-percent position in Enron in the portfolio, and that's well known by all the parties. We did not sell the stock in a private placement. That simply is not correct. And, as you've heard before, it is not true that the SBA was not notified of the sale for several

days. They were notified in exactly the same way that they're notified by all of our transactions, on the very next morning.

Thank you, sir.

Senator NELSON. Thank you for your statement.

Mr. Harrison, welcome. Let's see if we can learn something for the Committee that will help us as we craft this legislation.

It's my understanding—and you tell me if it's correct—that you met during this period of time about 10 times with Enron personnel. Is that correct?

Mr. HARRISON. During the year, we met physically with them both at the portfolio-management level and at the research-analyst level. I have a team, as I've indicated, of 25 people working with me. I was involved in a number of those meetings. Other people would be involved either as portfolio managers or the analysts on Enron stock.

Senator NELSON. And in addition to staff, you met with the principals, as well. Is that correct?

Mr. HARRISON. Oh, very definitely. I mean, we would normally meet with the CEO, probably somebody from the financial, the treasurer, and maybe the investor-relations people.

Senator NELSON. You met with Mr. Lay?

Mr. HARRISON. Yes, indeed.

Senator NELSON. And Mr. Skilling?

Mr. HARRISON. He did a video conference with us in, I believe, July.

Senator NELSON. And put it in context for us. When you would meet with Mr. Lay, for example, how many people would be in the meeting?

Mr. HARRISON. There would usually be anywhere between three and six from Enron and maybe anywhere between 10 and 20 of my colleagues, and we would almost surely have it on oral or video conference with our other offices so that people would be able to hear what was going on. That is a normal part of the Alliance research intensity, that anybody—any management coming into any office to discuss a stock can be heard by every other office at the same time.

Senator NELSON. And when you refer to 10 or 20 of your colleagues, you're talking about people in Alliance.

Mr. HARRISON. The people in Minneapolis would be there physically in the room, and then the others would be there by either phone or video conference.

Senator NELSON. Now, these meetings 10 times took place over the entire year?

Mr. HARRISON. Correct.

Senator NELSON. Did any of those meetings take place in this period of time, from October the 17th to November 30th?

Mr. HARRISON. Yes, the—as I previously mentioned, one of the meetings took place immediately after Skilling resigned in August, a week after he resigned. But the key meeting was when the announcement of the $1.2 billion writeoff and the loss reported on a—for the third quarter there, led to us having the seven or eight people in New York meeting with management there 1 day after their announcement.

Senator NELSON. And at the time you were having these meetings with Enron, you were also having meetings with the State Board of Administration of Florida.

Mr. HARRISON. The meetings with the State Board of Administration obviously were meetings that took place sporadically during that 2-month period.

Senator NELSON. And in the March 3rd edition of the New York Times, they refer to it—which was disputed by the SBA people—that you had met some 31 times in that last year, according to internal memos released by the fund.

Mr. HARRISON. I don't know where the 31 times came. And I heard Mr. Herndon, or somebody, talk about dozens of times. I think that those numbers are picked of the wall.

Senator NELSON. When you—but it was quite a few.

Mr. HARRISON. It was quite a few.

Senator NELSON. When you met with the Enron people in these 10 meetings over this period of time—and how many of those 10 were in that period of time right there represented by that chart?

Mr. HARRISON. I've already indicated, on October the 17th, that would be the only, I think, unless your chart goes back early, which I don't think it does.

By the way, could I just clarify one thing? When I say 10 meetings, these might be meetings over the phone, as well, not physical meetings.

Senator NELSON. OK. And when you had these meetings, did Enron urge you to buy their stock?

Mr. HARRISON. Every time management comes in, they are presumably trying to clarify us as to their prospects. And in that context, I suppose they would be said to be urging us to buy the stock, but that's our decision. Our decision is going to be made on the basis of the research that we do and, as I said, the combination of our understanding of the fundamentals and where the price is at any point in time.

Senator NELSON. I understand. What I'm trying to find out is: What did they communicate to you? Did they say, "Buy our stock?"

Mr. HARRISON. Oh, absolutely not. No.

Senator NELSON. Well, how did they urge you to buy their stock?

Mr. HARRISON. Well, I've said that really—they only urge indirectly through basically being very forthright as it relates to their prospects, the businesses they're in, which businesses they're divesting, which they're concentrating on, where capital is flowing, and a multiple of other questions that we would be feeding them.

Senator NELSON. OK. So you had that meeting on October the 17th, when the stock's here, and 5 days later, it's down to here, and you purchase 311,000 shares. Tell us what was in your mind to do that.

Mr. HARRISON. Yes. As a result of the meeting on October the 17th, we obviously had a decision to make as to whether or not the core business was still intact, and was Mr. Lay doing what, in essence, he had promised to do in terms of providing a greater level of openness and also writing off non-core assets. Our conclusions was that, yes, the core business was still intact. He reiterated to us the $1.80 estimate for the year and $2.15, $2.20 for the following year. This was a clearing of the decks, as I indicated. How-

ever, the price was in free fall, and we made our next purchase on the 22nd of October, as you've indicated, at a price of twenty-two, eighty-two cents.

Senator NELSON. Did anybody in Florida ask you to buy this stock?

Mr. HARRISON. No.

Senator NELSON. Did anybody intimate any kind of communication to that effect?

Mr. HARRISON. No.

Senator NELSON. Who would you typically talk to when you talked to the—your client in Florida?

Mr. HARRISON. The normal contact would be Ken Menke. When I would go down to visit Florida, the person that is not here today, the chief investment officer of equities, Susan Schueren, would be the chair of any meetings that we had.

Senator NELSON. You heard the quote by Mr. Webster just a few minutes ago, and I'll give it to you again, quote, "A stock that is falling when the company has accounting problems is almost always a bad time to buy. Alliance buying Enron since August has clearly been a mistake," in an October 24th memo, is what he says.

Mr. HARRISON. Right.

Senator NELSON. Did you ever see that memo?

Mr. HARRISON. Of course, I don't see any internal memos that Mr. Webster is alluding to.

Senator NELSON. You did not see that memo.

Mr. HARRISON. No, that would be internal to Florida.

Senator NELSON. I understand. But have you seen that particular quote, whether you've seen that memo or not, at the time? Was it conveyed to you verbally?

Mr. HARRISON. No, not at all.

Senator NELSON. I see. Well, what do you think about Mr. Webster's comment, since apparently the two of you have a considerable difference of opinion on——

Mr. HARRISON. Mr. Webster's comments are obviously personal to him.

Let me just, if I could, just read the first three lines of what we're supposed to be doing for Florida. "Alliance Capital's large-capitalization growth strategy emphasizes stock selection, portfolio concentration, and opportunistic trading to capitalize on unwarranted price fluctuations." This is very clear in my mind, that what we were doing is basically balancing all of the news that we had that was positive against the negatives that basically was out there in the press, and then making a price judgment. And we determined that the core business was still intact, from the intensive research that we had done, and we continued to buy the stock.

Senator NELSON. Were you, Mr. Harrison, aware of all of the outside analysts that we referred to a moment ago that will be made a part of the record—were you aware of their recommendations that people ought to sell instead of buy?

Mr. HARRISON. Not only am I aware of the firms that you spoke to, sir, but I believe that most of them had been carrying buy recommendations, including the one big bear on the street that has been—hit the press, and that is an analyst down in Houston as late as September. He turned from basically being a bear to a very

strong buy on the stock, and I think you'll find that most analysts were still of a buying mode right until the very end.

Senator NELSON. At one point, you were quoted in one article—I believe it was the New York Times—as saying you didn't know who Frank Savage—that you did not know that Frank Savage was a member of the Enron board.

Mr. HARRISON. That is correct.

Senator NELSON. Did you read the annual statement of Enron?

Mr. HARRISON. I didn't read it in the sense of checking the directors. Generally speaking, that is something that—I'm more interested in the income statement and the balance sheet of a company. You know, obviously every corporation has got a list of directors. That is not No. 1 on my priority.

Senator NELSON. Tell me about the October 30th conference call.

Mr. HARRISON. The October 30th conference call was obviously related to the fact that, for 2 years, growth stocks had been under pressure in the marketplace. As was previously indicated, we had taken the Florida funds up to $6.2 million. Over that 2-year period, most growth managers suffered something like a 30- or 40-percent decline, which was similar to our own. And that conference call was an attempt to isolate the various stocks that had perhaps been hurting us. And Enron was one of those stocks. And obviously Enron, given what was happening in the press, was probably receiving more of the dialog than the others. But we talked about the portfolio in general.

Senator NELSON. Did members of the State Board of Administration staff express to you in that October 30th teleconference their misgivings about Enron?

Mr. HARRISON. No, sir. They listened to what we had to say and presumably took note of what we had to say, that we had been meeting with Enron management. We had basically done our research. We were of the view that the core trading operations of this company were still intact.

Senator NELSON. So the comments of Mr. Webster written in an October 24th memo, some 6 days previously, was not conveyed to you in the October 30th teleconference?

Mr. HARRISON. Only to the extent that there might have been a dissatisfaction as it relates to the losses in the portfolio by the various stocks, of which Enron would be one, but nothing specific on Enron, certainly no direction to do anything about it.

Senator NELSON. And after that teleconference on October the 30th, then you went back out and bought another 317,000 shares.

Mr. HARRISON. The stock was now $12.22, correct.

Senator NELSON. And so there was nothing conveyed to you of a concern from the staff of the State Board of Administration about what had happened thus far on that October 30th teleconference.

Mr. HARRISON. This was obviously one of the stocks on which we were losing money, so if you would call that concern, obviously we talked about it.

Senator NELSON. But there was no message that was given to you that you should not buy, therefore you felt at liberty to go back out on that very same day, right after the telephone conference, to purchase more.

Mr. HARRISON. Absolutely. We have the authority and the fiduciary responsibility to do the best for our clients. And as far as we were concerned, based on all of the information that we had and the price of the stock, it seemed very attractive.

Senator NELSON. The State of Florida, as stated by Mr. Herndon, has filed suit against you all. They've distributed copies of the lawsuit, the pleadings, to the entire Committee. These are serious allegations. Are they true?

Mr. HARRISON. Sir, what——

Senator NELSON. Are they true?

Mr. HARRISON. The allegations?

Senator NELSON. That's correct.

Mr. HARRISON. Sir, we did everything in our fiduciary role here, as far as I was concerned, to exercise the care and skill and prudence that is part of our mandate, and I think that we can show that, on this particular stock, the faults were clearly with Enron and the fact that we had misleading information, incomplete information, and that the auditors did not do their job. We certainly did our job.

Mr. CALVERT. May I just interject, Senator?

Senator NELSON. Please.

Mr. CALVERT. We've stated publicly, and we would state again here, that we believe these allegations are totally without merit, and we plan to defend ourselves vigorously in this suit.

Senator NELSON. OK, were you able to hear that? OK. Thank you, Mr. Calvert. Thank you, Mr. Harrison.

Mr. Calvert, how about giving me—give the Committee some examples of your public and private clients, your client list.

Mr. CALVERT. Well, as I said earlier, we manage money for 45 of the Fortune 100. And, you know, I don't have a client list with me, and I'm a little nervous about—some clients ask us not to use their names, others say it's fine. But 45 of the Fortune 100 public funds in 43 of the 50 states.

Senator NELSON. Public funds, there wouldn't be any problem in telling that, would there, because it would be public record?

Mr. CALVERT. Generally not. We manage money for funds in the State of New York, the State of North Carolina, the state of South Carolina. We manage funds, not state—well, also the state funds in California, in Oregon, in Missouri. Those are the ones that come quickly to mind, but that's a small sample.

Senator NELSON. Help the Committee understand, with regard to your client in New York, that Alliance, being the money manager for the pension fund there, sold Enron shares in the month of August 2001.

Mr. CALVERT. Uh-huh.

Senator NELSON. Whereas, the experience in Florida was the opposite——

Mr. CALVERT. Correct.

Senator NELSON.—that the funds were purchased. Share with us there, what was the decision with regard to the selling of those shares in New York.

Mr. CALVERT. Yeah. In the final analysis, it was mechanical. As I stated at the beginning, we are a multiple-product firm. We offer a variety of investment services. Each of those teams has an in-

vestment philosophy, an investment process and so on. We don't try to coordinate across all those teams, because that would be against the objectives of the clients, who selected the team to do it the way they said they would do it.

In that particular portfolio, the money is managed directly by members of our research staff, and they have a rule that only one-rated securities can be held in the portfolio. Perhaps I should explain. One being their highest rating, two being their next rating, three being their lowest rating. And the analyst changed her rating from a one to a two on Enron primarily because she wanted to focus on some other companies in the same industry. And given that rule, the stock was automatically sold in that portfolio when that downgrade occurred.

Senator NELSON. Is it typical that, under the umbrella of your own house, that one hand would be selling and another hand would be buying?

Mr. CALVERT. It's—it doesn't happen very frequently, but it happens. For example, as you may know, one part of the firm invests in growth stocks in a number of different kinds of portfolios, but another firm, largely under the Sanford Bernstein name, which is a company we acquired, has a value approach to investing, and it's possible that stocks can be sold from one portfolio manager to another. It's not a frequent occurrence, but it happens.

Senator NELSON. Do you have any knowledge of anyone in Enron calling you to urge you to buy Enron stock in the fall of 2001?

Mr. CALVERT. No, sir. In fact, I should say, Senator, I have never met or talked to anyone from Enron directly. I've, you know, watched some presentations and so on, but I've never had a personal conversation.

Senator NELSON. You have no knowledge of anyone in your firm, other than has been represented by Mr. Harrison in his typical kind of meetings with his colleagues, that there was any kind of particular effort that was made by Enron to get you all to buy Enron stock in the fall of 2001?

Mr. CALVERT. No, sir, nothing out of their ordinary kind of presentations. And I'm quite sure it would have been brought to my attention had that occurred anywhere in the firm.

Senator NELSON. Mr. Savage, who you have previously testified about—it's my understanding that he resigned from Alliance along about August 2001. Is that correct?

Mr. CALVERT. July. Yes, sir.

Senator NELSON. And why did he do that?

Mr. CALVERT. Frank, was working on a project to raise money for a private equity fund that was going to invest in Africa, and he had a team of people working with him. And we had had an agreement with Frank, made roughly 2 years prior, that Alliance was going to support that activity for a defined period of time, but if he had not been successful in raising funds for that activity by a certain date, we were going to essentially pull the plug on that project.

As that date came and went, we entered into conversations, and we said that we were going to stop financing that project. And at that time, Mr. Savage decided that he was going to leave Alliance and form his own firm to pursue that project, which he still believed in.

Senator NELSON. Was he a member of the Enron board at the time?

Mr. CALVERT. Yes, he was.

Senator NELSON. And how long had he been a member of the board?

Mr. CALVERT. I believe he went on the board in 1999.

Senator NELSON. And how long had he been with Alliance?

Mr. CALVERT. We acquired a company called Equitable Capital Management in 1992, and so Frank became part of Alliance at that time, but he had been with that predecessor company for considerably longer.

Senator NELSON. And you have no knowledge that he had, at any point during this period of time—we're basically talking year 2001—urged any acquisition of Enron stock.

Mr. CALVERT. I have no knowledge of that, and I have gone out of my way to inquire about that, and I don't believe there were any such conversations.

Senator NELSON. When Mr. Lay came back to be chairman of Enron last year, he told the press that his focus was investor relations. Aside from what Mr. Harrison has testified to with regard to promoting Enron and Enron stock, are you aware of any additional things that Mr. Lay and/or other executives at Enron did to promote their company and their stock?

Mr. CALVERT. No, I'm not.

Senator NELSON. I understand that Alliance bought more shares of Enron than any other shareholder in the country, some 43 million shares by the fall of 2001. Were you, as the CEO, aware of Alliance's purchases of Enron?

Mr. CALVERT. I was, and we—I don't know that we had bought more by that time—some people may have been larger—but it is true that on September 30, we were the largest institutional shareholder, owning about—a little over 5 percent of the stock.

Senator NELSON. And what was your company's strategy in accumulating that fairly large percentage of a company.

Mr. CALVERT. Actually, Senator, that's a relatively small percentage, or it's an average sort of percentage. Recall that Alliance manages $450 billion, and over $300 billion of that is in equities, so usually when we take a position in a company, we become a relatively large shareholder for the company, even if, as in this case, it wasn't owned in all portfolios and it was only a 3- or 4-percent position in the portfolios where it was owned on that date, on September 30th.

Senator NELSON. How many of your portfolio managers purchased shares in Enron during the year 2001?

Mr. CALVERT. I don't know that number exactly, Senator. I'll be happy to get it for you, but, order of magnitude, I would say 10 or 12.

Senator NELSON. And do you know how many were purchasing shares of Enron in the month of August?

Mr. CALVERT. Perhaps Mr. Harrison can answer that specifically, but it would have been 6 or 7 at that point, probably.

Mr. HARRISON. That's fine.

Senator NELSON. And September?

Mr. CALVERT. The same.

Senator NELSON. October?

Mr. CALVERT. The same.

Senator NELSON. So 6 or 7 are purchasing, while at least some number are selling, as in the case of New York.

Mr. CALVERT. Well, within the large-cap growth discipline, others were holding. Within another discipline, yes, there were some sales, and——

Senator NELSON. Were you aware that Mr. Harrison was on a watch list in Florida?

Mr. CALVERT. I actually was not aware of that until recently. I am now aware of it. I wasn't aware of it at the time. We understand that—you know, that procedure, and that would not have been of particular concern to me. And if I can explain——

Senator NELSON. Please.

Mr. CALVERT.—why. I think all investment managers, no matter how good, do not perform the benchmark every quarter and every year. And, as has been said, I think it's the long-term record that matters. And from time to time, we—if we under perform for a short period of time, there's procedures where people put us under closer scrutiny or say that they are going to watch us. And I believe I'm correct in saying that we had, in fact, been in that position with the state of Florida in 1994, and, of course, went on to have very strong performance after that. And it would have been my belief that we would go on to have very strong performance after this period on the watch list.

Senator NELSON. So the bottom line is you weren't aware that he was specifically on a Florida watch list.

Mr. CALVERT. I was not.

Senator NELSON. And certainly you wouldn't have been aware, then, that he was on it for that period of time, 17 months.

Mr. CALVERT. I was not, but it—I would have viewed that—I would not have—I would—I view that as something that's—kind of happens in the normal course of our business, and I would not have expected it to be reported to me. On the other hand, I was very aware of all of our Enron purchases.

Senator NELSON. So you were aware that the Florida pension fund was more heavily invested in Enron than most other public funds.

Mr. CALVERT. I was aware that we were making the purchases. I was aware then, and am aware, that Mr. Harrison treated all of his portfolios identically, as did other members of the team, and as is required of us, but I was also aware that there were some portfolio managers who chose not to own Enron, and there were other groups in the firm that didn't own Enron. And again, that's not atypical.

Senator NELSON. Back at the beginning of the year, of 2001, Alliance sent out a notice to its clients stating—to caution about risks associated with buying stocks in a downturn. Do you have any knowledge of that?

Mr. HARRISON. Senator, may I take that question? I sent out a memo early in 2001 saying that, given the decimation in technology stocks, I did not expect an early recovery in technology stocks, and, therefore, I felt that the market overall was vulnerable. Do remember what I said. Enron looked like a standout in relation to the col-

lapse of technology stocks. So that memo that you're referring to referred to essentially the technology stocks, which people thought of as being leaders in the market.

Senator NELSON. And in your case, you said Enron was on the list.

Mr. HARRISON. No, I'm saying that Enron, at that time I sent out the memo, was basically a standout in relation—its earnings were going up at 20, 25 percent a year. Technology stocks were totally collapsing.

Senator NELSON. Well, I—my question, though, is to the CEO, because I think it goes beyond you, Mr. Harrison, that a communication came from Alliance in January 2001 to its clients and to its stockholders cautioning about the risk associated with buying stocks in a downturn.

Mr. CALVERT. The communication came from our large-cap growth group, not from the firm as a whole. Each, again, of our investment services, has communications with their specific clients, which is relevant or germane to what they're doing. And, as Al said, I think what he was cautioning against was buying companies where earnings were falling dramatically. In the case of Enron, we believed that earnings were still growing, so that memo was not a concern to me.

Senator NELSON. OK. Well, thank you for your comments. I'm sorry to have kept you here so long. Now I can get to Mr. Glassman.

Mr. Glassman, you've heard everything here. It's gone back and forth. Why don't you give us the benefit of your commentary on the basis of the answers that you've heard to the questions that have been proffered here today.

Mr. GLASSMAN. Thank you, Senator, for that open-ended question. Well, I think it's very important to understand the function that someone like Mr. Harrison plays in a large state pension fund. As has been stated earlier, there are a number of managers who are chosen typically to have different styles and to balance the styles in the fund. Mr. Harrison's particular style, which I this is—I think it's well known to most people in the investment community is, in fact, to look for companies that have been beaten up, companies that he believes are undervalued, and then to buy those stocks.

And I don't really think that the relevant question is did he—was one of his investments not profitable. I think the relevant question is the structure of his portfolio. Was he dangerously overweighted in any one stock. And we've heard different numbers, but I understand that in his portfolio he never had more than, let's say, 4 percent, maybe it was 5, but even that is not particularly high, in Enron stock. So that's one question.

And then I think the other question is did his losses in Enron seriously impair his overall performance. And, of course, it depends on how far back we go with the performance, but he's had a history the Florida pension fund over 17 years, and he's turned in what I would say is a pretty sensational performance. And I think it's really up to the fund—to the managers of the Florida State Pension Fund to decide whether they want to retain him as a manger. And I think they can say, well, he hasn't done very well in the last cou-

ple of years. I know what he did publicly—I mean, his public fund, which is called Alliance Premier Growth, between 1994 and 1999, according to Morningstar, he returned 46 percent in 1995, 23 percent in 1996, 32 percent in 1997, 48 percent in 1998. That's pretty darn good. Then he had two bad years. I'm sorry, in 1999, he was 28 percent. Then 2000 and 2001 were bad years. So maybe they should fire him. I think—you know, that's up to them.

What bothers me about a lot of the testimony that I've heard today is it almost sounds like, I don't know, sour grapes on behalf of the managers of the Florida pension fund that he made an investment in Enron that lost money. The chart that you're showing up there certainly does show the stock falling and then continuing to fall and continuing to fall. But that's through the benefit of hindsight.

You know, if we looked at, let's say, his investment in Continental Airlines immediately after September 11th, after September 11th, there was no flying in this country for a week. Airlines, subsequent to that, were in terrible shape. I mean, some of them were on the brink of bankruptcy. People felt, you know, who's ever going to fly? The stock price of Continental and a number of other airlines dropped at least 50 percent. You could have shown exactly that chart for Continental stock. He bought it, and it went up.

He has winners. He has losers. And I think overall you need to look at the—his entire record.

I just want to correct—or at least clarify my statement about the proportion of Enron stock in the overall Florida portfolio, because I think this is relevant, and actually I think it's a credit to the Florida pension fund, the people who manage it overall. Based on my calculations, they could be off by a little bit, I don't think at any time Florida had more than 0.3 percent of its entire $95 billion in assets in Enron stock. Florida was not placing a huge bet on Enron stock. The Standard & Poor's 500 stock index, which is a basket of pretty much—you know, most of—the vast majority of the market's capitalization—in January, the value of Enron was 0.53 percent. So that was my point about that.

But I think to look at Mr. Harrison's performance, you know, I would say it's pretty good. I certainly never owned Enron stock. I never advised any of readers to own Enron stock. I didn't particularly like the company, never would have bought it at that point, but I've got to say that, based on Mr. Harrison's record over the long term, I would not want to second guess him. If I were Florida, I would have hired him for a specific reason, which was to invest in this style with this amount of money while other people are investing with a different style with other amounts of money. And I think that's actually quite a successful practice.

But it does bother me, as I said earlier, that there's an attitude abroad, and perhaps significantly in the halls of Congress, that when you make money in the stock money, that's fine, that's yours to keep. But if you lose money, somebody must be doing something, you know, illegal or immoral. That's not the nature of stock investing.

The nature is, over the last 76 years, stocks have lost money 22 times. Stocks go down. Stocks go up. And I think that's important for all Americans to understand. And they need to protect them-

selves against risk. And the only way they can do is through diversification.

Thank you.

Senator NELSON. Mr. Glassman, what's unusual is the fact that the Florida pension funds lost more—almost as much as the next three pension funds lost together on an Enron investment—the University of California Regents, Georgia State Pension Funds, and Ohio State Pension Funds. And three is clearly something unusual about this. And this is part of the reason we're having a hearing, because we want to see if there's anything we can do about it.

Does the staff have any questions for the first panel? OK, thank you all very much for your patience. We appreciate it very much, and we'll call up the second panel.

Good afternoon. One of the witnesses on the second panel, because of the lateness of the hour, had to leave, Mrs. Sarah Teslik, executive director of the Council of Institutional Investors. And we will insert her testimony as a part of the record.

[The prepared statement of Ms. Teslik follows:]

PREPARED STATEMENT OF SARAH BALL TESLIK, EXECUTIVE DIRECTOR, COUNCIL OF INSTITUTIONAL INVESTORS

You have called this hearing to ask how pension funds can avoid losing money in the stock market. Many investors lost a lot of money in Enron and in other corporate disasters.

There is one clearly wrong answer. It is the answer that *seems* like the obvious *right* answer.

"Don't buy losing stocks" sounds good, but it doesn't work. Big pension funds will not—repeat will not—avoid losing money in the stock market by trying to pick winners and sell or avoid losers. The more a pension fund tries to do this—the more it buys and sells—the more it loses. Over three-quarters of managers lose money when they try to do well by active buying and selling. With large amounts of money you cannot, over time, avoid the losers. Instead, you aggravate losses by incurring large fees. I am happy to explain this key point further in plain English during the question period if you want. It takes two minutes and I only have five. I'll just say for now that it has been demonstrated with ample data that large funds that try to avoid investments in losing stocks by hyperactively managing their money fail to avoid the losers and instead incur large trading costs on top of losses.

Pension funds, in other words, should not have been trying to avoid Enron by hyperactive management. This is why most of the best-managed pension funds in the country had some Enron stock. In all cases of which I am aware, the amount of Enron stock the funds held was tiny compared to overall assets.

But that doesn't mean that something can't be done to reduce losses from future Enrons. A number of things can be done. Rather than reduce the chances of particular funds holding rotten companies' stocks, we should reduce the numbers of rotten companies. This is the better approach and it happens to be the only approach you can promote legislatively.

Our antiquated securities laws and conflict-ridden oversight systems give us poor quality information and prevent us from acting effectively on information we do get. Many companies like Enron would not have had to implode if owners had gotten key information and been empowered to act on it. Owners hate losing money; they don't need to be encouraged to act. And it doesn't cost taxpayers anything when owners spend their own money to prevent fraud and encourage good corporate behavior.

But the information investors get is flawed, incomplete and sometimes grossly misleading. And additional laws prevent or severely inhibit investors from acting on the information they get. Combine these two and you get Enron. Global Crossing. Xerox. Rite Aid. Sunbeam. Waste Management. MicroStrategy. Cendant. And on and on.

The problems have been obvious for decades before Enron. If you don't require companies to disclose stock option plans, and if you don't require companies to let shareholders vote on stock option plans, if you don't require companies to expense

stock options, you get runaway compensation that turns companies into Ponzi schemes.

If you allow companies to hide their directors' financial conflicts, if you allow companies to hide their debt just because a tiny portion of its equity is held by someone else, if you allow people who want wiggle room to write accounting standards, if you let brokers vote when shareholders do not, you will get more Enrons.

If you saddle shareholders with restrictions that make it look like the government is overseeing pedophiles rather than property owners, if you maintain disclosure requirements that give company managements ammunition to sue shareholders who question them, if you fail to prosecute individual wrongdoers and instead levying corporate fines that hurt victims but not wrongdoers, you will get more Enrons.

Worse yet, you will get markets that start to slip. All great societies start to crumble at some point. Many do when special interests start to dominate. The fact that we've had a good run of it doesn't mean we will continue to do so. We need accurate disclosure of company financials. We need accurate disclosure whenever officers' or directors' or auditors' interests are not aligned with shareholders. But we need more than disclosure: being told we're being taken to the cleaners is not helpful unless we can act to prevent it. I am submitting previous testimony of mine in which I catalog what needs to be done.

The key concept is this. Wall Street and some executives are enriched when shareholders bet on the horses. Betting, indeed, is strongly encouraged by those who profit at shareholders' and employees' expense. But while betting on the horses is encouraged, *training* the horses is actively discouraged. A significant collection of laws and regulations make it nearly impossible for shareholders to act like the owners they are. These laws and regulations are *not* accidental. There has been a major power struggle over the past many decades over who controls major companies, and, by and large, directors and managers have won.

Over time, the fact that shareholders are encouraged to do a lot of buying and selling and are discouraged from acting like owners has meant that shareholders are betting on slower horses. If everyone bets on the horses and no one trains them, our economy will suffer. If our regulators do not exhibit leadership to correct these problems rather than put Band-Aids over them, capital flight will start to occur.

I urge you to pass legislation and encourage regulation that gives shareholders both the information and the tools they need to oversee America's big corporations. This is America's grocery money at stake and you are the ones who can take—or not take—the right actions to protect it. Lean on regulatory bodies who don't demonstrate leadership. Assist training, discourage betting, and you'll create a more consistent field of thoroughbreds.

Previous Testimony

We are all Enron exhausted, so I'll start with the bottom line.

Accountants sign off on financials that trick investors *because we let them*. CEOs pay themselves hundreds of millions of dollars, even when they bankrupt their companies, *because we let them*. Boards look the other way *because we let them*.

There are almost no consequences for individuals who commit corporate crimes. There are almost no consequences for board members, CEOs, auditors, analysts, rating agencies and government employees who fail to do their jobs. *Even honest people start behaving badly when there are no consequences.* Especially when the reward is hundreds of millions of dollars.

This is not an Enron issue. Enron is already old news—questions about Global Crossing, PNC, WorldCom and A.C.L.N. all post-date it.

People will behave badly to get great wealth if the stock exchanges don't stop them. If the SEC doesn't deter them. If FASB and the AICPA enable them. If prosecutors rarely go after them. And if you legislate loopholes.

The causes of this problem are not recent. Frauds are bigger and more frequent because the laws that were passed 65 years ago to protect shareholders have been steadily worn down by special interests. Indeed, our laws now protect executives, accountants and financial wheeler/dealers at shareholders' expense instead of the other way round. We are reaping the harvest of this multi-decade legal hijacking now.

Great civilizations in history crumble when special interests take control of government machinery and use it for their benefit. I am well aware that these special interests are applying heavy pressure to each of you right now. If history is any guide, you will give in. I am begging you not to. The fact that we've had a good run of it the past 200 years doesn't mean we will in the future unless you reverse this erosion average Americans' protections.

What most urgently has to be done? Let's start with the auditors.

Right now we allow managers to pick and pay people to bless their work. If fifth graders picked their teachers, fifth graders would get As. People invariably act in their self interest.

Not only that. We allow auditors and managers to write accounting and auditing standards. If fifth graders wrote grading standards, all fifth graders would pass. People invariably act in their self interest. So who can be surprised that we have loophole-ridden, outdated standards that permit amazing things—what is *permissible* under current standards is more amazing than what is not.

Not only that. We allow auditors to fund and run their own professional oversight. You *all* know better than that. No profession self polices effectively. People invariably act in their self interest.

What should you pass? Legislation that aligns auditors' interests with shareholders' and that stops aligning auditors' interests with the managers whose numbers they review. Unless it is in auditors' financial interest to protect shareholders, it won't happen reliably enough. You also need legislation that keeps oversight and enforcement power free of undue influence by auditors and issuers.

Specifically: (1) Require the board audit committee, not the managers, to hire the auditors. This is critical. (2) Fix FASB's and the AICPA's accounting and audit standard-setting systems with guaranteed funding and better accountability to investors—current accounting principles gave Enron crater-size loopholes. In other words fix the *system* for setting accounting and auditing standards, not just a couple of the worst products of the current systems. (3) Require CEOs, audit committee members and outside auditors to sign the financials as true and accurate—just like you and I sign our tax returns. (You think twice, don't you, when you sign?) (4) Remove non-trivial conflicts of interest—conflicts affect behavior. And (5) Come down hard on individuals—not just companies—who break the law. If you merely fine audit companies for fraud, you simply increase a company's cost of doing business. Anderson settled case after case, wrote checks and moved on.

Relying on peoples' honor or professionalism will not work. Chinese walls never work. Independent bodies don't remain independent long. Unless you harness self interest as the legislative motivator, you will keep getting misleading financials.

But auditors are only partly to blame for this mess. If your legislation focuses mostly on audit reform, it will be ineffective.

It is not the auditor's job to oversee the company. It is not the auditor's job to detect fraud, absent certain red flags. It is not the auditor's job to prevent self dealing or make business decisions. It is not the auditor's job to set the tone at the top and say it is wrong to lend a rich CEO 341 million dollars. It is not the auditor's job to create secure jobs and shareholder value. These are jobs for managers and boards.

Why have so many boards allowed terrible things to happen? Let me ask you this: if your staffers had absolute power to remove you from office, would you discipline them if they were stealing? Our system allows executives to pick the boards who are supposed to police them. So, although boards are supposed to represent shareholders, they don't. You participate in real elections so you care about your constituency. We shareholders should be so lucky.

Fixing this fundamental misalignment is more important to fraud prevention than auditor independence because a board's responsibilities are more critical to a company's health. Yet current laws, rather than helping shareholders keep companies accountable, do the opposite. I'll give you a few examples.

(1) If a shareholder buys a mere 5 percent of a company's stock, he/she has to file forms as if the government is tracking a pedophile rather than an owner. The only way a shareholder can avoid this is to file a form promising to be passive. I'm not making this up. So shareholders without expensive form-filing lawyers *have to promise to remain inert*. Large pension funds that might otherwise be willing to pressure a troubled company, and who do not seek control, remain inert rather than filing burdensome forms that bring litigation risks with them. These requirements should be reworked.

(2) The government tells us what issues we can and cannot bring up with our own employees—company executives. The SEC decides what issues shareholders can raise for a shareholder vote. *Have any of you read these rules*? *They take almost every issue a shareholder ought to want to raise off the table*:

- We cannot ask about anything that is "ordinary business"—which covers almost everything we should care about.
- We can't ask about anything that is extraordinary business either if an issue affects only a small part of the company.

- We cannot ask about the thing we should *most* want to ask about—the election of the company's actual board. I'm still not kidding.

Many of the problems at Enron would be off limits for shareholders to raise under current rules.

Worse, the SEC is free to, and often does, change its interpretations of these rules, without warning or recourse, so we don't know from one year to the next what we can ask.

(3) When the SEC *does* allow a shareholder to raise an issue for a vote, it requires the shareholder to send someone to the annual meeting, even though few companies require *their own directors* to attend and most shareholders vote by proxy and not in person. If the shareholder's rep isn't there, the company can cancel the vote. So if you are disabled, have a job, are not rich or can't travel, forget it.

(4) As if this isn't enough, companies can, and do, move their annual meetings to hard-to-reach places, even foreign countries, so shareholders can't get there. Annual meetings of major U.S. companies have been held in Russia—or in towns without airports in Alabama on Friday afternoons before holidays. I'm not kidding.

(5) Managers can call off a shareholder vote on election day if they see they are losing. (Though a Council member sued a company over this recently and more or less won.) Can you imagine if a U.S. Senator could do this—people would howl.

(6) If a shareholder wins a majority of votes cast for its proposal, companies can, with few exceptions, ignore the vote. Most do. Some companies ignore majority shareholder votes even when an issue passes year after year. This makes the shareholder franchise a joke.

(7) Shareholders used to get to vote once a year on directors. But this year AT&T and Comcast have agreed to bar shareholders from voting again on the board of the new company until 2005.

(8) Some shareholder ballot items are rigged. The New York Stock Exchange allows brokers to stuff ballot boxes and vote for management when shareholders with broker accounts don't vote. Most shareholders don't know this. Studies show this throws important votes. The SEC and NYSE ignore our pleas to fix this.

On this subject, I would caution you not to put the New York Stock Exchange in charge of any investor protections. The NYSE is a private sector corporation. It gets money from corporate executives—listing fees. Never expect private-sector bodies to act against those who fund them—they won't do it. Not surprisingly, the NYSE has, in my opinion, consistently used its government powers to harm investors and protect managers, not the other way round. **In my opinion, anyone who assigns investor protections to the NYSE doesn't want to protect investors.** Democracies were designed to avoid precisely the problems we see over and over in this guild-like, government-protected, reportedly highly profitable franchise.

So, if you do want to make a real difference, what legislation do you pass?

We need better and immediate information about companies' executive compensation practices and directors' and CEOs' buying, selling, borrowing and hedging activities. And we need better ways to control this compensation—votes on all stock option plans and an ability to put up board candidates if existing boards are giving away the shop. Fraudulently calculated pay needs to be returned.

Why is all this so important? Because if we cannot control our employees' compensation, even honest people will gradually pay themselves more and more. It is happening all over. Power corrupts. In extreme cases companies become Ponzi schemes. Executives siphon money out in mega option grants and companies crash.

There is a reason that nearly a quarter of major-company CEOs get their companies to give them huge loans—loans as high as a third of a billion dollars to one person. There is a reason these loans are often forgiven, subsidized and/or used to hide CEO stock dumping. When shareholders' hands are tied behind their backs and key information stays secret, or stays secret until it is useless, executives get more and more generous with themselves. They do it because they can.

If you curb executive compensation abuse, frauds become less profitable to fraudsters. Money is the main motivator. Focus on it.

Neither the SEC nor the NYSE has used the powers they already have to address this problem adequately; if it doesn't come from you, it won't happen.

What else? Senator Nelson's bill gets at many of the issues I've raised today. It requires that companies disclose directors' conflicts better—something we asked the SEC to do years ago but which just sits over there. In fraud after fraud we discover undisclosed director conflicts. There is no excuse for hiding this critical information.

Nelson's bill also gets at board independence effectively because it uses a real-world definition of independence, not a weak definition, like those used by the NYSE and some companies.

At our meeting next week Council members will be discussing legislative language that would make it easier for shareholders to put director candidates on the com-

pany's proxy and get issues on company ballots. Why do you let companies ignore our majority votes? Why does the NYSE throw shareholder votes by letting brokers, who are not shareholders, vote? Shareholders will keep markets clean, at no government expense, if only you'd let us by removing our handcuffs.

Corporate governance should be at the heart of this debate, not at the periphery. Structures to stop frauds in the first place, rather than efforts to catch them when they arrive in auditors' hands, should be the starting point. Better information is useless without ways to act on it. We need both.

Finally, enforcement. There is too little enforcement and too much of it targets *companies* and not human wrongdoers. Five years from now when this hubbub is history and you are an auditor or a director being pressed privately by management to go along with a fraud, will you be more deterred by the thought that your company may be fined or by the thought you may go to jail?

When you punish companies, you punish innocent shareholders, the victims. I am therefore very pleased by the enforcement proposals in the Leahy, Daschle bill. Fraudsters will do anything you let them. Please stop letting them. And please do not go for mid-level scapegoats. Those who get the big bucks need to shoulder the responsibility. A CEO or a director going to jail would be a corporate governance shot heard round the world.

Senator NELSON. And I want to thank the remaining two witnesses for your patience. As you see, we have intended to be quite thorough in this hearing, and balanced, and it just took us a long time. So you are very kind to be so patient.

So why don't I just take you all in alphabetical order, Mr. Musuraca, assistant director, Department of Research and Negotiations, District Council 37, AFSCME, and Mr. Travis Plunkett, legislative director of the Consumer Federation of America. So if you will proceed. Thank you.

STATEMENT OF MICHAEL MUSURACA, ASSISTANT DIRECTOR, DEPARTMENT OF RESEARCH AND NEGOTIATIONS, DISTRICT COUNCIL 37, AMERICAN FEDERATION OF STATE, COUNTY, AND MUNICIPAL EMPLOYEES (AFSCME)

Mr. MUSURACA. Good evening, Senator. On behalf of District Council 37 members and the 1.3 million AFSCME member throughout the nation, I'd like to thank the Committee for the opportunity to discuss Enron's collapse on public pension funds.

The nation's 37 largest public pension funds lost nearly $2 billion at the hands of Enron. AFSCME believes that in order for this not to happen again, worker and retiree representation is essential on all public fund pension boards. And blatant conflicts of interest between corporate executives, auditors, and investment advisors must be eliminated in the capital markets.

The New York City Employers Retirement System, NYCERS, is the largest of New York City's five pension systems, funds with combined assets of over $85 billion. While our member benefits were never threatened, the combined losses of New York City's funds, due to Enron's collapse, was $109 million. The stock losses came from holdings in the plan's domestic equity index funds.

Now, most all institutional investors rely on index funds to provide a relatively cheap way to reduce risk and achieve a broad exposure to the full equity market. The obvious pitfall for index investors is that the manipulation of a company's financial condition can lead to a company's stock being artificially valued in the marketplace. Hence, if a company's filings with the SEC are fraudulent, or if market participants have reasons other than a company's performance or prospects to buy a stock and, thus, artificially in-

flate a stock's value, the index investor is the natural victim. This certainly happened in the case of Enron to index investors who bought Enron shares at prices based on what we now know to be Enron's false and misleading statements prior to the company's collapse. Other public pension funds, like Florida, as you just heard, lost in the stock market through accounts under active management as a result of Enron's demise.

Now, as Florida told you here, the majority of their losses came from an active account under management by Alliance Capital. Alliance, I should note, also manage such accounts as the New York City Firefighters Pension Fund and the New York State Common Fund, neither of which system reported losses on the scale of Florida. And AFSCME really has been unable to determine the decisionmaking process, even after listening to the testimony from these gentlemen, of either SBA or Alliance Capital on how Alliance continued purchasing Enron shares after the company was under SEC investigation. The SBA's own investment policy on stock purchases seems to have been breached. And the SBA analysts assigned to Alliance warned the board that Enron's stock price was in free fall.

AFSCME members that are part of the Florida system are most concerned that the SBA's own investment policies were broken when Alliance's Enron purchases topped 7 percent of the Florida portfolio, exceeding the 6-percent limit that the SBA had set for Alliance investment in any one stock. And the AFSCME Council 79 in Florida has recently filed a Freedom of Information request to ascertain what exactly happened.

As a trustee from New York City, the chronology of Alliance Enron purchases raises questions; and, moreover, the inaction of the SBA trustees is difficult to understand in light of their fiduciary duty that all trustees have to plan members and beneficiaries. Such duty would have led the trustees to fully examine the actions taken by Alliance and the warnings of its own staff members.

AFSCME believes that the structure of the SBA in which the three trustees are the Governor, the state controller, and the state treasurer, may, in fact, be a big source of the problem. Most retirement systems have an independent board of fiduciaries which include worker representatives or plan participants and retirees. Such representation helps to create a nonpartisan environment where loyalty to the plan is the most important consideration, ensures the board's independence, and more easily allows for the necessary oversight of the investment process. Worker representation also brings to the boardroom a better understanding of what workers and retirees need from their pension system. And even in plans in which one elected official is the sole fiduciary, as in New York State or Connecticut, there are mechanism to ensure a high level of member input and oversight. Such, to my knowledge, is not the case in Florida.

AFSCME asks the Committee to consider three suggestions to help ensure that public funds act as true trustee fiduciaries and manage retirement assets solely in the interests of plan members and beneficiaries. These changes could help prevent future catastrophic losses and strengthens trustees role as fiduciaries for

worker retirement assets. The first is require all public funds to have half of the system's trustees appointed or elected from the ranks of the plan members and beneficiaries. Second, institute some type of pay-to-play requirements that prevent political contributions to trustees from investment managers that do business with the public fund on which they serve. Third, provide incentives for states to close the revolving door between asset managers and political leaders.

Unlike Mr. Glassman, I believe Enron's collapse has sparked a crisis of confidence in the nation's capital markets. In order for Americans to regain a sense of confidence in the capital markets and the security of their retirement funds, equal representation of workers on public pension funds is vital. So is worker representation on private company 401(k) plans, as is provided in Senator Kennedy's bill.

AFSCME also strongly supports reform of our nation's capital markets, the markets our members retirements systems are invested in. Senators Nelson and Carnahan have proposed strong legislation in these areas to prevent the kind of blatant conflicts of interest that we now know exist, through Enron.

AFSCME members are the beneficiaries of trillions of dollars invested in our nation's capital markets. This money is their future. Public servants and all working families deserve better from our markets, our money managers, and the regulators than we got at Enron.

Thank you very much for your time.

[The prepared statement of Mr. Musuraca follows:]

PREPARED STATEMENT OF MICHAEL MUSURACA, ASSISTANT DIRECTOR, DEPARTMENT OF RESEARCH AND NEGOTIATIONS, DISTRICT COUNCIL 37, AMERICAN FEDERATION OF STATE, COUNTY, AND MUNICIPAL EMPLOYEES (AFSCME)

Good afternoon. My name is Michael Musuraca. I am an Assistant Director in the Department of Research and Negotiations, District Council 37, AFSCME, AFL–CIO, and a designated trustee to the New York City Employees Retirement System (NYCERS). On behalf of the 125,000 members of District Council 37 and the 1.3 million AFSCME members throughout the nation, I am grateful to the Senate Commerce Committee for the opportunity to discuss the impact of the collapse of Enron on large institutional investors and public pension funds. The nation's 37 largest public pension funds suffered combined losses exceeding $2 billion at the hands of Enron. AFSCME believes that in order to reduce the likelihood of this happening again, workers and retirees should be equally represented on pension fund boards and blatant conflicts of interest by corporate executives, auditors and investment advisors must be eliminated.

NYCERS is the largest of New York City's five pension funds, with over 300,000 active and retired members, the majority of which receive an annual benefit of less than $25,000. The total assets of NYCERS, the Teachers, Police, Fire, and Board of Education employees pension funds is approximately $85 billion, of which NYCERS accounts for slightly over $35 billion. While member benefits were not threatened, the combined losses of the five funds due to Enron's collapse was $109 million, $83 million of that total was from losses in the value of Enron stock, while $26 million came from assorted bond holdings.

The stock losses suffered by the NYCERS and the other City pension funds came from their holdings in a domestic equity index run on behalf of each system. Like many other large institutional investors, NYCERS and the other City pension funds have increased their exposure to the U.S. stock market through index funds over the past decade. NYCERS, for example, currently allocates over $17 billion, or 87.5 percent of all domestic equity investments, to two index funds, the Russell 3000 and the S&P 500.

There are a number of reasons that large institutional investors use index funds for their U.S. equity portfolios. Index funds provide a relatively cheap method for

pension funds to have a broad exposure to the full domestic equity market. Another, and perhaps the primary reason, that institutional investors have increased their exposure to the U.S. equity markets, especially for large cap companies like Enron, is that the information about the companies being traded is widely available to investors large and small. The widespread availability of information about companies to the investment community makes it more difficult for active managers to add value to a client's portfolio based on information that may not be in the public domain. Hence, not only are index funds seen as a cheaper method for achieving broad exposure to the equity markets, but one that allows institutional investors to fully capture value as well.

The obvious pitfall for institutional investors who are heavily invested in index funds is that the manipulation of a company's financial condition can lead to the price of a company's stock being artificially valued in the marketplace. In other words, if a company's filings with the Security and Exchange Commission (SEC) are fraudulent, or if market participants have reasons other than the company's performance and prospects to continue buying a stock, and thus artificially inflating the value of a stock within the index, the indexed investor is the natural victim of those practices.

This certainly happened in the case of the Enron Corporation, where NYCERS and other indexed investors held Enron as part of their S&P 500 or other indexed portfolio, stock we bought at prices based on what we now know to be Enron's false and misleading disclosures. Then, beginning in October 2001, the company made a number of negative disclosures about the company's financial condition and certain related-party dealings between Enron and entities owned and controlled by its Chief Financial Officer, Andrew S. Fastow. The disclosures led to a loss of over $600 million in the third quarter of 2001, the write-down of millions in assets, and a $1.2 billion decline in shareholder value. Shortly thereafter, the disclosure of accounting irregularities led the company to restate its earnings from Fiscal Years 1997 through the third quarter of 2001, so that reported net income for the period was lowered by nearly $600 million, nearly 20 percent.

These disclosures led to a swift decline in the Enron's stock and total market capitalization. The disclosures also accounted for the losses suffered by NYCERS and some of the 150 other public pension funds from New York to California in which AFSCME members participate throughout the country, and the nation's perception that something was seriously amiss in the nation's capital markets.

Unlike the New York City funds, other public pension funds suffered losses in accounts under active management. The Florida State Board of Administration (SBA), with whom the New York City funds joined in a failed attempt to achieve lead plaintiff status in the class action suit brought against the Enron directors, reported losses of more than $330 million, three times greater than the next largest loss, as a result of Enron's demise. The vast majority of the SBA's losses came from a domestic equity account managed by Alliance Capital Management.

Alliance Capital also managed such accounts for the New York City Firefighters Pension Fund and the New York State Common Retirement System. The fortunes of those pension funds, however, were dramatically different from that of Florida. While Florida reported losses of over $330 million, neither the City Firefighters nor New York State Common funds suffered losses of such magnitude. Indeed, the Florida SBA fired Alliance Capital shortly after Enron's bankruptcy, and earlier this month brought legal action against Alliance.

While it is a bit easier to fathom NYCERS' losses, we have not been able to determine the decision making process of either the Florida SBA or Alliance Capital that allowed Alfred Harrison, the Alliance investment manager in control of the Florida portfolio, to continue purchasing Enron shares even after the company was under SEC investigation; the SBA's investment policy on stock purchases had been breached; and the SBA analyst assigned to Alliance warned the board that the company stock price was in a free fall.

The AFSCME members that are members of the state pension system are most concerned that the SBA's own investment policies were broken when Alliance's purchases of Enron topped 7 percent of the Florida portfolio, exceeding the 6 percent limit the SBA had set for Alliance's investment in any stock.

As a pension fund trustee in New York City, the chronology of the Alliance Enron purchases raises additional red flags, and the inaction of the SBA trustees is difficult to understand in light of the fiduciary duty that all trustees have to plan members and beneficiaries. While I do not know the specifics of the Florida investment statutes, the common law duties of prudence and care would have led for trustees to fully examine the actions taken by the manager of the Alliance portfolio.

On October 22, 2001, for example, the day that the Securities and Exchange Commission announced it would investigate Enron, Alliance bought 311,000 shares for the State of Florida.

In an October 24, 2001 memo, SBA staff member Trent Webster, who was responsible for reviewing the Alliance portfolio, alerted his boss, Deputy Executive Director Susan Schueren, to Harrison's Enron buying activity. The memo, in part, reads: "Enron's stock is being crushed. The primary cause is the concern about the company's accounting . . . A stock that is falling when a company has accounting problems is almost always a bad time to buy."

Despite the internal staff warning, Harrison continued to buy Enron stock on behalf of Florida, paying $23 million for 2.1 million shares from October 25th, when Enron traded at $15 per share, through November 16th, when its shares had dipped to $9 per share.

Earlier this month, AFSCME's Florida Council 79 filed a Freedom of Information request with the SBA for all documents and communications with Alliance concerning purchases involving Alfred Harrison and other Alliance personnel to get to the bottom of what took place.

The Florida Retirement System is part of the Division of Retirement, which is headed by a director appointed by the Governor and confirmed by the State Senate. The Division is responsible for administering the trust and distributing benefits. The State Board of Administration, a state agency with its own staff, handles all investment issues. The SBA is composed of the Governor as Chair, the State Treasurer and State Comptroller. A 6 person Investment Advisory Council makes recommendations on investment policy, strategy, and procedures. All of its members are financial professionals and do *not* necessarily represent the interests of rank and file plan participants.

AFSCME believes that the structure of the SBA may, in fact, be a source of the trouble. Many public retirement systems have an independent board of fiduciaries, which include worker representatives or plan participants and retirees. Such representation helps to create a non-partisan environment where loyalty to the plan is the most important consideration, ensures a board's independence, and more easily allows for the necessary oversight of the investment process. Worker and retiree representation also brings to the boardroom a better understanding of what members need from their retirement system. Even retirement systems in which one elected leader is the sole fiduciary as in New York State and Connecticut, there are mechanisms in place that ensure a high level of plan member input and oversight. Such is not the case in Florida. AFSCME asks that the Committee consider 3 suggestions to help ensure that public funds trustees act as true trustee fiduciaries and manage retirement assets solely in the interests of plan members and beneficiaries. These changes could help prevent future catastrophic losses in their investment portfolios and strengthen their role as fiduciaries for worker retirement assets.

- Require all public funds to have half of the systems trustees appointed or elected from the ranks of the plan members and beneficiaries.
- Institute some type of pay to play requirements that prevent political contributions to trustees from investment managers that do business with the public fund on which they serve.
- Provide incentives for states to close the revolving door between asset managers and political leaders.

The Enron debacle has sparked a crisis of confidence in the nation's capital markets that *Business Week* recently suggested has raised the public's furor at the business community to levels last seen during the trust-buster era of Theodore Roosevelt. More recent revelations, uncovered by New York State Attorney General Eliot Spitzer's investigation of Merrill Lynch, about the complicity between investment management firms research analysts and their investment banking business, has only served to stoke the flames.

Clearly Americans, who as members of defined benefit pension plans like NYCERS or who participate in their company's deferred contribution plans, have come to believe that the deck is stacked against them as they seek to invest a portion of their earnings for their children's college educations and their own retirement. The daily revelations about new Security and Exchange Commission investigations, indictments, and company restatements of earnings only serves to convince more average Americans that the system is rigged to their disadvantage.

In order for Americans to regain a sense of confidence in the nation's capital markets and the security of their retirement funds equal representation of workers and retirees on public pension funds is vital. So is worker representation on private company 401-k plans, as is provided in Senator Kennedy's pension reform bill. AFSCME

also strongly supports reform of our nation's capital markets—the markets our members' retirement savings are invested in. Senators Nelson and Carnahan have proposed strong legislation in these areas, as has Senator Sarbanes and Senator Leahy.

In the face of inaction from the SEC and inadequate reforms passed by the House, the Senate needs to move quickly on these measures to protect working families' retirement savings from conflicts in the capital markets.

AFSCME's members are the beneficiaries of trillions of dollars invested in our nation's capital markets. This money is their future. Public Servants and all working families deserve better from our markets, our money managers, and the regulators than we got at Enron. Thank you.

Senator NELSON. Mr. Musuraca, I think you brought some very, very compelling points to the testimony with regard to reform of the laws. I appreciate it. Mr. Plunkett?

STATEMENT OF TRAVIS PLUNKETT, LEGISLATIVE DIRECTOR, CONSUMER FEDERATION OF AMERICA

Mr. PLUNKETT. Senator Nelson, it's good to be with you. Thank you for holding such a thorough hearing on this important topic. I am the legislative director of the Consumer Federation. We have 300 members organizations with a combined membership of 50 million Americans.

As you've heard extensively, many mutual funds and pension funds, not just individual investors, also invested heavily in Enron. As a result, workers who never heard of the energy giant had their retirement savings put at risk by Enron's practice of hiding debt and inflating earnings, and Arthur Andersen's willingness to let them.

So the next question is: What are the lessons that are learned? Let's move on. And what are the reforms that the Congress should be putting in place?

The first thing to say is that when a company hides debt and inflates earnings, this isn't just a stock that's getting beaten up. These aren't just bad business decisions that are being made. That's certainly immoral. And I think we're going to find that it's also illegal. So Mr. Glassman's statements about risk in the stock market—the point is well taken, but we have an altogether different situation here.

We have a situation where the company lied to the American people and lied to their investors. Therefore, the solution, the fixes that Congress needs to put in place, are very significant.

The central lesson that we've learned, the inescapable lesson, is that the market can't function without reliable information. And the key to reliable information is a truly independent audit. 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. When you hear from sophisticated institutional investors, as we have today, who say they've been easily duped, the average retail investor, then, doesn't have a chance.

I have to say that hopes for a real reform in Congress on this key issue now rests with the Senate, because the bill that passed the House last month does not do what is necessary to restore integrity to the independent audit. Several bills have been intro-

duced. You've put a bill in with Senator Carnahan. And I think the possibility, given our look at these bills, of real reform does exist.

On auditor and corporate board independence, we believe that the gold standard is the bill that you've put in with Senator Carnahan. Senator Sarbanes has also put in a much broader bill. It makes a number of significant steps forward, particularly on oversight of auditors. It's weaker on independence. It would create a very strong, effective, independent new regulatory body for auditors. It would enhance the independence of the Financial Accounting Standards Board, FASB. And both of your bills establish additional corporate governance reforms. Taken together, these two bills are a very strong package of reforms.

Now, let me get specific here for a minute on the key issue, auditor independence. The Nelson–Carnahan bill is a very comprehensive approach to auditor independence. It requires mandatory rotation of auditors every 7 years. It strictly limits the non-audit services that an audit firm may provide to those—to firms that are receiving audits. Tax consulting services are excluded from this ban, but they'd have to be pre-approved by audit committees of the corporate board. Finally, the bill proposes a 1-year cooling-off period before an audit firm employee could accept employment in a management or a policymaking position at a company that is an audit client of the firm.

The key here, for us, is really twofold. First, the mandatory rotation requirement. This diminishes the basic conflict that exists, because the auditor works for the audit client. The knowledge that a rival firm will soon be evaluating the books should also provide an incentive to get it right. Some have argued against this requirement by citing research that shows the preponderance of audit failures in the first year of an audit. But there's an inescapable fact that investors have suffered their largest losses in audit failures that involved ongoing, often very long-term audit relationships. And here I'm speaking not just of Enron but Waste Management, Microstrategy, Cendant, RiteAid, Sunbeam, and Lucent.

The next thing the Nelson–Carnahan bill does correctly is to further lessen the auditor's financial dependence on a single-audit client by strictly limiting the non-audit services that they may provide. The argument put forward by opponents of this consulting ban, that providing consulting services makes auditors less financially dependent on the audit itself and, thus, more independent, is absurd on its face. It assumes that the audit firm can challenge management to the point of losing the company as an audit client but still retain the more lucrative consulting services. The real world simply doesn't work that way.

Finally, the Nelson–Carnahan bill would impose tough new independent standards for both board audit and compensation committees. If audit committees are to bear greater responsibility for the oversight of the audit, as other bills, such as the Sarbanes bill propose, and we endorse, they must also have the independence and resources necessary to serve that function.

Now, we have an extensive menu of proposed reforms, many of which are reflected in other bills. I'm not going to get into them. We need to do more on regulatory oversight of auditors. As I mentioned, the Sarbanes bill is very good there. We need to reform the

private litigation laws and create a more fully funded, more aggressive SEC. We need to reduce incentives for managers so that they don't manipulate the numbers. And here, we like very much Senator McCain and Senator Levin's bill that require expending of stock options.

We need to do a lot of things. But the first—first and foremost, you have to go after auditor independence and get that right. And we think the two bills that I've mentioned, especially the Nelson–Carnahan bill, are a step forward, a significant step forward, and also much more effective than the bill that has passed the House. And we'll be working hard to get significant reforms of this type to the floor of the Senate.

Thank you, Senator.

[The prepared statement of Mr. Plunkett follows:]

PREPARED STATEMENT OF TRAVIS PLUNKETT, LEGISLATIVE DIRECTOR, CONSUMER FEDERATION OF AMERICA

Good afternoon. I am Travis Plunkett, legislative director for the Consumer Federation of America. CFA is a non-profit association of more than 290 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 one of our top priorities.

I would like to thank Chairman Dorgan, Ranking Member Fitzgerald and the other Members of the Subcommittee for the opportunity to offer our comments on this extremely important issue. When Enron suddenly collapsed last year amid allegations of accounting fraud and misleading financial disclosures, the magnitude of the damage was difficult to comprehend. As the dust has begun to settle, it appears that investors have lost roughly $93 billion dollars.[1] To put that in perspective, this one case has caused losses that are nearly equal to the estimated $100 billion in investor losses resulting from faulty, misleading, or fraudulent audits over the previous six years.[2] And that six-year total dwarfs similar losses in previous years. It is no wonder, then, that the Enron-Andersen fiasco has prompted Congressional, regulatory and judicial investigations into what went wrong and how to prevent such a debacle in the future.

Early attention focused on the tragic cases of the Enron employees and retirees, who saw their 401(k) account balances dwindle nearly to zero because of their heavy concentration in company stock. It soon became clear that many mutual funds and pension funds had also invested heavily in Enron. As a result, workers who never heard of the energy giant had their retirement savings put at risk by Enron's practice of hiding debt and inflating earnings and Arthur Andersen's willingness to let them.

Among the victims were public and private pension funds. One media account put the total of Enron losses in just 31 public retirement funds at a little over $1.5 billion.[3] Others have estimated that total losses in state pension funds are closer to twice that amount.[4] Pension managers, while outraged at the losses and at the apparent fraud that led to them, have nonetheless been quick to assure the public that pension benefits are not at risk. Diversification rules have guaranteed that, in most cases, losses totaled less than one percent of fund holdings, though concentrations are somewhat higher at certain individual funds.

An unknown portion of those losses resulted from the practice of index investing which is common among pensions, and which nonetheless remains a sound strategy for reducing risk. Of greater concern are the funds whose private money managers invested considerable fund assets in Enron stock, even after signs had emerged that this was a company in serious financial distress. Money managers who are paid with taxpayer money to manage public funds have a responsibility, arguably greater even than the fiduciary duty that all money managers owe their clients, to ensure

[1] "The Accountants' War," by Jane Mayer, *The New Yorker*, April 22—29, 2002, pg. 64.

[2] Ibid. The article cites an estimate by former SEC Chief Accountant Lynn Turner.

[3] "Enron's Many Strands: Fallout; The Enron Scandal Grazes Another Bush in Florida," Leslie Wayne, *New York Times*, January 27, 2002.

[4] "The Enron Wars," by Marie Brenner, *Vanity Fair*, April 2002.

that they make prudent investment decisions based on thorough and sound research. It is certainly appropriate for Congress to explore whether those standards were met in this case.

Still, just about everyone appears to have been fooled by Enron's false picture of financial health—from the media, which sang its praises, to the bankers, who loaned the company money, to the research analysts, who touted the stock, to the professional money managers who bought it. While Enron was clearly a speculative investment once the stock price had entered freefall, those who bought during its astronomical rise had little reason to think they were taking undue risks.

There are many lessons to be learned from Enron. Lessons about the fundamental dysfunction of a system that rewards top executives with millions or even billions of dollars in profits while rank and file workers and shareholders are taken to the cleaners. Lessons about the dangers of relying on private accounts to fund retirement and the need to enhance protections for those accounts. Lessons about the failure of securities analysts to provide reliable research, particularly when their firm has, or hopes to have, an investment banking relationship with the company being analyzed. Lessons about the gross inadequacy of Securities and Exchange Commission resources to police the nation's financial markets.

But the central, inescapable lesson from Enron is that the market can't function without reliable information. As this Committee's investigation today makes clear, even the most sophisticated institutional investors can be duped when corporate executives use financial disclosures to mask, rather than reveal, the true financial condition of the company. When the professionals can so easily be duped, the average retail investor doesn't have a chance.

The beauty of our system of investor protections, of course, is that it was designed with just this potential for misleading behavior in mind. It was designed to protect investors, not just when corporate executives are honest, forthcoming and aboveboard, but also when they are greedy, unethical and deceptive. That's why we have standardized rules that govern what companies have to disclose and how. It's why the SEC reviews financial disclosures for accuracy, completeness, and compliance with appropriate accounting rules. It's why rating agencies pore over massive amounts of information to determine the creditworthiness of companies that issue debt. It's why corporate boards have audit committees, made up primarily of independent board members, to supervise the audit. And, first and foremost, it is why we require an outside, independent auditor to review and approve a company's financial statements.

In the Enron case, as in others before it, all of those safeguards failed. The accounting rules failed to produce an accurate picture of Enron's finances, even where the company complied with the rules. The corporate board failed to ask tough questions, challenge questionable practices, or require more transparent disclosure. The auditors signed off on financial statements that clearly presented a misleading picture of company finances. The SEC had not reviewed the company's financial statements in several years. The credit rating agencies and securities analysts that investors rely on for an expert assessment of the company's prospects failed to provide any advance warning of possible trouble.

All of these issues deserve congressional and regulatory attention. But none is more crucial than the failure of the independent audit to serve its public watchdog function. Independent auditors are our first line of defense against misleading disclosure and accounting fraud. But as the rising tide of audit disasters in recent years makes clear, the system of independent audits is broken. It seems to work fine when companies are honest, and it is our good fortune that so many companies today maintain their commitment to providing investors with full and accurate information about their operations. But when the independent audit is really needed, when the company is both intent on deceiving investors about its true financial condition and powerful enough to assert itself, some auditors are all too willing to appease the client, devise justifications for the misleading disclosures, or, worse, earn millions helping to design structures and transactions with no purpose but to hide the company's true financial condition.

Investors burned by the Enron collapse and witness to a rising tide of failed audits are understandably skeptical about the ability of the system to produce reliable information. That doubt imposes costs on the system that harm not just those companies that engage in misleading disclosure, but all companies that raise capital in the securities markets. Unless Congress fixes this central problem, investors will continue to harbor those doubts, and with good reason.

A number of bills have been introduced with the intent of restoring integrity to the outside audit by enhancing the independence of auditors, improving regulatory oversight of audits, and improving the ability of corporate boards to supervise the audit. Just last month, the House passed a bill, H.R. 3763, that claims to do all

that, though frankly it is in our view a waste of the paper it is printed on. At best, it codifies the status quo. At worst, it would actually make it harder for the SEC to create an effective independent regulator for the auditing profession.

Hopes for real reform now rest with the Senate. Several bills have been introduced or are being drafted which could provide for truly independent audits, effective oversight of the audit by corporate boards, and a strong new regulator to set and enforce standards for the conduct of those audits. On auditor and corporate board independence, the gold standard is S. 2056, a bill introduced by Sen. Bill Nelson and Sen. Jean Carnahan. In addition, Sen. Paul Sarbanes and the Banking Committee will soon be marking up legislation that would, among other things, create a very strong, effective, independent new regulatory body for auditors, enhance the independence of the Financial Accounting Standards Board, and establish additional corporate governance reforms. Taken together, these two bills would provide a very strong package of reforms.

The remainder of this statement describes in more detail what we view as the key steps needed to restore integrity to and confidence in the capital markets, how these and other legislative proposals would address these issues, and the changes we recommend to make the legislation more effective.

I. Restore real independence to the independent audit.

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. Auditors have profited handsomely over the years from performing this important public watchdog function. Unless the auditor is free of bias, brings an appropriate level of professional skepticism to the task, and feels free to challenge management decisions, however, the audit has no more value than if the company were allowed to certify its own books.

A. The independent audit has never been more important.

The independent audit is arguably more important today than it has been at any time since the requirement was first imposed in the 1930s. More than half of all American households today invest in public companies, either directly or though mutual funds. They do so primarily to save for retirement. As a result, their financial well-being later in life is dependent on the integrity of our financial markets.

At the same time, corporations today are under great pressure to keep their stock prices on a smooth upward trajectory. As one writer has noted:

> No longer is a higher stock price simply desirable, it is often essential, because stocks have become a vital way for companies to run their businesses. The growing use of stock to make acquisitions and to guarantee the debt of off-the-books partnerships means, as with Enron, that the entire partnership edifice can come crashing down with the fall of the underlying stock that props up the system. And the growing use of the stock market as a place for companies to raise capital means a high stock price can be the difference between failure and success.[5]

Both because they will be judged by the company's success and because much of their compensation often takes the form of stock options, corporate managers have a strong incentive to manage their earnings in order to present the picture of steadily rising profitability that Wall Street rewards. And, as the Enron case clearly illustrates, murky accounting rules that rely on numerous subjective judgments make it easier than it should be to construct a false picture of financial health. The Enron case also makes it abundantly clear that an auditor whose independence is compromised may be all too willing to sign off on financial statements that conceal, rather than reveal, the company's true financial state.

B. Many factors undermine auditor independence.

Because of the central importance of the outside audit in upholding the integrity of our system of financial disclosure, the Supreme Court has stated that this "public watchdog function demands that the accountant maintain total independence from the client at all times."[6] Unfortunately, accountants have been unwilling to accept the responsibility for maintaining their independence that goes with the privilege of performing audits. This lack of independence takes several forms.

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[5] "Deciphering the Black Box: Many Accounting Practices, Not Just Enron's, Are Hard to Penetrate," by Steve Liesman, *Wall Street Journal*, January 23, 2002, pg. C1.

[6] U.S. Supreme Court, *United States v. Arthur Young*, 1984.

Much of the debate over auditor independence has focused on their provision of consulting and other non-audit services to audit clients. Since the mid–1990s, most of the big firms have dramatically increased their sales of such services to audit clients, despite the clear conflict-of-interest that this creates. Today, virtually all big companies receive both audit and non-audit services from their accountants, and they typically pay between two and three times as much for the non-audit services as they do for the audit itself. In some cases, the disparity between audit and non-audit fees is far greater. Furthermore, consulting services increasingly drive the profitability of accounting firms. If an auditor's tough questioning of management were to threaten its more profitable consulting arrangement, that auditor might expect to face tough questioning of his own from higher ups at the firm.

Other factors also undermine auditor independence. The lack of independence starts with the fact that auditors are hired, paid, and can be fired by the audit client. This basic conflict is exacerbated by the general lack of client turnover. Auditors may reasonably expect to keep the same client for 20, 30, even 50 years. The prospect of such long relationships make it that much harder for the auditor to challenge management aggressively, not only because of the friendships that are likely to develop up between auditors and company management, but also because they risk losing this seemingly endless stream of future audit (and consulting) revenues if their tough stance on the numbers causes them to lose the client.

Another problem that clearly needs to be addressed is the revolving door that all too often exists between auditors an 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.

C. Comprehensive reforms will be needed to restore auditor independence.

Legislation to restore independence to the audit must tackle all these issues. It must lessen the influence audit clients have by virtue of the fact that they hire, pay, and fire the outside auditor. It must limit the financial dependence of the auditor on the audit client that results from providing both audit and non-audit services to the same firm. And it must close the revolving door that all too often exists between companies and their auditors.

The Nelson-Carnahan bill provides just this sort of comprehensive approach to reform. S. 2056 would require mandatory rotation of auditors every seven years. It would strictly limit the non-audit services an audit firm may provide to those that are closely related to the audit and pose no conflict-of-interest. Tax consulting services are excluded from the ban, but would have to be pre-approved by the audit committee of the board. Finally, the bill proposes a one-year cooling off period before an audit firm employee could accept employment in a management or policymaking position at a company that is an audit client of the firm.

The mandatory rotation requirement is key to diminishing the basic conflict that exists because the auditor works for the audit client. First, an audit firm that knows it has a limited term of engagement has far less to lose by challenging management than one that expects to retain the client indefinitely. The knowledge that a rival firm will soon be evaluating the books should also provide an incentive to get it right. And the new auditor would have no reason to hesitate in setting past mistakes right. Some have argued against this requirement by citing research that shows a preponderance of audit failures occur in the first year of the audit, but it is an inescapable fact that investors have suffered their largest losses in audit failures in cases like Enron, Waste Management, Microstrategy, Cendant, Rite Aid, Sunbeam, Lucent, and others that involved ongoing, often very long-term audit relationships.

The Nelson-Carnahan bill would further lessen the auditor's financial dependence on a single audit client by strictly limiting the non-audit services they may provide. We strongly support this approach. The argument put forward by opponents of a consulting ban—that providing consulting services makes auditors less financially dependent on the audit itself and, thus, more independent—is absurd on its face. It assumes that the audit firm can challenge management to the point of losing the company as an audit client, but still retain the more lucrative consulting services. The real world simply doesn't work that way.

Our one suggestion for improving the bill in this area is would be to add a requirement that audit committees pre-approve all non-audit services. This would clarify that audit committees are directly responsible for determining what non-audit services are permissible based on a determination that they are "directly related to the audit" and pose no conflict-of-interest.

Finally, we support the cooling off period in the Nelson-Carnahan bill as a good first step, though we would like to see it strengthened. The bill effectively addresses the clearly inappropriate practice of members of the audit team applying for work at an audit client while engaged in conducting the audit. A further problem is the conflict that arises when certain high placed executives responsible for over-seeing the preparation of financial disclosures are former partners or employees of the audit firm. To address this problem, we advocate adding a requirement that a company change auditors if it hires an individual who has worked at its current audit firm during the past three years to fill certain key positions, such as chief executive officer, chief financial officer, or chief accounting officer.

Although it offers a less comprehensive package of auditor independence reforms than is contained in the Nelson-Carnahan bill and than we believe is needed, the draft bill being circulated by Sen. Sarbanes nonetheless offers some progress in this area. First, it would expand the list of prohibited non-audit services to reflect the definitions in the original SEC rule proposal under Levitt. All of those definitions were watered down in the final rules, not just those pertaining to internal audits and financial system design and implementation. In addition, the Sarbanes bill would require audit committee pre-approval of non-audit services. This would clarify that audit committees have the ultimate responsibility to ensure the independence of the audit. We can only hope that they have learned the lesson of Enron and other previous audit failures, that auditors who have millions of dollars at stake in consulting contracts are not the independent arbiters of financial disclosure that our system demands. The bill would also enhance the ability of audit committees to oversee the audit by requiring auditors to make separate reports on key issues to the committee.

Unlike the Nelson-Carnahan bill, the Sarbanes draft does not require mandatory rotation of audit firms. Instead, it calls for a General Accounting Office study of the issue and requires rotation of audit team members on a five-year basis. Like the Nelson-Carnahan bill, it would impose a one-year cooling off period. However, the cooling off period in the Sarbanes draft applies to only a few top positions at the audited company. We believe that provision should be expanded as outlined above.

Both Senate bills are significantly stronger than the House bill on the issue of auditor independence. The Nelson-Carnahan bill in particular offers the comprehensive package of reforms that we believe the current crisis of investor confidence demands.

II. Provide effective regulatory oversight of auditors.

Auditors' lack of independence makes them vulnerable to pressures to sign off on questionable accounting practices. This problem is exacerbated by the fact that they face relatively little fear of sanctions if they do so. Although a variety of groups including the SEC, state accountancy boards, and the AICPA all have power to discipline auditing firms and their employees for ethical and legal infractions, even serious violations typically receive little more than a hand slap.

A. The current "regulatory" system is under-funded, ineffective, and captive of the industry.

In theory, the real authority over auditors lies with the SEC. It has the power to bar individuals and firms from auditing publicly traded companies. It also has authority to impose potentially substantial fines. In reality, however, the agency does not routinely review how auditors perform their audits, and instead delegates that responsibility to the AICPA's SEC Practice Section and the Public Oversight Board. Furthermore, according to past agency officials, the SEC only has the resources to tackle the very worst cases of alleged accounting abuse, and it typically settles even those cases without an admission of wrongdoing. It took no action, for example, against a former Arthur Andersen managing partner whom the SEC said had allowed persistent misstatements on Waste Management's financial reports to go uncorrected.[7] Similarly, a PricewaterhouseCoopers partner ordered by the SEC in 1999 to cease and desist violating securities laws didn't even lose his position as lead partner on the audit in question.[8]

The AICPA sets audit standards, the Public Oversight Board (POB) oversees a peer review system to determine compliance with those standards, and the AICPA has disciplinary authority over its members for violations. According to former SEC chief accountant Lynn Turner, however, the audit standards adopted by AICPA are "so general that, as a practical matter, it's difficult to hold anyone accountable for

[7] "Deciphering the Black Box: Many Accounting Practices, Not Just Enron's, Are Hard to Penetrate."
[8] Ibid.

not following them."[9] The POB,[10] which is responsible for overseeing the industry's peer review system and other ethics investigations, is notable for having never sanctioned a major accounting firm in its 25 years of existence, even when peer reviews have uncovered serious short-comings in a firm's audit procedures.[11] Furthermore, the POB can't act against a firm without the AICPA's cooperation. In one case where, at the SEC's prompting, the POB did attempt to investigate possible stock-ownership violations at the major firms, the AICPA refused funding for and cooperation with the investigation, which as a result went nowhere.[12]

Even if they had the will to act, the AICPA and POB are also hampered by a severe lack of investigative authority. They cannot subpoena evidence or compel testimony, for example, and as a result are forced to rely on the public record in building a case. If the SEC settles a case confidentially, with neither a public ruling nor an admission of guilt, there is no public record the AICPA or POB can rely on in bringing its own enforcement actions. Where the AICPA does act, its maximum sanction is expulsion from the organization, which can have serious consequences, but does not prevent the individual from continuing to practice.

In reality, however, AICPA has shown itself to be a reluctant regulator. According to a *Washington Post* investigation, the AICPA took disciplinary action in less than a fifth of the cases in which the SEC imposed sanctions over the past decade. Even when AICPA determined that SEC-sanctioned accountants had committed violations, they closed the vast majority of ethics cases without disciplinary action or public disclosure.[13] The disciplinary action AICPA was most likely to take, according to the *Post* investigation, was issuing a confidential letter directing the offender to undergo additional training. Ethics committee member Dave Cotton has reported seeing "ethical lapses that resulted in millions of dollars of losses getting punished with as little as *16 hours* of continuing education."[14]

B. A complete overhaul of the system is needed.

There seems to be general agreement that a new, independent regulator is needed to oversee the auditors of public companies. We agree that such a body, operating under SEC oversight, could offer a vast improvement over the current system. To do so, however, it must be entirely independent of the accounting industry, be adequately funded, and have extensive rule-making, standard-setting, investigative, enforcement, and sanction authority.

As one former SEC official observed to *Business Week*, "The accounting profession is very creative at taking over every group that's ever tried to rein it in."[15] For a self-regulatory organization (SRO) to have any credibility, therefore, its independence must be unassailable. At a minimum, a super majority of board members must have no ties whatsoever to the accounting industry, and they must be subject to conflict-of-interest rules that prohibit ties to the industry for a significant period before they join the board, while they are on it, and after they leave it.

Just as important, funding for the organization must be totally free from threat by industry members. The AICPA and the Big Five firms have shown their willingness to use strong-arm tactics to head off potentially embarrassing investigations in the past. They must have no such hold over any SRO that is created to provide enhanced oversight in the wake of the Enron-Andersen disaster. Funding must also be adequate to support an aggressive oversight program.

Once its independence is guaranteed, the new regulator must be endowed with full authority for overseeing the conduct of audits of public companies. This includes authority for setting auditing standards. Both the bill that has passed the House and the proposal put forward by SEC Chairman Harvey Pitt would leave authority for developing auditing standards with the AICPA. This is unacceptable. Rules on how to conduct audits clearly need to be strengthened and clarified. That is the job of an independent regulator, not an industry trade association. The AICPA, as a

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[9] "After Enron, New Doubts About Auditors," by David Hilzenrath, *Washington Post*, December 5, 2001, pg. A1.

[10] The POB recently voted itself out of existence in protest over SEC Chairman Harvey Pitt's proposal to create a new self-regulatory body for the accounting industry.

[11] "Peer Pressure: SEC Saw Accounting Flaw," by Jonathan Weil and Scot J. Paltrow, *Wall Street Journal*, January 25, 2002, pg. C1.

[12] The case is described both in a May 12, 2000 letter from Rep. John Dingell (D–MI) to the SEC Chairman Arthur Levitt and in a May 22, 2000 *Business Week* editorial, "Why the Auditors Need Auditing."

[13] Ibid.

[14] "CPAs (and I'm One) Can Reverse Their Losses," by Dave Cotton, *Washington Post*, January 27, 2002, Op Ed.

[15] "Accounting in Crisis," by Nanette Byrnes with Mike McNamee, Diane Brady, Louis Lavell, Christopher Palmeri and bureau reports, *Business Week*, January 28, 2002, pg. 44–48.

trade association, should have no government-recognized role in the regulatory process.

A new regulator to oversee accountants must also have the ability to conduct routine, thorough inspections of audit firms to determine their compliance with auditing standards. It must have extensive powers to conduct timely investigations of suspected abuses, including the power to compel testimony and documents from both auditors and the public companies they audit. And it must have the ability to impose meaningful penalties for violations.

C. The Sarbanes draft bill offers the complete overhaul that is needed.

The Sarbanes draft would create a single new regulatory body to which all accountants that audit public companies would have to belong. It would be overseen by a 5 member full-time board whose members could include up to two current or past CPAs. The board would be funded through a combination of mandatory registration and investigation fees paid by members and a fee imposed on issuers. This should ensure a secure source of adequate funding that is free from influence by accounting firms.

The bill gives the board broad authority and the powers it needs to fulfill those responsibilities effectively. Specifically, the board would be responsible for: registering accounting firms that audit public companies; setting auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers; conducting inspections; conducting investigations and disciplinary proceedings; enforcing compliance with the act, the rules of the board, professional standards, and rules of the Commission; and, when appropriate, imposing sanctions on firms or individuals associated with a firm for violations.

Upon registering, audit firms must provide extensive information about their operations, which information is to be made available to the public. They must also consent to comply with requests by the board for documents or testimony and to obtain similar consents from firm partners and employees. Failure to comply is ground for suspension of registration, which costs the firm the ability to audit public companies. This gives the board the authority it needs to conduct effective investigations.

The board is also required to conduct routine inspections of firms on a regular basis. The bill specifies that inspections must include a review of selected audit engagements, which may include those subject to ongoing litigation. A written report detailing inspection findings must be provided to federal and state regulators and be made available to the public. The bill gives the board extensive sanction authority, including the ability to impose civil fines of up to $750,000 per person per violation and $15 million per firm per violation for fraud and deceit.

The bill includes a number of provisions designed to ensure the independence of the governing board in addition to the requirement that they serve full-time. Members would be appointed by the SEC, the Federal Reserve Board, and the Treasury Department. Members could not receive any compensation, except pension payments, from an accounting firm while serving on the board. This is a substantial improvement over the Oxley bill, which requires that two board members be current CPAs recently engaged in the practice of auditing public companies, permits an additional two members to be current or past CPAs, so long as they have not been associated with an audit firm for at least 2 years, and only requires that 1 member of the 5 person board actually be free of ties to the accounting industry.

Nonetheless, we are concerned that the bill does not do enough to ensure the independence of the board. A retired academic who is a CPA but is otherwise free of ties to the accounting industry would be subject to limitations on his or her ability to serve. A non-CPA who has spent a career in the accounting industry would not. To avoid these inconsistencies, we believe a better approach would be to define strong independence standards for the board and to require that a super-majority of board members meet those standards. To accommodate that requirement, the board would have to be expanded to 7 members. Despite this one concern, we believe the Sarbanes draft bill would dramatically improve the quality of regulatory oversight for auditors.

III. Reform private litigation laws to provide a real deterrent to wrongdoing.

Private litigation has long been viewed as an important supplement to regulation, since the threat of having to pay significant financial damages provides an incentive to comply with even poorly enforced laws. Even a reinvigorated system of auditor oversight would benefit from this support. In 1995, however, Congress passed the Private Securities Litigation Reform Act (PSLRA), which significantly reduced audi-

tors' liability in cases of securities fraud.[16] It did so, both by making it more difficult to bring a case against accountants and by reducing their financial exposure where they are found to have contributed to fraud.

Under PSLRA, it is not enough in a securities fraud lawsuit to show that an auditor made a materially false statement. You must also show that the auditor acted with an intent to defraud or a reckless disregard for the truth or accuracy of the statement. PSLRA set pleading standards with regard to state of mind that create a Catch 22 for plaintiffs' attorneys. They must present detailed facts showing the defendant acted with requisite state of mind, and they must do this before they gain access through discovery to the documents they need to establish state of mind. If plaintiffs can't meet the pleading standards, the case is dismissed. One result is a dramatic reduction in the number of cases filed against secondary defendants. By the time victims of fraud gain access to discovery and uncover the evidence that would support their case against such defendants, the statute of limitations has often expired.

In addition to making it more difficult for securities fraud victims to bring private lawsuits against accountants, PSLRA reduced accountants' liability when they are found to have contributed to fraud. The primary way it accomplished this was by replacing joint and several liability with a system of proportionate liability. Thus, accountants who are found to have contributed to securities fraud no longer have to fear being forced to pay the full amount of any damages awarded should the primary perpetrator be bankrupt. Under proportionate liability, the culpable accountant cannot be forced to pay more than their proportionate share of damages. As a result, according noted securities law expert Professor John C. Coffee, Jr., accountants will rarely be forced to may more than 25 percent of the losses.[17]

PSLRA was also notable for what it didn't do. It failed to extend the federal law's very short statute of limitations for securities fraud of no more than 3 years from the time of the wrong-doing and 1 year from discovery. This rewards those who are able to cover up their fraud for the relatively short period of 3 years and guarantees, for example, that some claims against Enron and Andersen will be time-barred. It also, as described above, helps to keep cases against secondary defendants from being filed. PSLRA also failed to restore aiding and abetting liability under securities fraud laws, which the Supreme Court's 1994 Central Bank of Denver decision eliminated as a potential cause of action. Thus, accountants can only be sued as primary perpetrators of securities fraud, not for their role in aiding and abetting that fraud.

The result is that the threat of private lawsuits now poses a diminished deterrent to accounting fraud. Restoring reasonable liability for culpable accountants should be part of any overall reform plan. This should include provisions: to enable plaintiffs to gain access to documents through discovery before having to meet the heightened pleading standards regarding state of mind; to restore joint and several liability where the defendant recklessly violated securities laws and the primary wrongdoer is bankrupt; to restore aiding and abetting liability for those who contribute to fraud but are not the primary culprit; and to extend the statute of limitations for securities fraud lawsuits.

Sen. Richard Shelby has introduced legislation to restore this needed deterrent to fraud. In addition, Sen. Patrick Leahy included a provision to lengthen the statute of limitations—to 5 years from the wrongdoing and 2 years from discovery—in legislation that was recently approved by the Judiciary Committee. We support passage of both those bills.

IV. The independent audit must be backed up by an aggressive, fully funded SEC.

In the wake of Enron's collapse, many have asked, "where was the SEC?" Given the SEC's responsibility for reviewing public companies' financial disclosures, why had the agency not detected the company's problematic accounting earlier? One answer is that the SEC had not reviewed Enron's financial disclosures since 1997. The reason is that the agency is so understaffed it is only able to review a small percentage of filings each year.

The General Accounting Office released a study earlier this year on the devastating effect that under-funding is having on the SEC's ability to perform its as-

[16] PSLRA also all but guaranteed that Enron's victims will receive mere pennies on the dollar in any recovery.

[17] "The Enron Debacle and Gatekeeper Liability: Why Would the Gatekeepers Remain Silent?" Professor John C. Coffee, Jr., Adolf Berle Professor of Law, Columbia University Law School, testimony before the Senate Committee on Commerce, Science and Transportation, December 18, 2001.

signed tasks. That report looks at the growth in workload at the agency since the start of the 1990s, and documents the degree to which funding has failed to keep pace. It tells only half the story. The real damage to SEC funding occurred before the period covered by the report, in the 1980s, when staffing stayed virtually flat while the industry experienced dramatic growth.

In 1980, for example, there were just over 8,000 publicly traded companies filing annual reports, according to a report commissioned in 1988 by the Securities Subcommittee of the Senate Banking Committee,[18] and there were 710 new registration statements filed. Excluding the staff for electronic filing and information services, 420 staff years were devoted to disclosure matters. As a result, the agency was able to review all transactional filings.

In 2000, the number of staff years devoted to full disclosure (again excluding the staff for electronic filing and information services), had dropped to 356, according to the SEC's analysis of the president's proposed FY 2002 budget. As a result of diminished staffing, dramatic growth in the number of publicly traded companies, and increased workload associated with review of initial offerings, "the percentage of all corporate filings that received a full review, a full financial review, or were just monitored for specific disclosure items" decreased to about 8 percent in 2000, according to the GAO report. Because of a dramatic drop-off in the number of IPOs in 2001, the SEC was able to complete "full or full financial reviews of about 16 percent, or 2,280 of 14,060 annual reports filed" last year, the GAO report found.

Among the financial statements that were passed over for review because of this staffing shortfall were the financial statements for Enron from 1998, 1999, and 2000. Although it is impossible to know whether more regular, more thorough reviews would have nipped the accounting problems at Enron in the bud, it is reasonable to think they might have. Certainly, it is irresponsible to so grossly under-fund the federal regulators that they can't hope to fulfill the important responsibilities assigned to them.

Last year, Congress had a historic opportunity to fix this problem. A decision was made not to use SEC-generated fees to fund other areas of the government. As a result, the agency no longer had to compete with other federal priorities in justifying its budget. Instead of taking that opportunity to dramatically boost agency funding, however, Congress approved a budget that required additional staffing cuts and passed legislation to reduce agency imposed fees to reflect that inadequate budget. The Senate fought to provide a funding boost, but those efforts were ultimately unsuccessful.

The collapse of Enron has focused new attention on the issue of SEC funding. Because of Enron, most of that attention is focused on staffing issues related to full disclosure and enforcement. The Sarbanes draft, for example, would provide a significant funding boost for the agency targeted primarily at these two areas. These are important priorities that certainly deserve increased funding, but similar trends have affected all areas of SEC responsibility. Think of what has happened in that time in the area of mutual funds or financial planning since the beginning of the 1980s. Think of how many more households are now participants in the markets and thus vulnerable to wrong-doing.

The GAO report has helped to make the case for across-the-board significant funding increases for the SEC. That case is even more powerful when the numbers from the 1980s are taken into account. Congress must undo the damage of last year's fee reduction legislation and provide a budget for the SEC that is commensurate with its responsibilities. The Sarbanes bill, which also would authorize full funding for pay parity at the agency, offers an important step in this direction, but it must be followed up with a more thorough analysis of agency funding needs.

V. Study credit rating agencies to determine why they failed to provide an earlier warning of problems.

Another troubling aspect of the Enron collapse is the failure of credit rating agencies to provide an early warning of trouble. In fact, both Moody's and Standard & Poor's still had Enron at investment grade until just five days before it filed for bankruptcy. According to a Bloomberg News account, Moody's had decided to downgrade Enron to junk in early November, but backed down in response to lobbying from Dynegy, which was then negotiating a takeover of Enron, and its bankers.[19]

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[18] *Self-Funding Study*, prepared by the Office of the Executive Director of the U.S. Securities and Exchange Committee, submitted in partial response to the request of the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs (S. Rpt. 100–105), December 20, 1988.

[19] "Moody's Enron Rating Shows Lack of Independence," Mark Gilbert, Bloomberg News, November 15, 2001.

Although this raises serious questions about the objectivity of the ratings, it is unclear that an earlier downgrade would have changed things for investors. A credit rating is not just an isolated measure of a company's financial health. A downgrade may not just reflect the company's worsening financial status, it can trigger further financial woes, as it did for Enron.

We strongly encourage Congress to conduct a further study of this issue to assess whether the operations of credit rating agencies are adequate to ensure accurate ratings and, if not, what should be done to enhance the quality of ratings. That study should examine the extent to which recently announced changes by the rating agencies are likely to provide the desired improvement. It should also examine whether lack of competition in the industry is contributing to the problem. We expect that a thorough review will identify areas in need of additional reform.

VI. Provide additional protections to prevent securities analyst conflicts-of-interest.

Credit ratings agencies were not alone in missing the warning signs. In early November, after the SEC had already announced it was looking into Enron's partnership transactions, 10 of 15 analysts who followed Enron still rated it as a "buy" or "strong buy." One reason, as the analysts are quick to point out, is that they were not getting good information from Enron's financial statements. Another is that Enron was apparently actively and intentionally misleading analysts about activity on its trading floor, for example.

However, this offers only a limited explanation. Red flags were there for those who were looking. And many now looking back—albeit with the benefit of 20–20 hindsight—have been able to point out obvious danger signs. These included wide discrepancies between the company's reported earnings and its retained earnings, negative cash flow of $2.56 billion in 2000 once proceeds from asset sales and other one-time activities not part of its core business were deducted, and actual revenues on energy trading that were a mere fraction of those that accounting rules let the company claim.[20] Surely it is analysts' job to look for just such clues and to probe deeper than the surface of company disclosures.

Another reason analysts may have missed these signs is that they simply weren't looking. Institutional investors, who vote a key annual beauty contest ranking analysts, tend to frown on negative reports on stocks they hold in their portfolios. Even more important, negative reports don't attract investment banking business, and Enron was clearly seen as a huge potential source of such deals. Since investment banking business is far more profitable than the retail sales business for large Wall Street firms, it is hardly surprising that those firms use their research arms to support their investment banking business. In the process, their research has become so compromised by conflicts of interest that it has no real credibility.

Recently, new rules have been adopted to address analyst conflicts of interest. They do so by attempting to limit the investment banking department's influence over research, limit analysts' investments in pre-IPO shares of companies in the industry they cover, limiting their purchase or sale of securities during a window of time around the release of a new research report, prohibiting trades against their own recommendations, and requiring better disclosure of conflicts. We view these rules as a positive first step. However, we believe more should be done in several areas, including banning compensation for analysts that is tied in any way to investment banking profits, improving the clarity and relevance of required disclosures, and extending disclosure to recommendations by sales representatives to retail clients based on the company's research. We are cautiously optimistic that the investigation being pursued by New York Attorney General Eliot Spitzer, and somewhat belatedly by the SEC, will force additional reforms along these lines. Absent regulatory action, Congress should intervene to impose higher standards.

VII. Protect FASB's independence.

In the wake of Enron's collapse, Arthur Andersen has tried to blame inadequate accounting rules—rather than its own poor performance as auditor—for Enron's less-than-transparent financial disclosures. This ignores the fact that Enron's financial statements have been shown to contain several violations of existing rules.[21] It also ignores Andersen's responsibility as auditor to ensure not just that Enron's disclosures complied with the letter of existing rules, but also that they presented

[20] "How 287 Turned Into 7: Lessons in Fuzzy Math," by Gretchen Morgenson, *New York Times*, January 20, 2002, Section 3, page 1.

[21] In his January 24, 2002 testimony before the Senate Committee on Governmental Affairs, former SEC chief accountant Lynn Turner outlined four areas of noncompliance with existing rules.

an accurate picture of Enron's overall financial status. However, this is not an either-or proposition. It is in fact the case that Andersen failed in its responsibility as auditor *and* existing accounting rules are inadequate.

One reason is the inability of the Financial Accounting Standards Board to produce strong rules in a timely fashion when faced with entrenched opposition from large corporations and accounting firms. It is difficult to criticize FASB for moving too slowly on improved accounting rules governing special purpose entities, for example, when their past efforts to pass similarly controversial rules—regarding pooling of interest accounting for mergers, derivatives disclosures, and accounting for stock options—have met strong resistance, not just from business, but also from members of Congress.

Something needs to be done to enhance FASB's independence. This is a difficult issue to tackle, since FASB is a private entity not subject to government oversight. The Sarbanes draft bill seems to offer a reasonable approach. It specifies that accounting principles recognized by the securities laws as "generally accepted" must be set by a private body, with a majority of independent board members and procedures to ensure prompt consideration. It also guarantees an independent funding source in the form of a fee imposed on issuers for the board. We believe this approach offers the possibility of real progress without exposing FASB to excessive risk of political interference. In addition, however, certain members of Congress must recognize that they have played a key role in undermining FASB's independence in the past and should refrain from interfering inappropriately in the future.

VIII. Improve corporate governance standards.

Enron's independent board members, and particularly the board audit committee, have come in for considerable criticism for authorizing some of the company's more controversial partnership deals and for failing to ensure clear, accurate financial disclosures. While it may be unrealistic to suppose that board audit committees will ever be equipped to closely scrutinize and challenge the outside auditor's work, steps can and should be taken to enhance the independence and expertise of independent board members.

The Nelson-Carnahan bill would impose tough new independence standards for both board audit and compensation committees. We strongly support those provisions of the bill. If audit committees are to bear greater responsibility for the oversight of the audit, as the Sarbanes draft bill proposes and we endorse, they must also have the independence and resources necessary to serve that function.

IX. Reduce incentives for managers to manipulate the numbers.

Although the above protections are designed to work even when managers are corrupt, reforms are most likely to be effective if corporate managers' incentives to manipulate the numbers are minimized. The Sarbanes bill includes several provisions to accomplish this goal, including: requiring CEOs and CFOs of public companies to certify in writing that financial statements present a fair and accurate picture of the financial condition of the issuer; making it a violation of the law to fraudulently influence, coerce, manipulate, or mislead the auditor; requiring forfeiture by CEOs and CFOs of bonuses and profits on sales of company stocks during the 12-month period before an earnings restatement resulting from material noncompliance with disclosure requirements; enhancing SEC authority to force disgorgement of salary, bonuses, stock option payments and other profits to corporate officers; and expanding SEC authority to prohibit certain individuals from serving as officers or directors of public companies. We support all these provisions.

We also support legislation introduced by Sen. John McCain and Sen. Carl Levin to require companies who claim stock option expenses on their tax filings to also show those expenses on financial statements to shareholders. The fact that corporate officers today earn a disproportionate share of their income in the form of stock option grants can give them a strong incentive to boost the company's share price. While that can be a positive incentive, within limits, it can also create an incentive to push the envelope on acceptable accounting. By lessening the incentive for companies to grant such outsized stock option compensation packages, the McCain-Levin bill should help to reduce those temptations. As such, we believe it is an important part of an overall reform package.

X. Conclusion

The collapse of Enron has provided a clarion call for reform. It has exposed gaping holes in the investor protections we rely on to keep corporate managers honest. Enron is not unique. These same shortcomings apply to all publicly traded companies. We are fortunate that so many company managers have remained committed to providing clear, accurate disclosures to investors. But we cannot rely exclusively on their integrity. We need a system that works even when company managers are

greedy and overly aggressive, and we need a system that reduces their incentives to be greedy and overly aggressive. Congress can repair the gaps in the current system. It is of paramount importance that you do so.

Senator NELSON. It's so nice to hear so many nice things about my bill. Thank you very much, Mr. Plunkett.

Mr. Musuraca, share with us, from your experience in New York and your knowledge of pension funds for AFSCME, and that is throughout the country, that you represent, tell us if you would typically see a large-cap money manager buying large positions of one particular distressed company.

Mr. MUSURACA. Let me clarify, I'm only a trustee at NYCERS in New York City.

Let me say, also, that when a board hires a money manager, any money manager, whether they be an active manager in a large-cap growth or a large-cap value or whether they be an index fund, you put guidelines on how they are to manage the fund's money. So if the guideline suggests that there are no restrictions on how large a stake they can take with any one company, then maybe perhaps you would. But, in my experience, we usually put a guideline of no more than 5 percent of the portfolio should be invested in any one company.

Senator NELSON. As a trustee, do you consider it part of your responsibility to monitor your outside money managers?

Mr. MUSURACA. It's one of my major responsibilities. Every month, I receive, on a chart prepared to me by staff of the New York City controller's office, the performance of all the active managers and the index funds that the NYCERS portfolio has. And it's done over a 1-month, 6-month, 1-year, 3-year, 5-year, 10-year rolling basis so that I can gauge both the short-term and long-term performance of the managers. And at any meeting of the board, I can instruct staff that the performance of any one of the managers has given me cause for concern. And as long as I can bring along a few more votes on the board, we can have a manager come in to sit down and discuss their performance and how they're doing things for the members of the fund.

Senator NELSON. And as a trustee, are you informed when a fund staff gives reviews on money managers on watch lists? You heard the testimony today, all about that. Give us the benefit of your experience.

Mr. MUSURACA. We have two ways of finding out what staff believes to be going on with any given money manager at any time. The controller's office staff will monitor the performance of a money manager, as will our outside investment advisor. From time to time, firms will go on a watch list that we keep, as well, for a variety of reasons, including poor performance, merger with another company, change in personnel. And we will be told about meetings that have taken place between controller office staff and our investment consultant. They will report on how long they think the company should be—the firm should be on the watch list. And we will—the board will either agree that that's a long enough time, disagree that that's a long enough time, or say, "Listen, you know, things have gotten so bad at Company X. We really—you need to bring them in to see us, and we need to make some decisions." Ultimately, the decision to terminate rests with the board.

Senator NELSON. Was it your fund that Alliance Capital Management sold the Enron shares in New York in August, or was that a different——

Mr. MUSURACA. That was a different fund.

Senator NELSON. That was a different fund. Well, in the fund that you are a trustee of, does the fund have any exposure to Enron? And did they sell? Did they buy? What's your experience?

Mr. MUSURACA. As I suggested, we had exposure through our index fund——

Senator NELSON. I see.

Mr. MUSURACA.—and you use index funds, large institutional investors, to, in fact, diversity your risk. And because of this—the notion—and this gets to the question that Mr. Plunkett raised about the reliability of information—one of the reasons you invest in index funds is that it's assumed, especially for large-cap companies like Enron, that the information is generally available to all investors, be they large or small, and it's reliable information, so that an active manager is not going to add value for you over the index. That's why you do an index fund.

If the information is bad, as we found out, index investors get hurt, because the regulatory agencies failed, the auditors failed, to find the misleading information and the blatant lies, in this instance, that Enron was putting out.

Senator NELSON. Do you want to comment about the fund that did lose—that did sell the Enron stock, the New York Common Fund?

Mr. MUSURACA. Well, I could talk to two. One is New York Common, and one is the New York City Firefighters, both of which had Alliance at one period of time as an active manager. It's my understanding that the portfolios that were run for them from a different office, a different Alliance officer, which had decided in August, after Skilling's resignation, to, in fact, pare back and sell their shares of Enron. I don't know exactly the dates that such sales took place, but I do know that Mr. Harrison's group acted in one way, and another Alliance group acted in a different way. And in this instance, luckily for both the State Common and the Firefighters system, they weren't exposed to such great losses.

Senator NELSON. Did Alliance meet with you in January of this year, 2002?

Mr. MUSURACA. Yes, sir, they did.

Senator NELSON. And was it Mr. Calvert, the CEO of Alliance?

Mr. MUSURACA. Yes, sir.

Senator NELSON. Can you describe the meeting for the Committee?

Mr. MUSURACA. This was a meeting that took place at the request of myself, representing the New York City Employees Retirement System, and a number of other public pension funds, the Taft Hartley funds, to discuss two concerns that had been raised by the Enron collapse and Alliance's stake in Enron. One was the role of Frank Savage sitting on both the Enron board and the Alliance board. And the other was how Alliance had come to arrive at its decision—at least Mr. Harrison—to buy throughout the fall—to buy Enron stock throughout the fall of 2001.

Senator NELSON. And who else attended there for Alliance? Was it just Mr. Calvert?

Mr. MUSURACA. It was Mr. Calvert, Liz Smith—I can't remember the counsel's name, but a general counsel, as well, and an expert on corporate governance that the firm had.

Senator NELSON. And in that explanation, did he describe the different investment patterns of different portfolio managers?

Mr. MUSURACA. Yes, he did. He was actually fairly forthcoming, although he could not comment directly, as he did today—the major difference was he could not comment directly on the relationship that Savage may have had and what Savage may have known. It was still fairly groundbreaking news at the time, so he hadn't come up with the formulation that he came up with today.

Senator NELSON. And what did Mr. Calvert say in that January meeting this year about Enron?

Mr. MUSURACA. He basically made similar comments that both he and Mr. Harrison made today, that Alliance was as much a victim as were large institutional investors who lost money in their index funds. Their due diligence did not produce evidence of the lies and deceit that were involved in Enron's case, and they kept investing thinking that they were buying a relatively sound company as its price was going down.

Senator NELSON. With your knowledge of pension funds, do you have any commentary on why you think Florida lost so much money while other plans did not?

Mr. MUSURACA. It's commentary, right?

Senator NELSON. Commentary.

Mr. MUSURACA. I wasn't in the Florida boardroom. They obviously have made an asset allocation decision and then structured the asset investment in a way that I differ with. I was—our system is much more heavily indexed. What is striking to me, however, is that the trustees never seemed to get involved in the process. Mr. Herndon is a very well-respected and qualified individual. I have nothing but the utmost respect for him. But at some point, it's the trustees' decision to make when looking at the performance of the fund.

And I come from a board that has 3 city-wide elected public officials: the mayor, the controller, and the public advocate. It also has 3 representatives of the workers. At any given time, from either side of the aisle, we can ask questions and take initiatives that I didn't see trustees at the SBA making. And that struck me, even here today.

I've had to defend to members of my system the losses that we suffered. It just seems that one would expect the same.

Senator NELSON. That's well stated. And you'll remember that Mr. Herndon also said, in response to my question whether you ought to insulate trustees from raising money from people that have business before the SBA—he said he thought that would be a good reform, as well, just like it is that some of those same trustees that sit as the Florida cabinet sitting as the Division of Bond Finance are prohibited by law from raising money in their campaigns from bond firms.

Mr. MUSURACA. I would tend to agree with Mr. Herndon's final comment, that it is something that should be regulated and prohibited.

Senator NELSON. Mr. Plunkett, you've been so gracious in your comments about Jean Carnahan's and my bill. Given the fact of practical politics, do you have any suggestions as we go forth, thus far, knowing that our bill is going to have an array of opponents who don't want to see reforms enacted. Have you got any suggestions of—that you'd share with the Committee of how we ought to approach it?

Mr. PLUNKETT. Other than divine intervention?

[Laughter.]

Mr. PLUNKETT. Well, obviously, the major focus of your bill is—has proven to be, in both houses, the most controversial approach, because it is the approach the accounting industry, which is extremely powerful, opposes. And that is a real ban on consulting services, virtually all consulting services, in the same year that an audit is done for a particular client. So other than working with obvious allies who support that approach, like the Council of Institutional Investors and consumer groups, and all together doing our best to educate members over here, starting with the banking committee—and we're doing meetings on that as we speak—I don't have any pearls of wisdom.

Our point that we keep making is if you can't assure the independence of the audit, why bother? And any—you know, I'll go back to Mr. Glassman's comments—any child or fool can see that there is a conflict of interest if, on average, firms are receiving two to three times more in consulting fees than they are in auditing fees. And if you don't go at the heart of that problem, you don't solve it.

Senator NELSON. You know, I'm usually an optimist, and I still am, although sobered sometimes, but I really believe that there is so much agitations out there in America over this Enron situation that we ought to have a decent shot of passing the legislation that will contain the part of separating the auditing from the consulting functions. And if we don't, shame on us for special interests preventing that from occurring, because that clearly is a reform that has come out of this whole debacle of which we have only examined one little part of it today, but a necessary part.

Does the staff have any further questions? OK, thank you all for being so patient. It's almost 6 o'clock.

The meeting is adjourned.

[Whereupon, at 5:55 p.m., the hearing was adjourned.]

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