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IMPLEMENTATION OF THE SARBANES–OXLEY ACT OF 2002

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

ON

THE DRAMATIC CHANGE ACROSS THE CORPORATE LANDSCAPE TO RE-ESTABLISH INVESTOR CONFIDENCE IN THE INTEGRITY OF CORPORATE DISCLOSURES AND FINANCIAL REPORTING

SEPTEMBER 9, 23, AND OCTOBER 2, 2003

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IMPLEMENTATION OF THE SARBANES-OXLEY ACT OF 2002

TUESDAY, SEPTEMBER 9, 2003

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met, at 10:01 a.m., in room SD–534, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing shall come to order.

I would like to welcome today's witness, Chairman William Donaldson of the SEC. A little over a year ago, President Bush signed the Sarbanes-Oxley Act into law and ushered in a new era of corporate responsibility. Today's hearing is the first hearing in a series that will examine the impact of Sarbanes-Oxley on corporate America.

When the "bubble" burst in the second quarter of 2000, it became apparent that the explosive growth in market capitalization in the late 1990's had been accompanied by egregious examples of corporate misconduct and an all too often disregard for business ethics. All too often, auditors turned a blind eye. As these problems came to light through a series of corporate scandals, investors lost confidence in corporate management and financial reporting and withdrew their money from the markets. The Sarbanes-Oxley Act was enacted, in part, to demonstrate to investors a commitment to fairness and integrity in corporate America. The Act aims to deter corporate misconduct and restore investor confidence primarily by increasing the accountability of corporate actors, strengthening corporate governance, and improving the transparency and reliability of audited financials.

First, the Act recognizes the respective roles that principal executive officers, lawyers, and accounting firms play in the operation and oversight of a public company. Sarbanes-Oxley assigns new responsibilities to these corporate actors to ensure that they are accountable for the operation of the companies with which they work. Through the creation of the Public Company Accounting Oversight Board, the Sarbanes-Oxley Act aims to restore confidence in the accounting profession. With new requirements regarding financial statement certifications, auditor independence, and lawyer reporting, the Act increases the accountability of corporate actors for their decisions or advice.

Second, the Act seeks to change the "tone at the top." For too long, boards of directors have operated in a "country-club" culture in which directors were more focused on networking than on the difficult task of objectively and critically analyzing management performance.

The Act recognizes that the board of directors, which is held accountable by a company's shareholders, is the focal point of the governance system. By mandating fully independent audit committees with the authority to hire and fire auditors and engage outside advisers, the Act takes an important step toward separating the board from management and restoring confidence in corporate governance and financial reporting.

And finally, Sarbanes-Oxley seeks to improve the transparency and the reliability of audited financials by requiring a range of new disclosures, including whether there is a financial expert on the audit committee, whether the company has a code of ethics for certain officers, and additional information regarding certain financial disclosures.

While recognizing the beneficial impact of Sarbanes-Oxley on corporate America, I also acknowledge that the implementation of the Act does not come without a cost for public companies, both domestic and international. To satisfy the requirements of the Act, companies have dedicated additional funds and resources to modify their operations and practices. These regulatory costs, however, were necessary, I believe, to address the surprising erosion of business principles and lack of investor confidence.

The Act has also had a significant impact on international companies that trade in U.S. markets. These companies have engaged in the process of harmonizing the mandates of Sarbanes-Oxley with their respective national laws. This process, however, ensures that global investors in U.S. markets receive consistent, comparable financial information on which to base their investment decisions.

In addition to criticizing the implementation costs associated with the Act, critics argue that the Act deters corporate risk-taking. By requiring companies to adopt regulatory checklists, critics argue that the Act encourages companies to be overly cautious and to focus on procedure and process at the expense of innovative management. I disagree. The Act does not penalize risk-taking but rather promotes transparent and honest business practices. Informed risk-taking and honesty within a company are not mutually exclusive policies. Although Sarbanes-Oxley was enacted only a little over a year ago, it has already caused beneficial changes in the corporate practices. The overall impact of the Act, however, will not become apparent until it has been fully implemented. The true measure of the Act will be whether it restores investor confidence in the markets and causes enduring changes to the corporate culture. To accomplish these goals, Congress and the SEC must be vigilant in supervising and enforcing Sarbanes-Oxley.

I would at this point like to recognize the SEC's commitment to implementing Sarbanes-Oxley during the past year. The President and Congress charged the SEC, Mr. Chairman, with an important task that it admirably accomplished. Chairman, I look forward to your testimony in a few minutes.

Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Chairman Shelby, and I join you in welcoming Chairman Donaldson back before the Committee for this important hearing, the first in a series, to review the implementation of the landmark legislation of last year and the efforts to restore investor confidence.

Just over a year ago, as the President signed this legislation into law, he called it "the most far-reaching reforms of American business practices since the time of Franklin Roosevelt." With the legislation now firmly in place, it is appropriate to assess the progress made in its implementation and more generally the efforts to restore integrity to our capital markets—and with that, restore the confidence of investors in those capital markets.

It is not yet 2 years since the collapse and bankruptcy of Enron Corporation. That event, shocking and unexpected as it was, was not isolated, but a pattern in which a number of major, highly regarded public companies and their auditors relied upon convoluted and fraudulent accounting devices in order to inflate earnings.

The result was not a ripple in the market but, indeed, a tidal wave. In the sober estimate of *The Wall Street Journal*, "The scope and scale of the corporate transgressions of the last 1990's now coming to light exceed anything the United States has witnessed since the years preceding the Great Depression."

That legislation, of course, came out of this Committee with an overwhelming 17–4 vote, as the Chairman will recall, and went on, of course, for overwhelming enactment through both the Senate and the House of Representatives.

I think it is appropriate, at this point, to engage in the oversight of the legislation, how it is being implemented, of course, keeping in mind that our objective is to ensure the integrity of our capital markets and to restore to investors the confidence that the information on which they base their investment decisions is complete, accurate, comprehensible, and timely. We also need to keep in mind the other significant changes taking place in the private sector, in the corporate boardrooms, in company-auditor relations, and at the exchanges, changes not mandated by the law but which have arisen as part of a general examination and reevaluation of the practices that were taking place. I think these hearings will be helpful in that regard as well, Mr. Chairman.

I am pleased to welcome Chairman Donaldson. I want to commend Chairman Donaldson and his fellow Commissioners and the very dedicated staff at the Commission for proceeding, as they have, to implement the statute with diligence and skill. I think the staff there is not always fully recognized, and, Mr. Chairman. You are fortunate to have so many capable people in the organization. I know you are very aware of that and, in fact, have been trying to do what you can to enhance the capacities at the SEC. We are up here trying to provide you some additional money with which you can do that and I look forward to your testimony this morning.

Chairman SHELBY. Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman. I appreciate your holding this hearing very much. And, Chairman Donald-

son, I appreciate you being here and the important work that you are doing at the Commission.

Our Chairman and our Ranking Member have very well stated already the reasons why the Sarbanes-Oxley legislation was needed and the benefits that we needed to achieve from it. I think that the necessity to restore integrity in capital markets and to achieve the transparency and honest business practices that have been described was evident to everyone in America.

I truly appreciate, however, the opportunity of this oversight, because at the time many of us were concerned about the law of unintended consequences and the fact that, although we needed to achieve the objectives that we sought to achieve to restore consumer confidence in our markets, we did not want to end up causing consequences that are more detrimental or going beyond the mark and causing difficulties that are unnecessary on American business, and doing what our Chairman said was a concern that has been raised, that is, causing resources of American business to go into regulatory compliance that does not achieve the necessary purposes and that diverts money away from the kind of creativity and entrepreneurship that we need to have in a dynamic economy.

And I am concerned about that. I think that we have achieved significant aspects of our objectives with Sarbanes-Oxley. But at the same time, I continue to receive concerns raised to me. I was in Idaho this August meeting with a number of small businesses who are looking at going public but, frankly, are not sure it is a good idea anymore because of the regulatory costs that they are going to pick up. And it is not all just this statute, but it is our entire regulatory burden that we put on American businesses today that I think we need to have a strong oversight of. And that is why I thank our Chairman and our Ranking Member for bringing this legislation forward.

Again, we need to hit the mark and achieve the integrity in our capital markets. But we need to make sure that we do not go past the mark, and it is that law of unintended consequences that I hope we have an opportunity as we review this legislation and other legislation that impacts our economy in the United States.

I thank the Chairman for holding this hearing and also for giving us the opportunity to come back, and I hope we will have continued opportunities to come back and take a close look and give the kind of scrutiny that is necessary to the way that we are managing these incredible policy issues in our country today.

Thank you.

Chairman SHELBY. Senator Santorum.

STATEMENT OF SENATOR RICK SANTORUM

Senator SANTORUM. Thank you, Mr. Chairman. I, too, want to thank you for holding this hearing.

I just want to echo some of the concerns that my colleague from Idaho has mentioned. I have heard words—and I agree with him—of the importance of integrity and transparency. I also believe in the importance of efficiency and productivity. And I am just concerned that we make sure that with this statute we have struck the proper balance between those very important interests.

I heard the gentleman from Idaho talk about talking to people who are thinking about going public. I have talked to a lot of people who have gone private because of this statute and because of the regulatory burden placed upon a lot of small businesses, and so they have gotten out of the regulatory scheme under this legislation and have gone private.

Now, in some cases, that may have been a good thing. Particularly in the 1990's, a lot of people went public who should not have gone public, and it is probably best that they go back and go private. And so maybe that is a positive. It may be unintended, but it may be an intended consequence of getting people in the proper markets.

But at the same time, I am concerned that we have chased people out of the public markets who, candidly, should be in the public market for the purposes of this economy and the growth that this economy needs to expand and create jobs and do the things that are necessary to move this country forward.

I would be curious to get some reviews as to the potential impact on the economy and growth as a result of this legislation. So, I think there is a good story to tell, and I think the Chairman and Ranking Member laid out a lot of positive things. And I would agree with a lot of the positive things that have happened as a result of this legislation. I am concerned that, as the Senator from Idaho suggested, there may be some unintended consequences, and I think we have to be vigilant even though ever Member who was here last year voted for this legislation. And I am very proud that I voted for it. I want to make sure that we are not burying our heads in the sand just claiming victory when there are some things we might have to look at, both in potentially enhancing some of the provisions, but maybe stepping back on some of those provisions that may not have the consequences that would be beneficial to both efficiency, profitability, transparency, and integrity on the other side.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Dole.

COMMENTS OF SENATOR ELIZABETH DOLE

Senator DOLE. Mr. Chairman, I have a statement that, in the interest of time, I am going to submit for the record.

Chairman SHELBY. It will be made part of the record.

Senator DOLE. And I am to be at three hearings in the same hour this morning.

Chairman SHELBY. Senator Bayh.

COMMENTS OF SENATOR EVAN BAYH

Senator BAYH. Thank you, Mr. Chairman for holding this very important series of hearings. I have some of the same questions about the role of small business, but I will wait and raise those in the question period so that we can hear from our witnesses.

Chairman SHELBY. Thank you.

Senator SARBANES. Mr. Chairman.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Mr. Chairman, I would like to put in the record, given the comments that have been made, an article from

The Wall Street Journal of July 22 of this year entitled "Cleaner Living, No Easy Riches," reporting on the concerns that some smaller companies are avoiding public offerings or going private in order not to comply. The article states, "Still, there is no sea change. Of roughly 15,000 public companies, only 83 went private in 2002, 63 percent more than the year earlier, but slightly fewer than the 89 companies in 2000, according to Thompson Financial, which compiles market and investment data for corporate clients. So far this year, 41 companies have announced plans to revert to private ownership."

As they say, there is no major sea change, and it may well be that companies that in the past went public should probably have thought about it a little more and stayed private. Once you go public and go on an exchange, you assume significant additional obligations because any investor anywhere here or, indeed, in the world can purchase your stock. And if you are not really up to that standard, falling shy will——

Chairman SHELBY. You should not be there.

Senator SARBANES. —cast a doubt on the validity, the honesty, and the integrity of our capital markets, which is, after all, one of our major economic assets. But, in view of some of the comments, I would like to put that article in.

Chairman SHELBY. Without objection, the article will be made part of the record in its entirety.

Chairman SHELBY. Chairman Donaldson, again, we welcome you to the hearing. If you have a written statement it will be made part of the record. You may proceed as you wish.

STATEMENT OF WILLIAM H. DONALDSON
CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

Chairman DONALDSON. Thank you, Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee. I would like to make just a brief beginning statement. Thanks for inviting me to testify on behalf of the Securities and Exchange Commission concerning the implementation of the Sarbanes-Oxley Act.

As you noted, it has been just over a year since Congress passed and President Bush signed the Sarbanes-Oxley Act into law. Sparked by the dramatic corporate and accounting scandals, the Act represents, in my view, the most important securities legislation since the original Federal securities laws of the 1930's. Your backing of the Act and the efforts to implement its sweeping reforms, along with the strong support of your counterparts in the House and our authorizing committees, demonstrates Congress' dedication to ensuring the integrity and vitality of our markets.

The Act set ambitious deadlines for more than 15 separate rulemaking projects by the Commission, called for the Commission to complete several studies on different aspects of the capital markets, and gave us new tools to enforce the securities laws. The bulk of the rulemaking was required by January 26, 2003, 180 days after the Act was signed, making this past January the busiest month of rulemaking in the Commission's history.

Because of the dedicated efforts of the professionals at the Commission, I am pleased to say we have met all the mandates and challenges set out by the Act, and in record time, without sacri-

ficing our other work or obligations, including our robust enforcement program and numerous regulatory initiatives unrelated to Sarbanes-Oxley. The professionals at the Commission not only worked quickly and efficiently but also thoughtfully.

In fulfilling the mandates of the Act, we provided a number of opportunities for public input on our proposals and carefully considered thousands of comment letters. We have also used our new enforcement tools, both on our own and in conjunction with the President's interagency Corporate Fraud Task Force, to expose and punish acts of corporate corruption.

I am pleased to report the Public Company Accounting Oversight Board, a cornerstone of the Act, is up and running under the strong leadership of its new Chairman, Bill McDonough, former President of the Federal Reserve Bank of New York. The Commission and the PCAOB will continue our joint efforts, which have already turned what was an outline on paper into a proactive organization that is registering accounting firms, operating an independent funding mechanism, developing inspection and disciplinary programs, and writing new auditing and attestation standards.

The framework for the reform mandated by the Act has largely been put in place and companies, their boards and executives, and other gatekeepers to our capital markets are proceeding to implementation. These are landmark rules and will require hard work and significant expenditures in the short-run. Some in the business sector feel that they are under siege from new regulations and the threat of additional litigation. But the short-term costs of compliance, particularly efforts to improve internal controls, should be seen, in my view, as an investment. In the long-term, I believe that the reforms realized from the Act will result in sounder corporate practices and more reliable financial reporting. New requirements coming out of the Act, such as the personal certification by CEO's and CFO's of their companies' financial disclosures, the renewed focus on the independence of corporate boards, and the focus on internal controls and procedures, will strengthen companies in the long-run if they focus on the underlying intent of the Act rather than on mere compliance.

Early on, almost every corporate law firm rushed to tout their expertise in navigating the new requirements, some in ways that emphasized technical compliance rather than real reform. But I have been pleased to observe, I believe, a shift in that attitude. More and more companies and their advisers seem to be channeling their energies into true compliance with the spirit of the Act. Good, honest companies realize that corporate governance is not primarily about complying with rules. It is about inculcating in a company and all of its directors and officers and employees a mind-set to do the right thing.

As I have said before, the focus on doing the right thing should become part of the companies' DNA. Companies that view the new laws as opportunities—opportunities to improve internal controls, improve the performance of the board, and improve their public reporting—will be better run, more transparent, and more attractive to investors.

There have been suggestions that requirements of the Act and recent crackdowns by criminal and civil authorities have discour-

aged honest risk-taking. I take a different view. I believe that the Act and the other steps that have accompanied it will lead to an environment where honest business and honest risk-taking, the foundation of American entrepreneurship, will be encouraged and rewarded. We do not want to discourage legitimate business risk-taking, but we are very concerned about activities some have sought to disguise as honest business risks but which are really legal and accounting maneuvers that have nothing to do with the underlying business of the company. Nothing in the law, its implementation, or in the Commission's agenda should make business fearful.

Indeed, during the past year we have been monitoring areas that may merit future attention, considering whether there are particular issues arising from the Act that should be addressed. For example, we have attempted to reduce the compliance burdens on smaller public companies and foreign issuers where appropriate and permitted by the Act, and the Commission staff has issued Frequently Asked Questions on the implementation of some of its views. The Commission has been and will remain vigilant through the implementation of the provisions of the Act and will consider further actions as appropriate in furtherance of its objectives.

While much has been done so far under the Act, its full impact has not yet been felt. Many of the rules that the Commission adopted are still taking effect, and some, such as the adoption of new exchange listing standards for audit committees, are still underway. While we will keep a close watch for regulatory burdens and loopholes that might need to be addressed down the road, I believe that the markets should be allowed to adjust to the significant new disclosures we will see this year, as well as the effect of other reforms put in place by the Act, before significant additional changes are made.

In conclusion, let me thank you again for your important leadership and support in the initiative to reestablish and strengthen investor confidence and integrity in our Nation's capital markets. While it may be a bit too early to judge the impact of all of the various provisions of the Act, I assure you that the Commission and its staff will continue to monitor its implementation and effects to ensure that its goal of protecting investors and restoring confidence in our securities markets remain paramount. And beyond Sarbanes-Oxley, the Commission will continue pressing ahead on multiple fronts, including addressing such critical areas as shareholder access to the director nomination process, the mutual fund and hedge fund industries, the structure itself of our securities markets, and the many issues that are embedded in the need for improved corporate governance.

I look forward to continuing and building on the strong and cooperative relationship that our agency has developed with you in the past as we move forward with fulfilling the promise of the Act. This is a critical time for our capital markets and the Agency, and the way we address the challenges before us will determine not only where we go tomorrow but also for years to come.

Thanks again for inviting me, and I would be happy to answer any questions.

Chairman SHELBY. Thank you, Mr. Chairman.

Sarbanes-Oxley, as you well know, Mr. Chairman, is a frequent topic of discussion with representatives from the European Union. I appreciate what the SEC has been doing to deal with the sensitive concerns raised by European governments and companies during this rulemaking process.

Can you today describe the process for addressing European concerns during the rulemaking and how that dialogue has impacted the final rules, if any?

Chairman DONALDSON. Yes, I would be glad to. Our efforts are to understand not only the European but also the world view, if you will, of mandates in the Sarbanes-Oxley Act, and particularly the registration of accounting firms who operate on U.S. companies' subsidiaries. We held a conference a number of months ago and invited many of the participants, if you will, from Europe, Japan, and elsewhere to come sit down with us, with the PCAOB Board, and with the Commissioners. We all were there, and listened over the course of a day to the objections and problems that they saw, including, but not limited to, the possibility that some regulations would run counter to national laws.

I think in addition to that, with the arrival of Bill McDonough as Chairman of the PCAOB, I think under Bill's leadership now we have been working to reach out to the European community, to reach out to other countries in the world.

I think the dialogue that has been underway has been very constructive. I think we have been uncompromising in the execution of a mandate that these accounting firms be registered. But we are attempting to seek a common ground here in terms of the actual coordination of our rules and national mandates.

Chairman SHELBY. Mr. Chairman, have you observed a noticeable decline in the number of international companies registering with the SEC as a result of this legislation?

Chairman DONALDSON. Well, I think that the decline in the number of companies registering is a part of an overall syndrome here. It is not a syndrome, really, but I think we are seeing an advance in the competitive nature of international markets. I think that, where the U.S. markets were the only real markets in the world for a number of years, we are seeing an improvement in the capability of American investors to execute orders in international companies in their home markets. I think that is a natural evolution of the trading techniques, if you will.

I suspect that there will be a period of time when companies are evaluating just what the new mandates here and the regulations, mean to them. And I think that is only natural.

Chairman SHELBY. This goes on anyway.

Chairman DONALDSON. Pardon?

Chairman SHELBY. This goes on every day.

Chairman DONALDSON. Yes, but I hope that in the final analysis, the non-U.S. companies that wish to access the markets that we have will realize that the rules and regulations we put in are in their interest, and in their shareholders' interest.

Chairman SHELBY. Sure. Mr. Chairman, I understand that at the SEC you have initiated a rulemaking regarding increased disclosure concerning the director nomination process and shareholder communications. What is the concern that the shareholder proxy

proposal is intended to address? And how will the increased disclosure improve corporate governance?

Chairman DONALDSON. A very good question. Let me try and briefly answer it.

As you know, and I believe the Committee knows, we have a number of proposed actions underway now that we put out for comment having to do with the entire proxy process.

Chairman SHELBY. Absolutely.

Chairman DONALDSON. I would divide this into two things: first of all, philosophically, I believe that, as Sarbanes-Oxley has moved the center of responsibility back to the board of directors, where the board of directors hires the CEO, not vice versa. I think we are——

Chairman SHELBY. The shareholders elect the board, don't they?

Chairman DONALDSON. The shareholders select the board, and the board selects the management.

Chairman SHELBY. Right.

Chairman DONALDSON. And we are in the process of reflecting that in terms of the increased responsibility that the board has.

Concurrent with that is the access to the board and the formation of the board, the election process by shareholders. And what we have put out for comment are several different proposed rules. Two of them are already out there. The first has to do with making companies explain in their proxy materials just how shareholders can have access regarding their concerns at a company. To whom do they write? Where is the forum for them to express, outside of voting, their views?

Number two is we have asked companies to explain in their proxy material just how they have gone about selecting directors. What is the process that the company has used to bring forth its slate? And how have they treated self-nominating people? How have they examined people? How have they made the selection and choice on directors?

Another part of our effort is upcoming, and that has to do with giving—in the event that there is indication that the company is not listening to the large shareholder groups—and by this we mean that when you have certain things in a proxy statement that have a 30- or 40- or 20- or 25-percent vote against certain things that shareholders want to have happen, and the company says, "Thank you very much," and then just goes on, we say that is an indication of some nonresponse to a legitimate shareholder concern of that magnitude.

In that case—and we have not yet proposed rules on this—we are saying that, if there is substantial evidence of that a situation or if there is substantial evidence of withholding of votes on the management slate indicating dissatisfaction, we want to make it possible for shareholders to get together and get somebody on a management slate.

Now, I do not want to go into too much detail here.

Chairman SHELBY. You probably do not need to.

Chairman DONALDSON. But there will be, I believe, safeguards associated with this if the Commission moves ahead with it, safeguards indicating that a nominated person cannot and will not be an employee of some special group that puts forth the nomination;

that the nominated person that goes on a management slate will be subject to the same conflicts of interest protections, if you will, so that competitors do not get put on the board. A whole series of safeguards, if you will.

But we think that it is time—and, again, I am speaking for myself now because the Commission has not voted on this. We think that it is time——

Chairman SHELBY. You feel you are on the right road, don't you?

Chairman DONALDSON. I am sorry?

Chairman SHELBY. You are on the right road here, aren't you?

Chairman DONALDSON. Well, I believe we are.

Chairman SHELBY. Thank you very much.

Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman Donaldson, first I want to thank you for a very comprehensive statement. I know you abridged it in your oral presentation, but it is very helpful to have this very thorough and thoughtful review which the Commission has provided us here this morning.

Chairman DONALDSON. Thank you.

Senator SARBANES. When we did the first hearing on accounting and investor protection issues raised by Enron, we had five former Chairmen of the SEC here to lead that off, and they all expressed concerns about a culture on Wall Street that led to the scandals. Chairman Ruder described a philosophy that seeks to skirt the edges of accounting rules. Chairman Williams described an attitude that form is more important than substance, whether complying with the letter of the law rather than the spirit is acceptable. Chairman Arthur Levitt characterized it as an obsessive zeal by too many American companies to project greater earnings from year to year in what he called a culture of gamesmanship that says it is okay to bend the rules, tweak the numbers, and let obvious and important discrepancies slide, in which the companies' analysts, auditors, and directors are all complicit.

And when you testified in May of this year, you said, "Recent remarks by some business leaders lead me to worry that some just do not get it. While I certainly hope and think that many do get it, let me say very clearly we are not just going to assume that Wall Street or the business community gets it. We are going to be vigilant. We are going to be watching for compliance."

Now, since those comments, and in view of the earlier comments by your predecessors, do you think that more and more business leaders are, in fact, now getting it? Do you sense any change in the culture that led to these deficiencies that we sought to address in the legislation?

Chairman DONALDSON. Well, without repeating and boring you with the repetition of what I might have said here before, let me say again, in direct answer to your question, that I think we are making some progress. This is a multifaceted attack on what I consider to be a complacency and an erosion of ethics, if you will, that occurred during almost the past decade of the bull market. And, again, going into history, if you look back to 1929, the history unfortunately does repeat itself. Similar things that went on back in 1929 that gave rise to the securities acts in the early 1930's.

I do not think that you turn that attitude around on a dime. I think it requires a multifaceted attack on it, and we are doing that. You have helped us do that with the Sarbanes-Oxley Act, which has brought a lot of companies and company boards up short in terms of their procedures. And I think that is step one.

I think the fact that we have the PCAOB now riding herd on the accounting profession and with a new level of supervision is step two. And I think that is beginning to have its effect.

I think the results of the so-called global settlement and the separation of research from the investment banking industry hopefully will place research back in its proper role. And hopefully a combination of all of these things will add to the beginning of the end of the game of earnings manipulation, and, again, the beginning of the end of that attitude that says we can play with our numbers, we can postpone expenses, or we can hide earnings in order to conform with the straitjacket of unrealistic earnings per share growth every quarter that Wall Street has insisted upon.

I think that is gradually changing. I do not think it will change overnight. My own personal hope is that perhaps long after I am gone, finally, companies will tell Wall Street how they are going to run themselves as opposed to Wall Street telling them how they are going to run their companies. Hopefully companies will announce that we are not going to have earnings per share growth every quarter, that we are going to reinvest, we are going to do what is necessary to make us a good, long-term investment. I believe eventually that will happen.

But that is an elaborate answer to your question, I think my own judgment on the intangible aspect of what we are trying to do, stopping short of going out to the new red line of law, of not skating on thin ice, I think that is beginning to happen. Although if you take a look at some of the sensitive areas of, let's say, compensation and so forth and look at what happened in the last proxy season, I think there still are areas where people are not getting it as far as pay for performance and definition of what performance is.

Senator SARBANES. Mr. Chairman, my time is up. I will defer to the next round.

Chairman SHELBY. Senator Dole.

Senator DOLE. Mr. Chairman, in the past few years, many commentators have raised concerns about the prevalence of pro forma financial statements, those statements that are not required, as you know, of course, to comply with generally accepted accounting principles. Can you tell us whether Sarbanes-Oxley and other reforms have reduced the use of pro forma financial statements? Do these issues still exist? Or has the law discourage market participants from making additional disclosures?

Chairman DONALDSON. Well, I think that increasingly the use of misleading pro forma kinds of calculations is being whittled out of the system. I think the issue, Senator, is one of misleading people. I mean, it is fine to have discussion of pro forma results so long as people get the GAAP results, the true results, and are not misled by a management decision to take out certain expenses and pro forma something based on what they think is the real earning power of the company.

Senator DOLE. It has been reported that there were problems implementing the CEO certification provisions of Sarbanes-Oxley. It was reported that problems have resulted from the two different CEO certification provisions contained in the securities law and in the criminal law.

Did reconciling these differences present a problem for the SEC? And has the provision really served its intended purpose?

Chairman DONALDSON. Well, I will answer that in one way. The head of one of America's largest corporations came to see me to discuss this, and he made the statement to me that he always felt that when he signed his name on anything, it should mean something. And he said it did not make any difference to him whether he had to sign these new statements or not. I thought that was an interesting comment. Referring back to the legal advice that a lot of companies are getting in the initial stages, I think lawyers have scared managements about the risk they are taking in signing these things. I think the whole process will be viewed eventually as a positive one. It requires a very careful internal review of what is going on, and it is not just a piece of paper that is passed by the CEO and he signs. He signs it, and he is careful with what he signs, and I suspect he is very careful with the numbers coming upward in the organization to him, requiring the same carefulness, if you will, and precision to the numbers coming up to him.

Senator DOLE. Could you discuss with us some of the findings of the I believe it is Section 702 of Sarbanes-Oxley that required a study of credit rating agencies. Could you tell us a bit about what the findings with regard to this part of the law are? And did the Commission find barriers to entry for credit rating agencies? Would we benefit from more credit rating agencies? And should the Commission even be involved in the process?

Chairman DONALDSON. Well, this is a major issue before the Commission right now. As you know, we have a system where access to being a recognized credit rating agency severely circumscribed. And it raises a number of issues as to whether there should be more access to becoming a recognized credit rating agency. It raises the issue of confidentiality of information given to the credit rating agencies.

Clearly, I think that the oversight that we have, we are part and parcel of the circumstances leading to the limited number of credit rating agencies there are right now. And we have put forth a whole series of questions and suggestions for public comment on the issue of credit rating agencies, and I expect I will be back to you at some point with some final conclusions that we have.

Senator DOLE. Could you tell us how much money has been returned to defrauded investors through the Fair Fund at this point?

Chairman DONALDSON. The Fair Fund?

Senator DOLE. Yes.

Chairman DONALDSON. Approximately a billion dollars.

Senator DOLE. A billion?

Chairman DONALDSON. A billion. But that money has not been distributed yet because the distribution mechanisms are still before the court in terms of the distributions of the money.

Senator DOLE. How do you envision the relationship of the SEC and the PCAOB? Has the PCAOB taken any action that the SEC disagrees with?

Chairman DONALDSON. The bottom line is that we have an excellent relationship, an increasingly good relationship with the PCAOB. The PCAOB is a start-up organization faced with not only renting offices but also setting standards and so forth against a tremendously demanding schedule.

I think that the schedule and the deadlines have been met, and I think that the PCAOB directors and staff deserve a lot of credit for meeting the schedule.

I will not say "clash," but the natural interface, if you will, between the PCAOB as they put forth these rules and regulations and our people as they review them against a deadline has caused a creative and constructive dialogue between the organizations.

Some of those deadlines are past. We have a new Chief Accountant coming to the SEC, arriving at the end of this month. We have a great leader who has come to the PCAOB. We interface with them on a daily basis, and that the relationship is excellent.

Senator DOLE. Thank you.

Chairman SHELBY. Senator Bayh.

Senator BAYH. Thank you, Chairman Shelby.

Thank you, Chairman Donaldson. I am very grateful for your taking on this arduous task and for getting off to such a positive and productive start. I regret that I was not able to hear the opening statements of our Chairman and Ranking Member, but I do share your positive assessment about the effects of this law. There is nothing more important than the transparency of our capital markets, and you have been played a big role in helping to get us off to this positive start.

I did not have a chance to hear the comments either of Senator Santorum or Senator Crapo, but I wanted to focus my remarks and my questions on small business. And you alluded to the fact that your staff has tried to look at small businesses and what we can do to try and lighten their loads, if at all possible.

My interest in this subject stems from the role that small businesses play in our economy. I believe the statistics show that over the last couple of decades the Fortune 500 companies have created close to zero net new jobs in our country, while small businesses have generated millions and millions of new jobs. So they tend to be one of the real dynamic forces in our economy, and anything that we can do to help to ensure their continued productivity, job hiring capacity, while meeting the transparency requirements, I think is in the best interests of our society. So it is how to strike that right balance, particularly for these smaller companies.

Most of the comments I have heard tend to focus on a couple of things, and let me just throw them out and see if I can ask for your response. The internal audit functions in the smaller companies, they have lower cashflow, and yet the smallest publicly held companies most often are held to the same standards as the ones that are much, much larger. And for them it is no big deal to meet these requirements.

Has your staff or have you focused on, given any thought to any additional flexibility there or what might be done to lighten their burden in that regard?

Chairman DONALDSON. Yes. Let me begin by making a personal comment, and that is that I was a small businessman at one point, and I went through the growth of a company and then through the decision to go public with that company. And as a result of that experience, I think I would emphasize that when one reaches the stage that you want to have access to public money and to bring in outside shareholders, you assume a new level of responsibility and cost.

Senator BAYH. Of course, but we should help them to meet that in as efficient a way as possible, recognizing that there are differences between the smallest publicly held companies and the gargantuans.

Chairman DONALDSON. Yes, and I just want to start by saying that, because I think there is an additional cost. And clearly the other side of this is that we are very aware—the Commission is and the staff is—of the burdens on smaller companies. We have tried as much as we could within the context of our obligations to recognize that. We have given some of the smaller capitalized companies an extension of time to get themselves organized in terms of bringing in outside directors, et cetera.

Senator BAYH. Well, let me ask about that before my time expires. That is another challenge I hear them mention with some frequency. Many of the smallest businesses, as you know, have a very high percentage of insider ownership, and very often seats on the board are held by venture capitalists. These are sophisticated investors who are unlikely to be confused in one way or another, and they want a seat on the board.

The perception of the greater risk of liability under the new standards and the pending changes in the treatment of stock options have made it, among other things, more difficult to attract outside independent directors for some of these smaller businesses.

Anything we can do about that?

Chairman DONALDSON. Yes, I think there is. I think not only for smaller businesses but also for larger businesses, we are putting more obligations, more responsibility on directors, and I think that means that companies—even large companies, but also small companies—are going to have to reach outside the traditional sources of directors. I mean, not everybody can have a CEO or a group of CEO's on their board. And there is a huge number of highly qualified people out there who could become directors. And I think one of our jobs and one of the jobs of the educational system in this country is to work on the education of a new class of directors, if you will.

Senator BAYH. My time has expired. I would just say one of the challenges—at a time when the downside of becoming a director is greater because of the potential for more liability, the upside has been affected because of the pending change in the treatment of stock options. And many of the smaller companies, it is much harder for them to pay cash. A Fortune 500 company has more tools in their arsenal to attract some of this new legion of potential directors you have referred to.

Chairman DONALDSON. Right. In terms of options for a second, I think that your statement is just right, that the options are only one tool. There is restricted stock. There is cash. There are a lot of noncash ways of compensating directors. In fact, I suspect in the type of company you are talking about that the expense—a recognition of option, the true expense of options will not eliminate the issuance of options. It will maybe make people a little parsimonious with them because now we know what their real cost is.

Senator BAYH. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Stabenow.

COMMENTS OF SENATOR DEBBIE STABENOW

Senator STABENOW. Thank you, Mr. Chairman, for having this important hearing, and thank you, Chairman Donaldson, for your leadership in this challenging time.

I would like to specifically ask for your comments regarding a portion of Section 301 that I authored concerning corporate whistleblowers, and I have written a letter directly to you and I appreciate the response. As we lay out the strategies for making sure this does not happen again and we do not see in the future tens of millions of dollars in equity or thousands of jobs lost are to make sure that those within the company or those who are investors who have information concerning questionable auditing practices, accounting practices, have the ability to speak directly to the audit committee. And as you know, that provision in Section 301 does allow that every employee at companies would have a mechanism through which to submit confidential and anonymous concerns about questionable auditing practices and procedures directly to the public company's audit committee.

What I am disappointed about is that the Commission opted not to create a clearer and more extensive rule implementing this portion of the law. The rule language that the Commission ultimately adopted basically mirrors the law itself without additional guidance, which I know has been raised as a concern by many that I have talked to.

I am certainly not supporting an overly prescriptive rule, but I do think that the current Commission guidance is insufficient regarding this point and is really stymieing effective enforcement. And I wonder if you might speak to a *Wall Street Journal* report on July 22, when they indicated that many observers feel that, "there still is not an easy way for corporate whistleblowers to communicate directly with board members. "Even more troubling," the article went on to say, "many executives have set up hotlines to take complaints from employees, investors, and others about ethical misdeeds, but executive often screen those confidential complaints before sharing them with directors."

Clearly, prescreening of the concerns does not comply with my intent or, I believe, the intent of the Members in passing this. And I am very concerned that some companies who are prescreening would argue that they are complying because the rule at this point is vague concerning that point.

The Wall Street Journal goes on to further confirm reports I have heard from other sources, including a major accounting firm, that, in fact, the rule is not being fully and effectively enforced. And so

I am sure you share the desire to have it fully and effectively enforced, so I would like to have you speak, first of all, to the report that some executives are prescreening confidential submissions by employees to their companies. Would you address that and whether or not you believe that is appropriate?

Chairman DONALDSON. Thank you for 301, and thank you for your concern. I think the Commission decided that, at least at this juncture, it would be a mistake to have a one-suit-fits-all hard and fast rule. I think that we decided to place within the audit committee the responsibility—and it can go beyond that if the overall board wants it to—for structuring a whistleblower system or regime that was appropriate to that company. Companies are all different sizes. There are many, many different ways of skinning a cat, if you will, in terms of having access to legitimate whistleblowing kinds of communication.

I think that this will be an area that we will continue to monitor very closely. And, again, hopefully access by shareholders to the board that we are putting forth in our proxy suggestions here should give another venue to communicating with the board if the whistleblowing procedures by individual corporations are not working. But as of right now, I think we wanted to give the flexibility to arrive at the suit of clothes that fit the particular situation.

Senator STABENOW. Mr. Chairman, I appreciate that, but I also know that without guidelines, without some more specific direction, it will be unclear to monitor whether or not they are complying with the law. And that is my concern, and I guess I would ask if companies, in fact, have management engaged right now in confidential communications that are supposed to be going directly to the audit committee, do you think that is appropriate?

Chairman DONALDSON. Well, I do not. I am glad to hear your comments. You have heighten my interest in this area, and you can be sure that when we come back to you at some point we will give you a report on our appraisal of the whistleblowing effectiveness.

Senator STABENOW. I see that my time is up, but I would just indicate I very much want to continue to work with you, and we continue to work with those in the field, and the feedback we are receiving is that it would be very helpful if the Commission were giving greater guidelines, understanding different sizes of companies and different structures. But if we are, in fact, going to use the knowledge of employees and have them feel they can come forward, as well as investors and others, to provide critical information, we have to be able to evaluate whether or not a company is, in fact, conforming with the requirements of this section of the law. I believe we have some work to do in order to make that happen.

Chairman DONALDSON. Let me offer to submit for the record a more elaborate analysis of the current status of the whistleblowing situation.

Senator STABENOW. Thank you.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you.

Senator Corzine.

COMMENTS OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman, I appreciate very much your holding this hearing. I think it is one of those oversight functions that we need to do on a pretty regular basis. I think a lot of us agree that the real test of this legislation and its impact will be through time, at times when people are a little less sensitive and markets are a little more robust; and time will be the real test of whether much of this stands in good stead. I predict that it will.

I compliment then Chairman Sarbanes, and Senators Dodd and Enzi and the current Chairman for their leadership in this effort. I think we have laid out a very strong framework.

I want to ask a couple of questions that I hear regularly tossed around, although as the stock market goes up, I hear less of this. There is a macro concern that Sarbanes-Oxley was somehow undermining the risk-taking taste of American business, that it had undermined the will of those to be entrepreneurial.

Have you, Mr. Chairman, seen any signs of that? Are there any indications about diminished risk-taking in our corporate world that are a function of this particular legislation?

Chairman DONALDSON. I, of course, hear those comments even as you do.

Senator CORZINE. They seem to be diminishing as the Dow goes up each 100 points or 50 points.

Chairman DONALDSON. I think that we have had a situation in this country in which we have had a recession, major overcapacity in particular industries, a major belt-tightening, and all of this against a backdrop of concerns that anybody who is running a company has, concerns as to making capital expenditures, in terms of working off the excess capacity before new expenditures are made, concerns obviously about the international situation, whether it be terrorism or Iraq. There are lots of reasons why business leaders might be not quite as eager to make certain kinds of business decisions based on the business situation.

I do not believe that Sarbanes-Oxley is a major part of that. I do not believe that this law has inhibited. I think businesses will make business decisions if they are good business decisions, and I do not think—again, there is a cost to Sarbanes in terms of the actual costs of implementing it, but in terms of——

Senator CORZINE. But obviously there are benefits that come from greater transparency and security.

Chairman DONALDSON. Exactly. As I said before you were here, I believe that ultimately people will recognize that business processes have been improved by Sarbanes-Oxley and businesses are running better because of them.

Senator CORZINE. Thank you. I am quite obviously in total agreement with that point of view.

We have recently seen in nonpublic forums some rising concern about governance of mutual funds within the context of some of the activities and the use of fees and interlocking relationships to generate relationships.

Do you think this is one of those areas where the safe haven of being a private enterprise since mutual funds interface with the public so much that we may want to examine some of the govern-

ance rules that Sarbanes-Oxley and reporting with respect to the governance rules might also apply? Have you thought that through? I suspect the Commission is concerned about some of the reports we have heard, but is this another place where we should examine governance and have some of the same requirements in application?

Chairman DONALDSON. As you know, we have been in the field, if you will, with a number of examinations in terms of some of the practices of the mutual fund industry in terms of inducements to sell their shares, inducements that are not known by the purchaser. This also has to do with the brokerage firms that sell the shares. We are looking at a number of issues in the mutual fund industry, and in many ways, that all tracks back to governance and oversight, and I clearly believe that this is an area, particularly in view of some recent developments, where the whole issue of oversight comes front and center.

Senator CORZINE. Thank you. I see my time is up. I have a number of questions——

Chairman SHELBY. You go ahead.

Senator CORZINE. —not unlike Senator Stabenow with Section 307, your early views with regard to the lawyer provisions and whether you think the rules of reporting up the chain of command are accomplishing the end. Have you had enough observation—enough datapoint of observation—to understand whether it is effective and any general comments you have on it. I think it ultimately could be one of the more important checks and balances that you put into a system. And I know there is a lot of controversy about who is representing who with regard to this. Lawyers see a lot of the activities.

Do you have comments that you would like to make?

Chairman DONALDSON. Yes. You touch on a number of things there. Clearly, in terms of the so-called reporting up, I think that this has been clarified. I think it has been helped by some of the recent rulings of the House of Delegates of the ABA in terms of flying in the face of traditional lawyer concepts of confidentiality.

As far as how well is it working, I think it is too early to tell, but I think major progress has been made in terms of the acceptance of the reporting up issue.

Senator CORZINE. Are there empirical examples where you have seen—or objective situations—that process work in a different way than you would have expected it to prior to Sarbanes-Oxley?

Chairman DONALDSON. I really hesitate to make a judgment on that right now. It is in place, and I just do not think we have had enough experience with it.

Still unresolved is the issue of reporting out, so-called "noisy withdrawal" and so forth; that is a much more complicated issue, and we are thinking about it, but we have not addressed it yet.

Senator CORZINE. This is one of those areas, Mr. Chairman, where I am sure I will ask questions in the future, because I think it does have tremendous power in bringing discipline to the internal processes of checks and balances on behavior.

Chairman SHELBY. Thank you.

Senator Dodd.

STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Thank you, Mr. Chairman.

First of all, Mr. Chairman let me add my voice to others' and thank you for the hearing today. This is extremely worthwhile. I do not know of anything that we have done in this area in the number of years that I have been on the Committee that is as important as the Sarbanes-Oxley legislation.

Let me also commend my colleague from New Jersey. While he sits at the end of the table here in terms of Senatorial seniority, his contribution to the product that ultimately became Sarbanes-Oxley was immeasurable, and his previous experience added a great deal of value to the debate and discussion. And Mike Enzi as well as my colleague from Maryland, played critical roles.

The wonderful thing is that no legislation is ever perfect, of course, and this is no exception, but it has been remarkable for this Senator, anyway, the tremendously favorable comments. Normally, with something this radical in many ways, done in the period of time in which we did it, considering how short a period there was between basically February and July, I think it was, Paul, stunning the positive response I have received, anyway, from members of the corporate community on how well this is working. Now, obviously, it is early yet in the process, but I fully expected far more negative reactions to this, at least in the early phases of it, and I am getting quite the opposite reactions.

I think we are also fortunate, Chairman Donaldson, to have you heading the SEC, and I do not say that lightly. We have known each other for a long time, but aside from that personal friendship, I think you are the right person here at the right time and am very grateful for your willingness to serve.

I just had a couple of quick questions I wanted to ask, but let me preface the comments if I may about some concerns that I have. One is the accounting industry—and this probably does not need to be said with this audience here, but it is critically important—obviously bears a tremendous burden for an awful lot of the problems that occurred with Enron and with WorldCom. But we also need to make it clear that with the idea of capital formation in this country, a healthy, vibrant corporate sector depends absolutely and critically on a vibrant accounting industry. And sometimes I worry that there are those who almost think that we can be better off without an accounting industry, but it is going to be extremely important that we restore the confidence that this industry contributes to the restoration of confidence and that we do the same. It is going to be absolutely essential.

I state that as a backdrop to a couple of questions about what is going on. There have been some articles recently that indicate there has been a surge in mergers occurring within the accounting industry. I wonder if you might share with us your thoughts about this, if you have any at this moment. Is this a positive or a negative thing?

A lot of it, we are told, at least in the articles I have read, is occurring as a result of Sarbanes-Oxley. Some firms are, of course, applauding the Sarbanes-Oxley legislation as providing new opportunities for them. I note one article that caught my attention on the subject matter, written for *The Chicago Tribune* by—and I hope

I do not mispronounce the name—Ameet Sachdev, a *Tribune* staff reporter. It goes on and talks about since January, there have been about 10 deals led by New Jersey-based J.H. Cohn acquisition of the Videre Group. In the Midwest, there have been some smaller transactions.

The article goes on to say it is not exactly merger mania of a few years ago, but there are some clear trend lines that are occurring in this area.

I will ask unanimous consent that this article be included, along with my questions, so that people can get some sense of it here.

Chairman SHELBY. It will be made part of the record.

Senator DODD. But my question is, as I have stated already to ask you, do you think these mergers will have a positive or a negative effect on the industry as a whole, and does the existence of fewer accounting firms, which may be the end result here as we are looking at it, indicate less competition as a logical outcome of the mid-size firms expanding to compete with the Big Four accounting firms?

Chairman DONALDSON. I think that the challenges facing the accounting industry are considerable, and I think that we are lucky to have the PCAOB in business and operating as it is, devoting the resources to the oversight of the accounting industry, and in terms of its standards, registering the participants, et cetera.

The challenges facing the accounting industry are considerable. Number one has been the shrinkage down to four major firms and the change in the structure that these firms have been faced with in getting rid of their consulting activities and so forth. I think that as a business, the accounting business has lots of challenges.

Number two is that our generally accepted accounting practices are under considerable need for review, particularly as we move into trying to reach an international standard, if you will, as we become more globalized. And the tradeoffs between rules-based and principle-based accounting are very difficult to reconcile in terms of attitudes toward that, particularly in Europe and here. If you want to go one step further, we are a post-industrial society, and we have an accounting system that is based on a heavy industrial society. And they are not particularly pertinent or realistic in terms of the service society we are in and the whole change of valuation of human assets as opposed to plant and equipment.

So, I think there are tremendous competitive issues. I think the fact that we have only four major accounting firms is a matter of concern to me. I do not have an answer to that, but that is a problem for the Nation, I believe.

Senator DODD. Well, the merger issue is one; it goes to that point of dropping of clients. I read here, if I could go back to this article, that, "Ernst & Young LLP has parted ways with about 200 public and private clients." Some have left over fee disputes and so forth, according to this article. But one of the purposes of having a hearing like this is to determine what is happening out there in the marketplace, and I happen to have been a strong supporter of all the provisions in the Sarbanes-Oxley legislation—although none of us can guarantee there will not be unintended consequences. Obviously, there have been issues raised about the functions, the combination of functions, the consultative function in addition to the

traditional accounting function and the prohibition in those areas that probably led to some of this.

What are the implications of that? Are you monitoring this? Are you watching it? How is the accounting profession changing its practices? We notice already, according to one survey here, that prior to the adoption of Sarbanes-Oxley, audit committees were meeting—they are now meeting more frequently with outside auditors. Before the Act, as determined by one accounting firm, only 15 percent of their corporate clients surveyed met at least six or more times per year. Since the passage, that number has jumped to 60 percent, from 15 to 60 percent—obviously a very positive outcome.

What is going on? This is obviously an area that is critical, as I said at the outset of my questions. We need to get this accounting industry right. You are not going to function if it does not get right. I am uneasy about a lot of mergers and acquisitions that could even further limit the number of firms. A lot of firms are not taking on public clients at all, do not want to deal with public clients. What are the implications of that?

That is the thrust of my question.

Chairman DONALDSON. Yes, it is a very legitimate question. I think that one statement I would make is that I believe we have very strong leadership now in the various government or quasi-government agencies having to do with the accounting industry. At the FASB, the standard-setting organization, I think we have very strong leadership there, facing up to a number of problems that have not been faced up to. I think we have, as I mentioned before, strong leadership in PCAOB in terms of not only oversight but also constructive oversight.

I think we have a need on the part of the industry itself, the profession itself, to have a recognition of past failures or breakdowns and internally what can be done about that. It is a group effort.

I think we are moving in the right direction, but, as I say, the challenges are immense.

Senator DODD. Yes, I know that. You might keep an eye on this. As I say, I realize all of that is from the regulatory and governmental standpoint, but watching what goes on at the marketplace as a result of what we are doing here is also very much—I am interested in monitoring and following that and what sorts of behavior and changes in behavior—some are obviously very positive. You only had 15 percent of the corporate clients who were meeting more than six times a year as an audit committee—no wonder—it amazes me we did not have more problems—maybe we did, we just did not find them. In fact, that number has jumped from 15 percent to 60 percent. It is tremendously healthy and a very positive outcome.

I am not even sure that maybe more mergers and acquisitions make sense. I am not even suggesting it is negative. I just want to know what you think about it, or what the SEC thinks about it, as to whether or not this is a trend line that should cause us some pause or some concern, as we monitor the implications of Sarbanes-Oxley.

Anyway, we can stay in touch on this. I do not expect necessarily a categorical answer today, but I would like to follow up on that, Mr. Chairman, if we could, to keep an eye on that.

Chairman SHELBY. Sure.
Chairman DONALDSON. Yes.
Senator DODD. Thanks.
Chairman SHELBY. Senator Schumer.

COMMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman, and thank you, Chairman Donaldson.

I want to follow up on some questions I asked you at your confirmation hearing on an issue that has been of concern to me all along, and that is the balkanization of some of our laws and securities laws in particular; the need for, one, national securities regulation and two, how having State involvement affects that.

Obviously, you want all prosecution of wrongdoing done by no matter who does it, but then, when there are settlements, those tend to be on the borderline between punishment for a single act and setting new rules. I was interested in the recent indictment by the Oklahoma Attorney General of WorldCom executives. In the past this would have been a national function, because each State again could have its own rules, and there could be 20 different indictments. If there were ever a need for national markets, it is in these kinds of things.

So the question is where is the balance. There have been some articles suggesting that maybe things have tipped too far, and frankly, some of them say that—I do not know if this applies to WorldCom—but there has been a vacuum in the SEC, and that is why State regulators have moved in, or State prosecutors have moved in, to fill it.

I would be interested in your perspective now. We talked about this early on, and you were aware that this was a danger. Now you have been there for several months. Do you see a risk to our national system and a risk to national competitiveness from a balkanization of securities policy and enforcement?

How successfully have you been able to work with State prosecutors and State regulators that involve the securities industry as they operate both within their States and at the Federal level?

Chairman DONALDSON. As I said before, and, now that I have been in this role for a little bit longer, I do not think my opinions have changed at all except to recognize that the SEC has had an excellent relationship with the local State security regulators. We have worked cooperatively with them. We need them. They operate at a level that, for many reasons, we may not be able to get at in terms of being on the ground locally and having the ability to get into situations that may fly under our radar; so that we enjoy working with them. And I think that the more cops we have on the beat out there, the better.

On the other hand, when it comes to the solution, if you will, when it comes to not only finding the bad things and so forth, but also when it comes to what you are going to do about it, then I believe very strongly that we have to have a national securities regulatory mechanism, which we have in the SEC. And I think that we cannot tolerate the balkanization of that. It would be intolerable to have different rules in different States for how prospectuses should read or whatever.

I think that, unfortunately, there has been a politicization, if you will, of enforcement in some areas of the country, and I think this is very dangerous. Let me cite the fact that both the civil and criminal procedures here are very delicate, as you know very well, and when you have people coming in from left field and not communicating with the people who are handling these procedures and run the risk that the people who are guilty of something are going to get away because of crossed wires, that is extremely dangerous.

To my knowledge, Oklahoma, to use a specific example, did not consult with the authorities who were working on that case, did not consult in New York with the U.S. attorneys. They certainly did not consult with the SEC. And I think that that is not good.

In terms of the uncovering of certain securities law violations, I think we really encourage that uncovering, and I believe that there should be cooperation. I believe that, if a tip is given to a local regulator, it would be only natural for them to come and talk to the SEC about it and try to work together on it. There should not be competition for glory, if you will, or political whatever, and unfortunately, that does tend to creep in.

As our Director of Enforcement said the other day, relative to your State, we commend the Attorney General for the announcement last week that he brought forward. We wish that he had talked to us about it. We are working with him right now. But as far as there being any problem with his doing that, we have none.

I think the only problem we have is in the structuring of the marketplace, which cannot be balkanized.

Senator SCHUMER. You mention the marketplace, and I know Senator Corzine mentioned this before I came in, and I would like your judgment on this as somebody who represents New York and represents a lot of the financial service people. You are beginning to hear that because the rules, the goal lines are moving, that there is a dampening of entrepreneurial spirit. And one thing that has always been great about our markets is its entrepreneurial vigor. We have always had two kinds of regulation—we have had a banking industry where you put your money, and you want it to be safe, and it has been far more regulated. We have had a securities industry where you might make a fortune. You might lose a fortune. And obviously, the guidelines have been disclosure and treating all investors, big and small, equally; but otherwise, you are pretty much on your own.

Do you worry about a decline in the entrepreneurial vigor? What some have gone so far to say is that we could push our securities markets overseas to other places if this goes too far; that when someone has a good idea or a potentially good idea that might have a big down side, they are not going to launch it in the United States anymore, and they might go overseas.

I have not heard any examples specifically of that happening, but I have heard some talk about it. Could you give me your opinion? I am not sure what is the right answer on that one.

Chairman DONALDSON. Yes. I think that businessmen—and particularly legitimate businessmen and women—have a right to expect that they are not going to be unwarrantedly attacked from all angles by uncoordinated regulators. I think that they have a feeling that "the Government"—Federal, State—is coming at them

from all directions in the securities industry. I understand that feeling, and I think they have a right to demand that there is some coordination, that there is some cooperation between the regulatory authorities, and I think we can improve that. We are working to improve that right now with the North American Securities Administrators Association. We have a project underway with them now, working to set down some voluntary codes between us, which I think will enhance the good relationship that we have had.

But I am sympathetic with those who feel that the uncoordinated attacks are coming from all directions.

Senator SCHUMER. One final question if I might, Mr. Chairman.

Chairman SHELBY. Go ahead.

Senator SCHUMER. A different issue—your views on the gap between a public company's financial accounting, which is book income, and its tax accounting or tax income. The IRS statistics showed that in 2 years, the difference between these two widened from $92 to $159 billion, and most of that was in large companies who have assets of more than $250 million.

There are clearly differences in the underlying rules, such as depreciation and stock options, but they do not explain the large difference. What you end up having is companies in their reports say, "Hey, we made all this money," and to the IRS saying, "Oh, we did not make much money at all," and I think it is a problem.

I have drafted legislation that basically says, without exposing any proprietary information that might help a competitor, that we would require companies to reveal both, and that would have a prophylactic effect—it would not change any rules, but it would have a prophylactic effect of decreasing the gap.

What do you think of that idea, just off the top of your head preliminarily?

Chairman DONALDSON. Off the top of my head, I think it is a pretty interesting idea. I have a few experts here——

Senator SCHUMER. Well, do you know what? I think I am going to quit while I am ahead, and I would ask you to respond in writing. But I think it is a very good idea, and I have been talking to some of the regulators about this, and Mr. Chairman, I would just ask unanimous consent that Chairman Donaldson be given a period of time to respond in writing to that one for the record.

Chairman SHELBY. That would be fine.

Senator SCHUMER. Great. Thank you.

Chairman SHELBY. Senator Carper, you are just in time for the first round if you have any questions.

COMMENTS OF SENATOR THOMAS R. CARPER

Senator CARPER. Thanks, Mr. Chairman.

Mr. Chairman, how are you?

[No response.]

Senator CARPER. I will say it again. Mr. Chairman, how are you?

Chairman DONALDSON. Great. Thank you.

Senator CARPER. You are not sure, are you? Welcome.

Well, you have had a while to settle in; how does it feel?

Chairman DONALDSON. I am sorry, I did not hear you.

Senator CARPER. You have had a while to settle in; how does it feel?

Chairman DONALDSON. How do I feel? I feel pretty good, thank you.

Senator CARPER. How do you feel about the team you have assembled?

Chairman DONALDSON. How do I feel about——

Senator CARPER. The team you have assembled. Some of them are sitting right behind you.

Chairman DONALDSON. I feel very good about the team—and again, I am going to define that not only as the people who have come into the SEC while I have been there, but also I feel very good about the people who were there. As mentioned earlier here, I think they have done an incredible job in conforming to the dictates of Sarbanes-Oxley. I feel even better about the team that we are starting to build now. As we build up, with new people coming in and we are seeing some excellent candidates. I feel very good about the team that has been built with the PCAOB and the leadership there.

So, I feel pretty good.

Senator CARPER. Good. When I was Governor of Delaware, I used to make regular "customer calls." I would call on the businesses in our State, and I would ask them three questions. I would say: "How are you doing? How are we doing, our administration? And what can we do to help?"

I have already asked how you are doing. How are we doing on the legislative side?

Senator SARBANES. A key question.

Chairman DONALDSON. I think you are doing just exactly what you should do, which is to have a hearing such as this and get a report and feedback from me. I think you should get it as you do as part of your job, if you will, of being out there and listening to people. I think you can provide good feedback for us.

We are working ourselves to listen. My role is to talk this morning, but I think we are trying to listen to what people are saying and their legitimate concerns about what we are doing.

In terms of—if I may put in a plug here—I think the resources that you have given us are really needed as we build this thing up. I hope we are going to have the ability to stay with those resources coming down the pike, because we cannot build this thing up and move it back down again. The SEC has needed more resources that we have now, so I thank you for that.

Senator CARPER. You and your predecessor both encouraged us to provide those resources, and we have done that.

Chairman DONALDSON. You have done that.

Senator CARPER. And I am pleased to hear that they are proving adequate.

What can we do to help?

Chairman DONALDSON. How can you help?

Senator CARPER. What can we do to help further, to enable you to do your job better, and your troops to do your job better?

Chairman DONALDSON. I think that we are working as fast and as hard as we can to address a number of issues. I think you have been helped by understanding in terms of the people buildup we have, that we are undergoing, that we are doing it carefully, that we are not going to run out and spend this money ill-advisedly. So

we are going to build the new people in very carefully, and I think an understanding on your part would be helpful to us.

We need to recognize that some of the rules and regulations that we are contemplating now need to be put through a process. They cannot be done overnight. We are trying to go about our work on hedge funds. We are trying to go about our work on market structure, on a whole series of issues facing us, and we are trying to do it carefully and brick-by-brick, and I know that there are some who may feel that these things should be done more quickly, and some feel they should not be done at all. And your support of what we are doing—and I do not ask your support other than if you believe testimony by me and others from the SEC that we are working as hard as we can to get done what I think you want to have done.

Senator CARPER. Thank you.

A last question if I could, Mr. Chairman.

Chairman SHELBY. Go ahead.

Senator CARPER. Just real briefly, what do you feel best about in terms of your accomplishments so far, you and your team; and what are some areas where it is really work in progress, that you are working on it, but you are not there yet?

Chairman DONALDSON. Well—your microphone is just a little garbled for me, but if I understood——

Senator CARPER. It is probably not the microphone.

Chairman DONALDSON. —but if I understand what you are saying, one of the things we have not talked about at all in terms of projects yet to be completed is the structure within the SEC. I mean, we are adding a lot of people, and we have a structure and organization that we are trying to shift and change so that it will be more anticipatory than it is now, so that we will be able to have more communication between the divisions and more what I would call looking around the corners and over the hill to try to anticipate problems coming down the pike rather than just responding to stuff coming in over the transom, and that is a work in process.

Also, and as I said before, we will make a terrible mistake, I believe, if we add people and simply have four people doing what three used to do. That requires organization and structure change, and we are working on that.

Senator CARPER. Unless maybe those three people did not have a life before, and now they do because there is a reasonable number of people to help them do their jobs, and you are not losing them or having the kind of turnover you were faced with before.

Okay, good. Thanks. Good to see you. Our best to you and your team. Thanks for the work that you are doing.

Chairman DONALDSON. Thank you.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

Chairman Donaldson, I am interested, as you know from our past discussions, in this pay parity issue for your employees with the other Federal financial regulators.

When we put that provision in the law, we also said "and benefits," so it is not just salaries, it is also the benefits—in other words, the entire employee package. And it is my understanding that as yet, a system of full comparability with the other financial

regulatory agencies has not been achieved with respect to salary and benefits—in other words, the total package.

We put that in because we were concerned about losing good personnel and about attracting personnel. We know we are not going to reach the levels that people can reach by going into the private sector, but at least we wanted to even the playing field as far as the public sector was concerned.

Where are we on that issue?

Chairman DONALDSON. In terms of pay parity, I think we are very far along. I think we have pay parity. In terms of the benefits side of the equation, we are working right now with the unions. We have similar benefits, but not exactly the same, and, as in any organization going through change, we are working hopefully with those concerned to work at a benefits side that is consistent with benefits elsewhere and also consistent with the dictates of running an efficient organization.

Senator SARBANES. Sometimes, you know, the 401(k) provisions or the supplemental health benefits, things of that type, can make a very big difference in people's calculation about their employment situation, about the prospects of moving over to some other Federal financial agency that provides those things, and I think it is important for the SEC—we constantly cite the SEC as the premier regulatory agency in the financial field—that the whole package, both pay and benefits, be comparable to what is provided by the other financial regulators. I urge you to continue to look at that matter closely.

Now, Mr. Chairman, I have a lot of questions that I could ask, but I know the hour is getting late, and I want to take the balance of my time—this is somewhat out of the ordinary—but I really want to quote from Chairman Donaldson's statement just to underscore it.

Chairman SHELBY. Go ahead. I agree with you this is an outstanding statement.

Senator SARBANES. Yes, yes, it certainly is.

Toward the end of it, you have the heading, "Honest Business in the Current Environment."

Just as the Commission has been moving forward with implementation of the Act, so too must American businesses. Corporate leaders are responding not only to the Act's mandates, but also to the movement toward increased transparency that underlies Sarbanes-Oxley. However, I have become aware that some in the business sector feel that they are under siege from new regulations, and the threat of additional litigation.

As I have mentioned before, good, honest companies should fear neither Sarbanes-Oxley nor our enforcement efforts. Rather, they should recognize that the improved standards that the Act mandates and smart and fair enforcement of the laws are the right thing to do and help attract capital and investment. As William O. Douglas, then Commission Chairman and future Supreme Court Justice, pointed out in a 1938 speech: "To satisfy the demands of investors there must be in this great marketplace not only efficient service but also fair play and simple honesty. For none of us can afford to forget that this great market can survive and flourish only by grace of investors.

End of Chairman Douglas' quote, and resuming with Chairman Donaldson's statement:

Good corporate governance is not primarily about complying with rules. It is about inculcating in a company, and all of its directors, officers, and employees, a mindset to do the right thing. As I have said before, the focus on doing the right thing should become part of the DNA of a company and everyone in the company

from top to bottom. For companies that take this approach, most of the major concerns about compliance disappear. Moreover, if companies view the new laws as opportunities—opportunities to improve internal controls, improve the performance of the board and improve their public reporting—they will ultimately be better run, more transparent, and therefore more attractive to investors.

I believe that this attitude is beginning to take hold in corporate America. During my travels, and in my discussions with company officials, countless people have told me that America cannot afford a return to the lax standards that preceded Sarbanes-Oxley. Many have added that while they initially questioned the merits of the Act, they now see that it can help show the way to a brighter, more competitive era in American business.

The success of a new era under the Act must involve a continued measures of the risk-taking and entrepreneurship that are the hallmarks of honest American business. There have been suggestions, including in the press, that the recent crackdowns on corporations and executives by criminal and civil authorities, including the Commission, have discouraged honest risk-taking.

I have a different perspective on recent developments. I believe the Act and the other steps that have accompanied it will lead to an environment where honest business and honest risk-taking will be encouraged and rewarded. What should be discouraged, and what we are committed to stamp out, are the activities that some have sought to disguise as honest business but that, in reality, are no such thing.

Transactions with no substance that are designed solely to assure increased earnings or cashflow in financial reports involve no risk and are not honest business. Neither are transactions that are disguised as rewards for entrepreneurship or superior management but that in fact provide risk-free, excessive compensation or facilitate self-dealing for the benefit of insiders.

I hope we have learned some lessons from the era just passed—and I believe we have. I also hope that America's corporate leaders will not use Sarbanes-Oxley as an excuse for putting off innovation and investment. Looking back 1 year, and also looking forward, nothing in the law, its implementation, or in the Commission's agenda should make business fearful. Indeed, a period marked by the responsibility and realism I have just discussed can provide the foundation for a new era of long-term growth and prosperity.

Mr. Chairman, I agree with that statement of yours, and I urge you on in your endeavors.

Thank you, Mr. Chairman.

Chairman SHELBY. Chairman Donaldson, I will try to wrap this up if I can.

Sarbanes-Oxley, as you well know, provided the Securities and Exchange Commission with increased enforcement authority regarding corporate fraud and created new criminal liability for principal executive officers.

There is a public perception that all too often, executive officers escape liability despite their fraudulent and criminal acts. Can you please describe—and you can do it for the record if you want to—can you describe the enforcement actions that the Securities and Exchange Commission and the Corporate Fraud Task Force have taken based on Sarbanes-Oxley, and has Sarbanes-Oxley led to a greater number of convictions and guilty pleas?

As I said, you can do it for the record if you want to.

Chairman DONALDSON. Yes. Let me give you a complete list here.

Chairman SHELBY. Sure.

[Pause.]

Chairman DONALDSON. In fiscal year 2003—and that is not yet over—the Commission has already brought 60 more enforcement actions than fiscal year 2001.

Chairman SHELBY. Did you say 60?

Chairman DONALDSON. More enforcement actions.

Chairman SHELBY. Sixty enforcement actions.

Chairman DONALDSON. Yes, 60 more enforcement actions than in fiscal year 2001, which is the last year before Sarbanes-Oxley came into effect.

In terms of cracking down on corporate wrongdoing, particularly issuer financial fraud and reporting violations, a top priority—as of August 20 in fiscal year 2003, the Commission has filed 543 enforcement actions of which 147 actions, or 27 percent of the total, involve issuer financial fraud and reporting violations.

Further, during this period, the Commission sought to bar 144 offending corporate executive officers or directors from holding such positions with publicly traded companies—nearly three times——

Chairman SHELBY. What was that last number—how many?

Chairman DONALDSON. That is 144.

Chairman SHELBY. One hundred forty-four.

Chairman DONALDSON. One hundred forty-four offending corporate executive officers and directors from holding such positions with publicly traded companies. That is nearly three times the number barred just 2 years ago.

The Commission has achieved these results without sacrificing other areas of enforcement. Issuer fraud, insider trading, and misconduct by regulated entities and persons are all important program areas.

I can go through these statistics in detail——

Chairman SHELBY. You can furnish that for the record.

Mr. DONALDSON. —and I would be glad to provide them to you.

Chairman SHELBY. But you are making progress under this Act is the message you are giving us right now; is that correct?

Chairman DONALDSON. Right. Well, let me stop there and say that I think the trends are in the right direction, and we are pleased with these results—not so pleased that we are going to let up, but pleased with the results to date.

Chairman SHELBY. You are sending a strong message, aren't you, that you mean business?

Chairman DONALDSON. Yes. We are trying to do that.

Chairman SHELBY. We appreciate your appearance, and we appreciate what you are doing with your leadership at the SEC. Keep it up.

Thank you.

Chairman DONALDSON. Thank you.

Chairman SHELBY. The hearing is adjourned.

[Whereupon, at 11:53 a.m., the hearing was adjourned.]

[Prepared statement and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR ELIZABETH DOLE

It is truly remarkable when we compare this year's business climate to the one we were experiencing just 1 year ago. Last year seemed to bring almost daily revelations of corporate scandal that extended all the way up to the very highest officers of some of our Nation's largest corporations. The greed exhibited by a handful of business leaders caused heartbreak for millions of Americans as pensions were lost and stock prices fell dramatically. The end result was that while some companies went out of business or struggled to regain their footing, the entire American economy underwent a grave crisis of confidence.

While our economy continues today on its difficult path to recovery, there is little doubt that the recent scandals paved the way for valuable reforms. Most notably, the Sarbanes-Oxley Corporate Accountability law has given us new confidence in the financial statements of our businesses.

While I do believe there are steps that can be taken to further ensure true auditor independence, we are seeing many positive results of the Act that President Bush signed into law a little over a year ago. Because of the scope of the law as well as its relatively recent implementation, I believe we must give the initiatives contained in Sarbanes-Oxley a chance to fully take effect before we consider additional steps.

While Chairman Greenspan commented that he saw the expanded criminal penalties as the most significant portion of the bill, I would point as well to other important results of Sarbanes-Oxley. For instance, it has been reported that 2 years ago only 1 percent of Wall Street analysts recommended that investors sell. Today, that number is up to 20 percent. Honest assessments of a companies potential helps investors and employees alike.

Of course, many of us still have questions as to how effective some of the initiatives in the law have been. That is why I want to thank Chairman Shelby for conducting today's hearing—so we can hear from Chairman Donaldson of the Securities and Exchange Commission about his agency's perspective on the implementation of the legislation. The SEC deserves special acknowledgement for their excellent work on Sarbanes-Oxley, which they have taken on in addition to all of their normal duties. Chairman Donaldson, I thank you for taking the time to join us here today and I look forward to your testimony.

I believe the enactment of Sarbanes-Oxley marked a turning point in our Nation's economic history. While a few will still seek to manipulate financial statements for short-term gains, we now have strong checks against such efforts and even stronger penalties for those who perpetrate fraud on investors and employees. In addition, we have in Sarbanes-Oxley a mechanism to return funds to defrauded investors. This is a significant change in how corporations and the law will operate, and all of America is better for it.

PREPARED STATEMENT OF SENATOR DEBBIE STABENOW

Thank you, Mr. Chairman. I appreciate that you have called this hearing to provide oversight on the implementation of the Sarbanes-Oxley Act.

Although scandals like those that occurred at Enron and WorldCom are no longer front page news, it is essential that we remain vigilant and that we ensure that Sarbanes-Oxley is having the intended effect of restoring investor confidence and leading to greater accuracy and transparency in the financial statements of publicly traded companies.

I am particularly interested in examining today how a portion of the law that I authored is being implemented. I am referring to Section 301's whistleblower reporting mechanism.

I offered that language to the bill because it became obvious to me during our 10 Committee hearings on the subject that, people knew there were problems in these companies and tried to speak up. Unfortunately, they were trapped in a corporate culture that silenced them. If their concerns had reached the proper people early on, maybe some of these companies would have stopped their phony accounting practices and tens of millions of dollars in equity and thousands of jobs would have been saved.

As you know, Mr. Chairman, the amendment I offered to Sarbanes-Oxley ensured that, for the first time, every employee at these companies would have a mechanism through which they could submit confidential and anonymous concerns about questionable accounting procedures directly to the public company's audit committee. It is the audit committee, after all, that is ultimately responsible.

I was disappointed to learn that the Commission opted not to craft a clearer and more extensive rule implementing this portion in the law. The rule language that

the Commission ultimately adopted closely mirrors the law itself without sufficient additional guidance.

While I would not have supported an overly proscriptive rule, the current Commission guidance is insufficient and this is styming its effective enforcement.

Indeed, as *The Wall Street Journal* reported on July 22, many observers feel that, "there still isn't an easy way for corporate whistleblowers to communicate directly with board members." Even more troubling, the article goes on to state that: "Many executives have set up hotlines to take complaints from employees, investors, and others about ethical misdeeds. But executives often screen those confidential complaints before sharing them with directors."

Prescreening of these concerns clearly does not comply with my intent nor the intent of the greater Congress in passing this accounting reporting mechanism. But I fear that some companies who prescreen can and will argue that they are complying because the rule is too vague.

This *Wall Street Journal* article only further confirms for me reports I have heard from other sources, including the head of a major accounting firm, that the rule is not having the full effect intended.

That is why I decided to wrote Chairman Donaldson last month about the need to clarify the rule. I ask that a copy of my letter and his reply be included as a part of this hearing.

In my letter, I articulated seven key actions that the SEC should be taking to make the corporate whistleblowing mechanism more effective. This list included: (1) instructing companies to make information about the reporting mechanism widely available to employees and shareholders; (2) requiring audit committees to examine ALL submissions, without interference or editing by company management; (3) keeping all submissions for at least 7 years; (4) interpreting the definition of "employees" for purposes of the rule to have a broad meaning, and, (5) moving to implement the rule more quickly.

I am strongly committed to seeing this rule implemented effectively and I hope that Mr. Donaldson and I will have the opportunity to discuss this further today. I truly believe that this reporting mechanism is essential to restore investor confidence and avert any number of Enron-like scandals in the future.

Thank you, Mr. Chairman. I appreciate your holding this hearing today, and I look forward to working with you, Senator Sarbanes, and our other colleagues to ensure that our securities markets can remain strong and vibrant.

PREPARED STATEMENT BY SENATOR MICHAEL B. ENZI

It does not seem so long ago that we would find ourselves back in the days of a seemingly endless list of corporate scandals. Almost every day we heard story after story of big corporations that had serious and severe financial problems and accounting staffs that had failed to live up to their responsibilities.

As the only accountant serving in the Senate, I was very concerned about my profession and the very large black eye it received—and justifiably so—from the activities it had pursued over the years. I believe that we took the right step in passing the Sarbanes-Oxley Act to put the corporate governance system on the right track.

At the events marking the first anniversary of the law, Chairman Donaldson, you remarked that, "There is much, much work still to be done—many miles to travel." I fully agree with you. While the SEC has finished nearly all of its regulatory tasks the true work and effects of the law are just being realized.

Now that we have passed the first anniversary of President Bush's signing of the Sarbanes-Oxley Act into law, we have witnessed broad changes in the marketplace and in overall corporate governance. We also have witnessed the placement of independent directors and effective auditors who are now an integral component of corporate oversight.

As we now move into the next phase of the Sarbanes-Oxley Act, I urge the SEC to be vigilant in ensuring that small auditors and small publicly traded companies do not incur a disproportionate regulatory effect of the law. The growth of our small business community is vital to the health of our capital markets, and therefore, vital to our economic growth.

The passage of the Sarbanes-Oxley Act was but the starting point of returning regulatory control back to the Securities and Exchange Commission. Another important step came with the enactment of the Accountant, Compliance, and Enforcing Staffing Act of 2003 that the President signed into law on July 3. This law provided the Securities and Exchange Commission with the much needed authority to hire

accountants just as the Agency could then hire attorneys. This demonstrates the importance of accountants as an integral part of a strong regulatory system.

In addition, the establishment of the Public Company Oversight Accounting Board has begun to make a difference in the auditing world. As Chairman McDonough continues to bring the Board up to speed, we will see the public company auditors providing financial accounting oversight on a much higher level.

Just as important as it was to improve the corporate governance structure in the public markets, it now appears that we need to improve the corporate governance structure of the regulators of our securities markets. Recently, you sent a letter to the New York Stock Exchange on its corporate governance practices. I am very interested in the Exchange's response and would greatly appreciate if you would share it with me. I strongly believe that the regulators of our securities markets should not permit themselves to be held at a much different standard than we require of the companies that they regulate.

Finally, I would like to thank Chairman Donaldson for taking such quick and firm control of the reins as Chairman of the Securities and Exchange Commission and for working with the Congress to ensure the implementation of the provisions of the Sarbanes-Oxley Act is done with investor respect and confidence in mind. I also would like to recognize all of the hard work of the SEC Commissioners and staff who have made the implementation of the law possible.

Chairman Donaldson, I look forward to your testimony today.

PREPARED STATEMENT OF WILLIAM H. DONALDSON

CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

SEPTEMBER 9, 2003

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, thank you for inviting me to testify today on behalf of the Securities and Exchange Commission concerning implementation of the Sarbanes-Oxley Act of 2002. I appreciate having the opportunity to discuss this important matter with you.

Introduction

It has been just over a year since Congress passed and President Bush signed the Sarbanes-Oxley Act into law. Sparked by dramatic corporate and accounting scandals, the Act represents the most important securities legislation since the original Federal securities laws of the 1930's. The Act effects dramatic change across the corporate landscape to reestablish investor confidence in the integrity of corporate disclosures and financial reporting. Your backing of the Act and the efforts to implement its sweeping reforms, along with the strong support of your counterparts in the House and our authorizing committees, demonstrates convincingly that the Congress is dedicated to ensuring the financial integrity and vitality of our markets.

The first year of the Sarbanes-Oxley Act has produced an impressive record of accomplishments in an incredibly short period of time. The Act set ambitious deadlines for more than 15 separate rulemaking projects by the Commission to implement many of the Act's provisions. The Commission provided a number of opportunities for public input on its proposals, and we carefully studied thousands of letters of public comment in crafting final rules. The bulk of the required rulemaking was required by January 26, 2003, and this past January was the busiest month of rulemaking in Commission history. The Act also called for several mandated studies on particular aspects of the capital markets.[1]

Because of the dedicated efforts of the Commission and the select corps of professionals who work at the SEC, I am pleased to say we have met all of the mandates and challenges set out by the Act, and in record time. Moreover, we met these deadlines without sacrificing our other work or obligations—including our robust enforcement program and numerous regulatory initiatives unrelated to Sarbanes-Oxley.

The Act also provided welcome new enforcement tools to combat corporate fraud, punish corporate wrongdoers and deter fraud with the threat of stiffer penalties. The Commission, both on its own and in conjunction with the President's inter-

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[1] The Commission has issued five studies as required by the Act. The Commission is preparing one remaining study and report required by Section 401(c) of the Act on special purpose entities. The Act also mandated other studies, such as those to be conducted by the General Accounting Office on consolidation of public accounting firms (Section 701), mandatory rotation of accounting firms (Section 207), and investment banks (Section 705). The Act also called for reviews of Federal Sentencing Guidelines by the U.S. Sentencing Commission (Sections 805, 905, and 1104).

agency Corporate Fraud Task Force, is moving decisively to utilize these new tools to expose and punish acts of corruption, improve corporate responsibility, and protect America's investors.

For the fiscal year through August 20, 2003, the Commission has filed 543 enforcement actions, 147 of which involve financial fraud or reporting violations. During this period, the Commission has sought to bar 144 offending corporate executives and directors from holding such positions with publicly traded companies. Further, we are holding accountable not just the companies who engage in fraud, but also the other participants. For example, recent actions signify the Commission's willingness to pursue directors who are reckless in their oversight of management. And we have increasingly designed strategies that take advantage of the creative provisions of the Act to return funds to investors who have suffered losses rather than merely collect those funds for the Government.

I am pleased to report that the Public Company Accounting Oversight Board, a cornerstone of the Act, is up and running under the strong leadership of its new Chairman, William McDonough. We will continue to crack down on malfeasance, and thanks to the Sarbanes-Oxley Act we have the tools and resources we need to tackle this task. The rules mandated by the Act are in place and companies, their boards and executives, and other "gatekeepers" to our capital markets are proceeding to implementation. These are landmark rules. They will require hard work and significant expenditures in the short-run. But the short-term costs of compliance, particularly efforts to improve internal control over financial reporting, should be viewed as an investment. In the long-term, the reforms realized from the Act will result in sounder corporate practices and more reliable financial reporting. Moreover, the spirit of the Act and its requirements are sinking into corporate America. Companies should, as I have said before, make the approach of doing the right thing—in disclosure, in governance, and otherwise in their businesses—part of their companies' DNA.

The Commission has been and will remain vigilant in the implementation of these and other provisions of the Act and will consider further action as appropriate in furtherance of its objectives. And beyond Sarbanes-Oxley, we will continue pressing ahead on multiple fronts in the months ahead, including addressing such critical areas as shareholder access to the director nomination process, the mutual fund and hedge fund industries, the structure of our securities markets, and the many issues embedded in the need for improved corporate governance.

In these and other endeavors, I look forward to continuing and building on the strong and cooperative relationship that our agency has developed with you in the past as we move forward with fulfilling the promise of the Act. This is a critical time for our capital markets and the Agency, and the way we address the challenges before us will determine not only where we go tomorrow, but also for years to come. Before reporting in more detail on the Commission's achievements in implementing the Sarbanes-Oxley Act to date, I would first briefly put the Act in perspective.

Events Leading to Sarbanes-Oxley

The specific events leading to passage of the Act are now well documented. The mid-1990's saw the beginning of the full flourish of the so-called "new economy" in America. The stock market reflected the enormity of the changes taking place in the economy. Stock averages rose at increasing rates from the mid-1990's through early 2000. New entrants undertaking IPO's in the market were among the biggest gainers, especially those that symbolized the "dot.com" sector of the economy. Communications, the explosion of information technology, and changes in the culture of equity investing, including the shift to more self-directed retirement accounts, brought millions of individuals with their savings into our stock markets for the first time.

Starting in the second quarter of 2000, the bubble burst. Stock prices plummeted. Investors fled the markets. The IPO market disappeared. As happened after the crash of 1929, the falling market that began in 2000 led to other revelations. Starting with the unfolding of the Enron story in October 2001, it became apparent that the boom years had been accompanied by fraud, other misconduct, and a serious erosion in business principles. The low points in this story are now household names—not just Enron, but also WorldCom, Tyco, Adelphia, and others. There was other serious misconduct as well, including in the once-celebrated IPO market, which in too many cases lacked both fairness and integrity. The cost of this corner-cutting to investors has been enormous. While thankfully we have not witnessed the same intensity of human suffering that came with the Depression of the 1930's, the most recent downturn in the market directly affected many more investors than the 1929 market crash, because many more individuals had much more of their savings invested in the stock market.

In addition to the grossest displays of greed and malfeasance, there were other more subtle but still pernicious developments. During the boom years, corporate America increasingly emphasized a short-term focus, fueled by an obsession with quarter-to-quarter earnings. In some cases this focus was sharpened by the temptation that inherently resulted from massive amounts of stock options granted to corporate insiders. Analysts, some tainted by conflicts of interest, became cheerleaders for the game of "hitting the numbers." Winning that game, rather than creating the conditions for sound, long-term strength and performance, became the primary goal. Finally, the perception that uninterrupted earnings growth was the hallmark of sound corporate progress caused too many managers to adjust financial results with the purpose of meeting projected results—in ways that were sometimes large and sometimes small, but, especially given the purpose, in all cases unacceptable.

To address the widespread collapse of investor confidence and the recognition that something had gone seriously awry in segments of corporate America, Congress approved and the President signed into law the Sarbanes-Oxley Act. At the East Room signing ceremony, the President promised, "to use the full authority of the Government to expose corruption, punish wrongdoers, and defend the rights and interests of American workers and investors."

Implementation of Sarbanes-Oxley

The sweeping reforms in the Sarbanes-Oxley Act address nearly every aspect and actor in our Nation's capital markets. The Act affects every reporting company, both domestic and foreign, as well as their officers and directors. The Act also affects those that play a role in ensuring the integrity of our capital markets, such as accounting firms, research analysts, and attorneys. The overarching goals of the Act are far-reaching and include restoring investor confidence and assuring the integrity of our markets. Within these goals, the principal objectives addressed in the Act can be grouped into the following themes:

- To strengthen and restore confidence in the accounting profession;
- To strengthen enforcement of the Federal securities laws;
- To improve the "tone at the top" and executive responsibility;
- To improve disclosure and financial reporting; and
- To improve the performance of "gatekeepers."

RESTORING CONFIDENCE IN THE ACCOUNTING PROFESSION

A strong central focus of the Sarbanes-Oxley Act is to enhance the integrity of the audit process and the reliability of audit reports on issuers' financial statements. As discussed below, the Commission has taken the actions directed by the Act and, when appropriate, pursued additional measures with the goal of restoring public confidence in the independence and performance of auditors of public companies' financial statements.

Public Company Accounting Oversight Board

A centerpiece of the Act is the creation of the Public Company Accounting Oversight Board, or PCAOB. In 1 year, the joint efforts of the Commission and PCAOB turned what was an outline on paper into a proactive organization that already is accepting accounting firm registrations, operating an independent funding mechanism, actively developing inspection and disciplinary programs, and writing new auditing and attestation standards, starting with those related to auditors' reports on companies' internal controls over financial reporting.

Under the Sarbanes-Oxley Act, the Commission, among other things, appoints PCAOB members, approves all of the PCAOB's rules and professional standards, and the PCAOB annual budget and support fee, acts as an appellate authority for PCAOB disciplinary actions and disputes related to PCAOB inspection reports and generally oversees the PCAOB's operations. Accordingly, the Commission has appointed the PCAOB, approved the PCAOB's bylaws, registration system for public accounting firms, funding rules, interim auditing and other professional standards, annual budget and support fee, and has in process a review of the PCAOB's ethics code and various proposed rules related to the PCAOB's standards-setting process and inspection program.

We were extremely pleased when William McDonough, formerly the President of the Federal Reserve Bank of New York, assumed the Chair of the PCAOB last June. Prior to his appointment, Charles Niemeier, then the PCAOB Acting Chairman, and PCAOB members Kayla Gillan, Dan Goelzer, and William Gradison developed the infrastructure necessary for the Commission to determine in April that the PCAOB was appropriately organized and had the capacity to carry out the requirements of the Sarbanes-Oxley Act. Under Chairman McDonough's leadership, we expect the PCAOB to continue to grow and to implement reforms that will restore investors'

confidence in the audit process and in the integrity of the audited financial information that investors use every day to make investment and voting decisions.

Auditor Independence

Auditor independence is at the heart of the integrity of the audit process. As directed by the Sarbanes-Oxley Act and under the Commission's general rulemaking authority, the Commission strengthened its rules regarding auditor independence last January. The principal thrust of the revisions is to:

- Expand the nonaudit services that, if provided to an audit client, impair an auditor's independence;
- Require an issuer's audit committee to preapprove all audit and nonaudit services provided to the issuer by the auditor;
- Require that certain partners on the audit engagement team rotate off the engagement after either 5 or 7 years depending on the partner's role in the audit;
- Establish a "cooling off" period between participation on the team auditing an issuer's financial statements and assuming certain functions as a member of that issuer's management;
- Require the auditor to report certain matters to the issuer's audit committee; and
- Require certain disclosures to investors of information related to audit and nonaudit services provided by, and fees paid to, the auditor.

The Commission also adopted rules stating that an accounting firm would not be independent with respect to an audit client if certain partners on the audit engagement receive compensation based on their procuring engagements with that client for services other than audit, review, or attest services.[2]

Improper Influence on Auditors

On April 24, 2003, the Commission adopted a provision pursuant to Section 303 of the Act prohibiting officers and directors of an issuer, and persons acting under their direction, from taking any action to coerce, manipulate, mislead, or fraudulently influence the auditor of the issuer's financial statements if that person knew or should have known that such action, if successful, could result in rendering the issuer's financial statements materially misleading. These rules, in combination with other Commission rules, prohibit officers and directors from subverting the auditor's responsibilities to investors to conduct a diligent audit of the issuer's financial statements and to provide a true report of the auditor's findings.

Retention of Records Relevant to Audits and Reviews of Financial Statements

On January 22, 2003, the Commission adopted rules pursuant to Section 802 of the Act that, for the first time, require auditors to retain certain records relevant to their audits and reviews of issuers' financial statements. These records, which are to be retained for 7 years, include an accounting firm's workpapers and certain other documents that contain conclusions, opinions, analyses, or financial data related to the audit or review.

Recognition of the Financial Accounting Standards Board

Section 108 of the Act sets forth criteria that must be met by an accounting standard-setting body in order for that body's standards to be considered "generally accepted" for purposes of the securities laws.[3] In April, the Commission announced its determination that the Financial Accounting Standards Board and its parent organization, the Financial Accounting Foundation, meet the criteria in the Act and that FASB's pronouncements would be considered to be "generally accepted" and must continue to be followed in the preparation of financial statements filed with the

[2] In addition, to assist companies and the auditors of their financial statements in implementing the auditor independence rules, the Commission staff recently published on the Commission's website a list of Frequently Asked Questions about those rules. The FAQ's clarify the application of certain rules related to nonaudit services, partner rotation, audit committee preapproval of services, auditor communications with an issuer's audit committee, the disclosure by an issuer of fees paid to the auditor of its financial statements, and other matters.

[3] The criteria include, among other things, being a private entity; having, for administrative and operational purposes, a board of trustees that serves the public interest; being funded as provided in the Act; having procedures to ensure prompt consideration, by majority vote of its members, of changes to accounting standards to reflect emerging issues and changing business practices; and considering the extent to which international convergence of accounting standards is necessary or appropriate in the public interest.

Commission.[4] Subsequently, as required by Section 109(e) of Act, we reviewed the FASB support fee for 2003 and found that it is consistent with the Act.

Study on Principles-based Accounting Standards

In enacting the Sarbanes-Oxley Act, Congress recognized that accounting standards that contain too many exceptions, interpretations and bright-line percentage tests might have contributed to efforts by managements and accountants to structure transactions that provide a desired accounting result and yet allow the company to avoid clear disclosure of the economic consequences of those transactions in its financial statements. Congress, therefore, mandated in Section 108(d) of the Act that the Commission study whether a system of "principles-based" accounting standards should be adopted in the United States. The Commission staff released its study in July.

After considering the issue, our staff found that standards reflecting only a stated principle of accounting (principle-only standards) would present enforcement difficulties because they would provide little guidance or structure for exercising professional judgment in applying that principle. The staff also found that accounting standards that are too detailed (rules-based standards) often provide a vehicle for circumventing the intention of the standard.

As a result, the staff indicated that the best approach would be to develop accounting standards that:

- Are based on a conceptual framework;
- Clearly state the accounting objective of the standard;
- Provide sufficient detail and structure so the standard may be applied on a consistent basis;
- Minimize exceptions from the standard; and
- Avoid the use of percentage tests that allow financial engineers to achieve technical compliance with the standard while evading the intent of the standard.

The staff's recommendation is consistent with the approach currently being developed by the Financial Accounting Standards Board.

STRENGTHENING THE ENFORCEMENT OF THE FEDERAL SECURITIES LAWS

The Act also has helped the Commission to restore investor confidence in the capital markets by strengthening enforcement of the Federal securities laws. The Act added a number of new weapons to the Commission's enforcement arsenal to better deter would-be securities wrongdoers and compensate injured investors. It also required the Commission to undertake studies of enforcement actions and report to Congress. These studies contain important recommendations to further strengthen the Commission's enforcement program.

New Enforcement Tools

With the Act, Congress provided the Commission a number of new tools with which to further our enforcement mission. The Act strengthened the Commission's ability to obtain meaningful remedies and expanded our authority to return funds to harmed investors. Significant new enforcement tools include:

- Authority, in certain cases, to distribute civil money penalties to harmed investors, under the "Fair Funds provision;"
- Authority, during an investigation of a public company or its officers, directors, or others, to seek a temporary order from a Federal district court to escrow extraordinary payments;
- A more appropriate standard for the Commission to obtain an officer and director bar in an injunctive action;
- Authority to seek officer and director bars, under the new standard applicable in injunctive actions, in cease-and-desist proceedings;
- Authority to censure or restrict brokers, dealers, investment advisers, and associated persons, who are subject to certain final State, Federal banking agency, or National Credit Union Administration orders;
- Access to audit workpapers of foreign audit firms that issue an audit opinion or perform material services upon which a registered public accounting firm relies in issuing an audit opinion; and
- Authority to seek penny stock bars in injunctive actions.

[4] The Commission's determination was premised on an expectation that the FASB would address certain issues announced by the Commission and that the FASB would continue to serve the public interest and protect investors.

Use of Sarbanes-Oxley Enforcement Tools

This fiscal year, the Commission has used the new tools to facilitate maximum return of funds to harmed investors. For example, the Commission has twice invoked Section 1103 of the Act, which provides that during an investigation of a public company or its officers or directors, the Commission may seek a temporary order from a Federal court to escrow "extraordinary payments" if it appears likely the company will make such "extraordinary payments" to an officer or director. Section 1103 helps ensure that company insiders do not receive unusual rewards during the course of an SEC investigation that may uncover misconduct by those individuals. This "preventive measure" helps to address one of the toughest challenges facing the Commission—finding, recovering, and returning funds to defrauded investors—by securing funds before they are provided to alleged securities-law violators.

In its most recent use of Section 1103, the Commission successfully petitioned the court to place in escrow for 45 days, a $37.64 million payment intended for two former officers of Gemstar-TV Guide International. This allowed our Enforcement staff to advance its investigation, and the Commission to file securities fraud charges against the two former Gemstar officers in Federal court, without permitting the officers to receive, and then dissipate, funds that allegedly belong to the company and its investors.

Section 308(a) of the Act, the "Fair Funds" provision, has also quickly become an important tool. Before the Act, by law, all civil penalties were paid into the U.S. Treasury, and, as a result, kept out of the hands of defrauded investors. Now, however, the Commission has authority, in certain circumstances, to use civil penalties to help make defrauded investors whole. In just over 1 year, the Commission has used the Fair Funds provision to designate over $1 billion in penalties for distribution to defrauded investors. A significant example of the effectiveness of the Fair Funds provision is in the Commission's case against WorldCom, Inc., where the company has agreed to satisfy its civil penalty obligation by paying $500 million in cash and $250 million in stock to defrauded investors. Thanks to the Fair Funds provision, all of this amount can be made available to harmed investors.

Studies and Reports

The Act required the Commission to conduct several enforcement-related studies. Section 308(c) directed the Commission to review and to analyze its enforcement actions in which disgorgement and penalties were sought to determine how such proceedings may best be utilized to provide recompense to injured investors. The principal findings of the Commission's study were set forth in a report submitted to Congress on January 24, 2003.

This enforcement study, along with others conducted pursuant to Sarbanes-Oxley, made several recommendations intended to bolster the Commission's collection program, strengthen its enforcement efforts generally and provide more compensation for defrauded investors.[5]

These recommendations included:

- Permitting the Commission, under the Fair Funds provision, to use penalty moneys for distribution to investors even if no disgorgement is ordered;
- Removal of State law impediments to the Commission's collection of judgments and administrative orders;
- Expressly authorizing the Commission to hire private attorneys to conduct litigation to collect its judgments;
- Expanding the Commission's access to grand jury materials;
- Providing nationwide service of trial subpoenas; and
- Facilitating cooperation by preserving the privilege of information produced voluntarily to the Commission by a person or entity under investigation.

These recommendations provided a basis for several provisions of a bill, H.R. 2179, now pending in the House of Representatives.

IMPROVING THE "TONE AT THE TOP" AND EXECUTIVE RESPONSIBILITY

Another critical purpose of the Act was to improve the "tone at the top." This important theme dates back to President Bush's ten-point plan of March 2002, even before passage of the Sarbanes-Oxley Act. The tone set by top management is the most important factor contributing to the integrity of the financial reporting process.

[5] Section 703 of the Act directed the Commission to study securities professionals who violated the Federal securities laws, and Section 704 of the Act directed the Commission to study enforcement actions to identify areas of issuer financial reporting that are most susceptible to fraud, manipulation, and inappropriate earnings management. Both studies were submitted to Congress on January 24, 2003.

Executive Certification of Company Reports

The Act contains two different executive certification provisions, Sections 302 and 906, each of which requires CEO's and CFO's of reporting companies to certify the financial and other information in their reports filed with the Commission.[6] On August 27, 2002, the Commission adopted rules to implement Section 302 of the Act. Section 906 of the Act, which contains a separate certification requirement subject to specific Federal criminal provisions, is self-operative and became effective immediately upon enactment. On May 27, 2003, the Commission adopted amendments to its rules under Section 302 in connection with its implementation of the internal control reporting requirements of Section 404, and also mandated that the certifications under Sections 302 and 906 be submitted as exhibits to Commission reports to aid investors and regulators in locating these statements.

These certifications affirm senior executive responsibility for financial reporting.[7] An important aspect of the certifications is the CEO's and CFO's responsibility for establishing and maintaining disclosure controls and procedures. In addition to the required certification regarding these controls and procedures, the Commission included an express requirement in its rules that reporting companies must maintain disclosure controls and procedures. These are controls and other procedures designed to ensure that information required to be disclosed is recorded, processed, and accurately reported within the required time frame. The combination of the certification requirements and the requirement to establish and to maintain disclosure controls and procedures has been to focus appropriate increased senior executive attention on disclosure responsibilities and has had a very significant impact to date in improving financial reporting and other disclosure.

Code of Ethics for Senior Financial Officers

To further focus attention on honest and ethical conduct, the Commission adopted rules on January 15, 2003 pursuant to Section 406 of the Act. These rules require a reporting company to disclose annually whether the company has adopted a code of ethics for the company's principal executive officer and senior financial officers.[8] If a company has not adopted such a code, the company is required to explain why. The rules also require a company to disclose on a current basis amendments and waivers relating to the code of ethics for any of those officers. The Act required disclosure only of the applicability of the code of ethics to senior financial officers. Given the role of the CEO in setting the "tone at the top," the Commission also included a company's principal executive officer in its final rules.

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[6] The Act's provisions complement previous actions by the Commission regarding executive certifications. Before enactment of Sarbanes-Oxley, the Commission had previously published proposals to require CEO and CFO certifications for Exchange Act reports. See Release No. 34-46079 (June 17, 2002). In addition, the Commission required written statements, under oath, from the CEO's and CFO's of the 947 largest public companies regarding the accuracy of their companies' financial statements and their consultation with the companies' audit committees. *See* File No. 4–460: Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934 (June 27, 2002).

[7] For example, the rules adopted by the Commission pursuant to Section 302 require a company's CEO and CFO each to certify that:

- They have reviewed the report;
- The report does not contain an untrue statement or fail to state a material fact;
- The financial statements fairly present in all material respects the financial condition and results of operations of the company;
- They are responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting for the company and have:
  - Designed such disclosure controls and procedures to ensure that material information relating to the company is made known to them;
  - Designed such internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements;
  - Evaluated and reported on their company's disclosure controls and procedures; and
  - Disclosed any material change in the company's internal control over financial reporting; and
- They have disclosed to the auditors and audit committee:
  - All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting; and
  - Any fraud, whether or not material, that involves management or other employees who have a significant role in internal control over financial reporting.

[8] Companies are required to provide the new disclosures regarding codes of ethics in annual reports for fiscal years ending on or after July 15, 2003.

Disclosures of Insider Transactions

Section 403 of the Act effected two important changes that will result in earlier public notification of insiders' transactions in their company's securities and wider public availability of information about those transactions.

First, on August 27, 2002, the Commission adopted rules to implement the accelerated filing deadline applicable to change of beneficial ownership reports. The Act accelerated these deadlines to the second business day following the execution date of such transactions. As provided for in the Act, the Commission provided limited relief for certain transactions only where the two business day period is not feasible.[9]

Second, on April 24, 2003, the Commission adopted rules to implement Section 403(a)(4) of the Sarbanes-Oxley Act, which requires electronic filing of insider transaction reports and Internet accessibility of such reports. To facilitate the implementation of this requirement, the Commission created a new online filing system for these forms.[10]

Prohibition on Insider Trading During Pension Fund Blackouts

On January 15, 2003, the Commission, after consultation with the Department of Labor, adopted rules implementing Section 306 of the Act. Section 306 prohibits any director or executive officer of a company from purchasing or selling any equity security during a pension plan black out period that prevents plan participants and beneficiaries from engaging in transactions involving those securities. Section 306 equalizes the treatment of corporate executives and rank-and-file employees with respect to their ability to engage in transactions involving company equity securities during black out periods.[11]

IMPROVING DISCLOSURE AND FINANCIAL REPORTING

Apart from increasing focus on executive responsibility, the Act takes several important steps toward improving disclosure and the financial reporting process. Accurate and reliable financial reporting lies at the heart of our disclosure-based system of securities regulation and is critical to the integrity of our securities markets. Investors need accurate and reliable information to make informed investment and voting decisions. Investor confidence in the reliability of this information is fundamental to the liquidity and vibrancy of our markets.

Internal Control over Financial Reporting

The impetus for reform that culminated with the Sarbanes-Oxley Act helped coalesce widespread support for extending internal control reporting requirements to all public companies.[12] On May 27, 2003, the Commission adopted rules to implement Section 404 of the Act, which requires public companies to file an annual internal control report as part of their annual reports. This report will address management's responsibility to establish internal control over financial reporting and will require management to evaluate the effectiveness of internal control over financial reporting.

In addition, the Act requires the auditor of the company's financial statements to attest to, and report on, management's assessment of the company's internal control over financial reporting in accordance with standards established by the Public Company Accounting Oversight Board.[13] In this regard, the Commission's Director

[9] This limited relief focuses on limited categories of transactions where the insider does not select the date of execution. For these transactions, the reports must be filed within two business days after the insider receives notice of the transaction, but the notification date may be no later than the third business day after the transaction is executed.

[10] These changes became effective on June 30, 2003, 1 month ahead of the statutory deadline.

[11] The Commission's rules, which implement both the trading restrictions and the black out notice requirements of Section 306, became effective on January 26, 2003.

[12] Since 1993, larger depositary institutions or their bank holding companies have been subject to similar requirements under the FDIC Improvement Act of 1991 (FDICIA). In addition, the Commission has twice, in the past, proposed an internal control report requirement. A mandated internal control reporting requirement also was one of the recommendations of the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission, in its landmark 1987 report.

[13] Section 404(b) of the Act. *See* also Section 103(a)(2)(A)(iii) of the Act, which directs the PCAOB to write an auditing standard that requires an auditor to describe in the audit report the scope of the auditor's testing of the company's internal control structure, as required by Section 404(b), and to present (in such report or in a separate report): (1) the findings from such testing, (2) an evaluation of whether the company's internal control structure (a) includes maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of assets of the company, and (b) provides reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures are being made only

of the Division of Corporation Finance and our Deputy Chief Accountant recently participated in a PCAOB Roundtable on internal control attestations. Roundtable participants included representatives of institutional investors, public companies, Federal and State regulators, accounting firms and others. The PCAOB intends to consider the information and views provided at the Roundtable as it develops a new standard on auditor attestations of an entity's internal control over financial reporting. There will be an opportunity for public comment before the PCAOB finalizes its standard, and this standard, like all PCAOB rules, will be subject to Commission approval before it becomes effective.

For many companies, the new rules on internal control reports will represent the most significant single requirement associated with the Sarbanes-Oxley Act. The establishment and maintenance of internal control over financial reporting has always been an important responsibility of management.[14] An effective system of internal control over financial reporting is necessary to produce reliable financial statements and other financial information used by investors. By requiring a report stating management's responsibility for internal control over financial reporting and management's assessment regarding the effectiveness of such control, investors will be better able to evaluate management's stewardship responsibilities and the reliability of a company's disclosure. The required annual evaluation of internal control over financial reporting will encourage companies to devote adequate resources and attention to the maintenance of such control. Additionally, the evaluation should help to identify potential weaknesses and deficiencies in advance of a system breakdown, and may help companies detect fraudulent financial reporting earlier and perhaps thereby deter financial fraud or minimize its adverse effects.

In light of the substantial time and resources needed to properly implement the rules and the corresponding benefit to investors that will result, our final rules provide for a transition period based upon the type of reporting company.[15] The additional time also will permit the PCAOB to develop revised attestation standards.

Off-Balance Sheet Transactions

One of the revelations of the recent corporate accounting failures was the abuse of off-balance sheet transactions. On January 22, 2003, the Commission adopted amendments to implement Section 401(a) of the Sarbanes-Oxley Act, which requires each annual and quarterly financial report filed with the Commission to disclose all material off-balance sheet transactions, arrangement, and obligations.[16] The Act's mandate complements efforts of both the Commission and the FASB in this area,[17] and the Commission's final rules also require most companies to provide an overview of certain known contractual obligations in an easy-to-read tabular format.

Non-GAAP Financial Measures

On January 15, 2003, the Commission adopted rules implementing Section 401(b) of the Act to require that any public disclosure of a non-GAAP financial measure by a public company (referenced as "pro forma financial information" in the Act) must be presented in a manner that:

- Does not contain an untrue statement of a material fact or omit to state a material fact necessary in order to make the non-GAAP financial measure, in light of the circumstances under which it is presented, not misleading; and
- Reconciles the non-GAAP financial measure with generally accepted accounting principles (GAAP).[18]

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as authorized by management or the board of directors, and (3) describes material weaknesses in, and material noncompliance with, those controls.

[14] As the Commission emphasized in its release implementing Section 404, the design, implementation, documentation and testing of internal control over financial reporting, as well as documentation of that testing, are responsibilities of management. *See* Release No. 33–8238 (June 5, 2003).

[15] Larger companies subject to our accelerated filing deadlines must comply with the new rules as of the end of their first fiscal year ending after June 15, 2004. All other companies, including small business and foreign issuers, must comply beginning with their first fiscal year ending after April 15, 2005.

[16] Companies are required to comply with these new disclosure requirements in Commission filings that include financial statements for fiscal years ending on or after June 15, 2003.

[17] *See,* for example, Release 33–8056 (Jan. 22, 2002) (Commission cautionary advice on off-balance sheet transactions); Financial Accounting Standards Board Interpretation No. 45 (Nov. 2002); and Financial Accounting Standards Board Interpretation No. 46 (Jan. 2003).

[18] The Commission's rules on this topic became effective on March 28, 2003. Like Congress, the Commission also had been concerned with the use of non-GAAP financial information. Most recently, in December 2001, the Commission issued cautionary advice regarding the use of such

Continued

In addition to defining the category of financial information that is subject to the mandate, the Commission took a two-step approach to regulating the use of non-GAAP financial information. First, the Commission adopted new Regulation G, which applies whenever a company publicly discloses or releases material information that includes a non-GAAP financial measure. This regulation prohibits material misstatements or omissions that would make the presentation of the material non-GAAP financial measure misleading and requires a quantitative reconciliation of the measure to GAAP (by schedule or other clearly understandable method). Second, the Commission adopted rules that address the use of non-GAAP financial measures in filings with the Commission. These amendments apply to the same categories of non-GAAP financial measures covered by Regulation G, but contain more detailed requirements than Regulation G.

Authorizing a "Real Time" Disclosure System

Each investor should have prompt access to critical information. Section 409 of the Act obligates public companies to disclose "on a rapid and current basis" information concerning material changes in the financial condition or operations of the company as the Commission determines, by rule, is necessary or useful for the protection of investors and the public interest. This authorization is consistent with the Commission's ongoing mission to modernize the public reporting system and improve the usefulness of these reports to investors.

For example, on September 5, 2002, the Commission adopted amendments to accelerate the filing deadlines for quarterly and annual reports by nearly one-third for larger, seasoned reporting companies. The deadlines for these reports were last changed over 30 years ago. In part to accommodate the implementation of other provisions of the Sarbanes-Oxley Act, the changes to filing deadlines will be phased in over 3 years.

On January 15, 2003, the Commission adopted amendments to require public companies to furnish to the Commission their earnings releases or other announcements disclosing material nonpublic information about completed annual or quarterly fiscal periods.[19] These amendments will not require the issuance of earnings releases or similar announcements; however issuing such releases and announcements will trigger the new requirement. Bringing these disclosures into the formal reporting system will provide widespread and uniform access of this information to investors. Special accommodations were made to address presentations made orally, telephonically, by webcast, or by similar means.

Current Commission proposals to expand dramatically the list of significant events requiring prompt disclosure between reporting periods are also consistent with the mandate of Section 409. These proposals go a long way toward implementing a "real time" disclosure system. Specifically, the proposals would:

- Require current disclosure of 11 new items or events;
- Move two items that are currently required only on an annual or quarterly basis to disclosure on a current basis;
- Augment several existing items that are required to be disclosed on a current basis; and
- Accelerate the deadline for reporting all of the items required on a current basis.

I expect the Commission will revisit these proposals in the coming months.

IMPROVING THE PERFORMANCE OF "GATEKEEPERS"

In addition to addressing auditors and the accounting profession, as discussed above, the Sarbanes-Oxley Act and our new rules require better focus by other gatekeepers in our capital markets on their proper roles. The effective operation of these gatekeepers is fundamental to preserving the integrity of our markets. Revelations from the recent corporate and accounting scandals revealed that these parties did not always fulfill their proper responsibilities.

Audit Committee Listing Standards

Recognizing that financial statements, financial reporting, and the audit itself is the bedrock upon which full and accurate disclosure is built, and also recognizing the importance of the audit committee in these processes, Congress in Section 301 of the Act called for, and on April 1, 2003 the Commission adopted, rules directing the Nation's exchanges to prohibit the listing of any security of a company that is not in compliance with the audit committee requirements established by Section 301. Under the new rules, listed companies must meet the following requirements:

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information. See Release No. 33–8039 (Dec. 4, 2002). *See* also *In the Matter of Trump Hotels & Casino Resorts, Inc.,* Release No. 34–45287 (Jan. 16, 2002).

[19] These rules became effective March 28, 2003.

- All audit committee members must be independent;
- The audit committee must be directly responsible for the appointment, compensation, retention and oversight of a company's outside auditors, and the outside auditors must report directly to the audit committee;
- The audit committee must establish procedures for the receipt, retention, and treatment of complaints regarding accounting and auditing matters, including procedures for the confidential, anonymous submission of concerns by employees; and
- The company must establish funding for the audit committee, including the means to retain and compensate independent counsel and other advisors, as the audit committee determines necessary to carry out its duties.

The new rules apply to both domestic and foreign companies that list in the United States. Based on significant input from and dialogue with foreign regulators and foreign issuers, several provisions, applicable only to foreign issuers, were included in the final rules to address potential conflicts with foreign legal requirements where consistent with fulfilling the investor protection mandate of the Act. These provisions include accommodating foreign "co-determination" requirements, allowing shareholders to select or ratify the selection of auditors consistent with requirements in many foreign countries and allowing alternative structures, such as boards of auditors, to perform auditor oversight functions where such structures are provided for under local law.

We are continuing our work with the Nation's markets to implement these requirements into their listing rules, and the Commission established ambitious deadlines in its final rules for the Nation's markets to implement the new listing standards.[20] These efforts complement reform efforts previously instituted by our Nation's markets at the Commission's request to strengthen corporate governance listing standards for publicly traded companies. In particular, the proposals by the New York Stock Exchange and the Nasdaq, which will both be finalized within the next few weeks, will increase board independence and effectiveness by, among other things, mandating that boards be composed of a majority of independent directors, requiring executive sessions outside the presence of management, and requiring strong audit, compensation, and nominating/governance committees composed of independent directors. We have already approved changes to listing rules to require shareholder approval of equity compensation plans.

These are significant changes that should have a lasting impact on improving responsibility and accountability in our markets. They also have focused attention on corporate governance reforms by the private sector. Many companies already are moving to adopt the new requirements. In addition, leading private sector organizations have been hard at work studying ways to increase corporate governance. In May, the Conference Board released its report, *Corporate Governance Best Practices: A Blueprint for the Post-Enron Era,* in which it suggested numerous corporate governance best practices. Similarly, the Business Roundtable has issued its own *Principles of Corporate Governance* suggesting further best practices.

Research Analysts

On July 29, 2003, the Commission approved rules proposed by the NYSE and NASD that satisfy Section 501 of the Act, which directed the Commission to adopt, or to direct the SRO's to adopt, rules designed to further address research analyst conflicts of interest. The Commission worked closely with the SRO's to conform their rules to meet the directives of the Act.

Some of the Act's requirements were satisfied by NASD and NYSE rule provisions existing at the time of enactment. Others necessitated amendments, such as to limit the compensatory evaluation of analysts to officials not engaged in investment banking activities and to further define periods during which a member firm engaged in a public offering of a security as an underwriter or dealer may not publish research on such security. The new rules also require analysts and members to disclose specified conflicts of interest to the extent that the member or analyst knows or has reason to know, including whether the member or any affiliate received any

[20] The affected markets were required to submit proposed listing rules by July 15, 2003, and all of them met that deadline. Final listing rules must be approved by the Commission by December 1, 2003. The vast majority of listed companies must comply with the new rules by the earlier of their first annual shareholders meeting after January 15, 2004 or October 31, 2004. This time frame was selected to coincide with a company's next annual shareholders meeting to facilitate any elections for new audit committee members that may be necessary to meet the rule's independence requirements. Given that foreign issuers and small business issuers were previously not subject to rules of this type, they were given additional time (until July 31, 2005) to comply.

compensation from the issuer that is the subject of the research report; and whether that issuer has been a client of the member firm and, if so, the types of services provided.

As urged by commenters, to clarify the scope of information about which the analyst or member would be deemed to have reason to know, the SRO rules set forth two mechanisms by which analysts and their firms can satisfy the requirement that they disclose noninvestment banking compensation that was received from the issuer by an affiliate of the member. The rules provide that the disclosure requirement will be deemed satisfied if the member, on a quarterly basis, discloses affiliate noninvestment banking compensation that it has identified as having been received from the issuer. In the alternative, the rules provide that a member or analyst would be presumed not to have a reason to know of noninvestment banking compensation received by an affiliate, if the member has in place informational barriers designed to prevent the analyst or any influential employee from receiving such information from the affiliate.

Also of note, in the compensation disclosure provision, the Act explicitly authorized the Commission to permit an exception for material nonpublic information regarding specific potential future investment banking services transactions of the subject company. The SRO rules also apply that exception to the client disclosure provision. We believe that providing this exception in the client disclosure provision is consistent with the Act's compensation disclosure provision, and fulfills the Act's mandates that rules be adopted that are reasonably designed to provide disclosure of broker-dealers' clients and client services, while appropriately addressing concerns related to the potential dissemination of material nonpublic information.

Standards of Conduct for Attorneys

On August 5, 2003, the Commission's rule implementing Section 307 of the Sarbanes-Oxley Act became effective, setting "standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers." The rule, adopted last January, requires an attorney to report evidence of a material violation "up-the-ladder" within the issuer to the chief legal officer of the company. It also requires an attorney, if the chief legal officer does not respond appropriately to the evidence, to report the evidence to the issuer's audit committee, another committee of independent directors, or the full board of directors.

In addition to requiring up-the-ladder reporting, the final rule allows an attorney, without the issuer's consent, to reveal confidential information related to his or her representation to the extent the attorney reasonably believes necessary: (1) to prevent the issuer from committing a material violation likely to cause substantial financial injury to the financial interests or property of the issuer or investors; (2) to prevent the issuer from committing an illegal act; or (3) to rectify the consequences of a material violation or illegal act in which the attorney's services have been used.

At the same time as the Commission adopted its final rule, it approved an extension of the comment period on the so-called "noisy withdrawal" provisions of the original proposed rule and put out for comment an alternative reporting out rule that would require the issuer to report to the Commission its attorney's withdrawal from representation. The Commission has not decided how it wishes to proceed with respect to "noisy withdrawal."

Rating Agencies

On January 24, 2003, the Commission submitted to Congress and the President a report on the role and function of credit rating agencies in the operation of the securities markets in response to the Congressional directive contained in Section 702 of the Act. The report was designed to address each of the topics identified for Commission study in Section 702, including the role of credit rating agencies and their importance to the securities markets, impediments faced by credit rating agencies in performing that role, measures to improve information flow to the market from credit rating agencies, barriers to entry into the credit rating business, and conflicts of interest faced by credit rating agencies. The report also addresses certain issues regarding credit rating agencies that go beyond those specifically identified in the Act, such as allegations of anticompetitive or unfair practices, the level of due diligence performed by credit rating agencies when taking rating actions, and the extent and manner of Commission oversight of credit rating agencies.

In preparing the report, the Commission pursued several approaches, both formal and informal, to conduct a thorough and meaningful study of credit rating agencies. These efforts included informal discussions with credit rating agencies and market participants, formal examinations of credit rating agencies and public hearings

where market participants were given the opportunity to offer their views on credit rating agencies and their role in the capital markets.

To further address issues raised in the report, the Commission published a concept release on June 4, 2003 seeking comment on a number of issues relating to credit rating agencies, including whether credit ratings should continue to be used for regulatory purposes under the Federal securities laws, and, if so, the process of determining whose credit ratings should be used, and the level of oversight to apply to such credit rating agencies. The comment period for the concept release ended on July 28, 2003, and the Commission received 42 comment letters from a wide range of interested persons. The staff is currently preparing an analysis of the comment letters to assist the Commission in determining what further action may be appropriate.

Audit Committee Financial Experts

On January 15, 2003, the Commission adopted rules pursuant to Section 407 to require a reporting company to disclose annually whether it has at least one "audit committee financial expert," and if so, the name of such expert and whether the expert is independent of management. A company that does not have an audit committee financial expert will be required to disclose this fact and explain why it has no such expert. These disclosures will improve transparency to investors in evaluating the experience of the audit committees of companies in which they invest.[21] In response to public comment, the final rules broadened the categories of experienced individuals with accounting and financial expertise that could meet the definition of "financial expert" from our original proposals, while still incorporating all of the considerations for the definition set forth in Section 407. The rules also provide several limited safe harbors to address concerns that being designated as an audit committee financial expert would dissuade qualified candidates from board service.

Investment Companies

We also have fully implemented the requirements of the Act with respect to mutual funds and other registered investment companies (funds). With few exceptions, the Act did not draw any distinctions between operating companies and funds, and the rules that we have adopted generally apply with equal force to both. In some cases, this has required us to adapt the requirements of the Act to address the unique circumstances of funds, such as the fact that, unlike most operating companies, funds are typically externally managed by an investment adviser. For example, in implementing the statutory requirement that an issuer's audit committee preapprove permissible nonaudit services provided by its auditing firm, we applied the preapproval requirements not only to services provided to a fund, but also to certain fund-related services provided to the fund's adviser and other entities in a fund complex. The positive effects of our rules under the Act with respect to funds will be reinforced as we continue to vigorously pursue other initiatives to improve the disclosure that funds provide to investors, particularly with respect to fees and expenses.

Moving Forward After Sarbanes-Oxley

COMMISSION OPERATIONS

Section 601 of the Act authorized substantial additional appropriations for the Commission. I believe that the efficient functioning of the SEC is as much a part of investor protection as ushering in new rules and regulations. I am committed to ensuring that every penny of the new money granted to the Commission is spent wisely. We will bring on the people we need to help us fulfill our mission, and not simply to increase our head-count. I have been working with senior staff of the Agency to determine appropriate changes to address both our internal and external needs. As an illustration of the seriousness with which we view this part of our responsibilities, I recently reorganized the Office of the Chairman to include three managing executives, one of whom is the Managing Executive for Operations and works full-time on the SEC's efficiency and operational effectiveness.

On February 20, 2003, the President signed into law the Consolidated Appropriations Resolution, providing the Commission with a fiscal year 2003 appropriation of $716 million, which is $278 million more than our fiscal 2002 appropriation. A portion of these funds will be used to hire 842 new staff to:

- Implement the Sarbanes-Oxley Act, including the review of each registrant's financial statements every 3 years;

[21] Companies are required to provide the new disclosure in annual reports for fiscal years ending on or after July 15, 2003. Small business issuers will be required to provide the new disclosure in annual reports for fiscal years ending on or after December 15, 2003.

- Enhance our enforcement program so we can bring more investigations and complete them sooner;
- Review investment advisers and investment companies more frequently, based on risk criteria; and
- Conduct more broker-dealer branch-office examinations.

Without the Accountant, Compliance, and Enforcement Staffing Act of 2003, many of these initiatives would be in jeopardy due to our difficulties hiring additional professional staff in a timely manner. We are extremely grateful for the support of the Congress and the President in quickly addressing our personnel and operational needs.

With the addition of a substantial number of accountants to our Division of Corporation Finance, we will strive to achieve the 33 percent annual review level mandated by Section 408 of the Act. The Division also will continue its focus, also mandated by Section 408, on the largest companies and other companies where review is most important. In addition, the Division has modified its selective review process in a manner that will allow it to focus on companies and on disclosure that appear to be critical to an understanding of each company's financial position and results. The Division will continue to refine this process to allow it to efficiently use its resources and review material disclosure issues in a broad range of companies. Through increased staffing and focused reviews, the Division will strive to complete either a full, financial, or other review of the filings of one-third of the reporting companies each year.

THE AGENDA BEYOND SARBANES-OXLEY

Implementing Sarbanes-Oxley has been a tremendous accomplishment in its own right. I also want to touch on some of our other areas of progress, as well as our ongoing priorities, which reflect our desire to restore investor confidence while helping America's financial markets to continue allocating capital effectively and sparking job creation.

For example, we are continuing to build on the July 15 report of our Division of Corporation Finance, which recommends improved disclosure and greater shareholder access to the director nomination process. We have already issued proposals on improved disclosure, and the Commission will consider proposals in the shareholder access area as soon as this month.

We are examining the mutual fund industry, and its impact on investors, looking at everything from how fund companies do business to the fees they charge and the information they disclose to their customers. We are also in the process of reviewing the hedge fund industry, given its extraordinary recent growth, to ensure that investor protection remains paramount. Recommendations from the SEC staff in this area are likely to be issued in the near future.

We also are taking a comprehensive look at the complex issues involving the structure of our securities markets—including their regulation, the balance between competition and fragmentation, and the use of market data—all in the context of our global marketplace and its impact on investors. These market structure issues are among the thorniest the Commission faces, but also among the most important. Revolutions in technology and communications and the unrelenting pace of globalization make it imperative that we revisit on a comprehensive basis the framework of our system for regulating markets.

We will continue to monitor areas that may merit future attention and whether there are particular items, regulatory burdens or unintended consequences that should be addressed. For example, the Commission staff has issued Frequently Asked Questions on implementation of the non-GAAP financial measure rules and the auditor independence rules. In addition, we have attempted to reduce the compliance burdens on smaller public companies where appropriate and permitted by the Act. While initial concerns that the costs of the Act would drive many public companies to go private have not played out, we intend to continue to review the effects of the new requirements on smaller public companies.

Similarly, we will continue to pay attention to possible unintended consequences of the Act for foreign issuers. The Commission and its staff have had extensive consultations with foreign regulators and members of the foreign community, and have considered ways to accommodate foreign requirements and regulatory approaches, while safeguarding the investor protection objectives of the Act. This approach should preserve the attractiveness of the U.S. markets to foreign investors.

HONEST BUSINESS IN THE CURRENT ENVIRONMENT

Just as the Commission has been moving forward with implementation of the Act, so too must American businesses. Corporate leaders are responding not only to the Act's mandates, but also to the movement toward increased transparency that

underlies Sarbanes-Oxley. However, I have become aware that some in the business sector feel that they are under siege from new regulations, and the threat of additional litigation.

As I have mentioned before, good, honest companies should fear neither Sarbanes-Oxley nor our enforcement efforts. Rather, they should recognize that the improved standards that the Act mandates and smart and fair enforcement of the laws are the right thing to do and help attract capital and investment. As William O. Douglas, then Commission Chairman and future Supreme Court Justice, pointed out in a 1938 speech, "To satisfy the demands of investors there must be in this great marketplace not only efficient service but also fair play and simple honesty. For none of us can afford to forget that this great market can survive and flourish only by grace of investors."

Good corporate governance is not primarily about complying with rules. It is about inculcating in a company, and all of its directors, officers, and employees, a mindset to do the right thing. As I have said before, the focus on doing the right thing should become part of the DNA of a company and everyone in the company from top to bottom. For companies that take this approach, most of the major concerns about compliance disappear. Moreover, if companies view the new laws as opportunities—opportunities to improve internal controls, improve the performance of the board, and improve their public reporting—they will ultimately be better run, more transparent, and therefore more attractive to investors.

I believe that this attitude is beginning to take hold in corporate America. During my travels, and in my discussions with company officials, countless people have told me that America cannot afford a return to the lax standards that preceded Sarbanes-Oxley. Many have added that while they initially questioned the merits of the Act, they now see that it can help show the way to a brighter, more competitive era in American business.

The success of a new era under the Act must involve a continued measure of the risk-taking and entrepreneurship that are the hallmarks of honest American business. There have been suggestions, including in the press, that the recent crackdowns on corporations and executives by criminal and civil authorities, including the Commission, have discouraged honest risk-taking.

I have a different perspective on recent developments. I believe the Act and the other steps that have accompanied it will lead to an environment where honest business and honest risk-taking will be encouraged and rewarded. What should be discouraged, and what we are committed to stamp out, are the activities that some have sought to disguise as honest business but that, in reality, are no such thing.

Transactions with no substance that are designed solely to assure increased earnings or cashflow in financial reports involve no risk and are not honest business. Neither are transactions that are disguised as rewards for entrepreneurship or superior management but that, in fact, provide risk-free excessive compensation or facilitate self-dealing for the benefit of insiders.

I hope we have learned some lessons from the era just passed—and I believe we have. I also hope that America's corporate leaders will not use Sarbanes-Oxley as an excuse for putting off innovation and investment. Looking back 1 year, and also looking forward, nothing in the law, its implementation or in the Commission's agenda should make business fearful. Indeed, a new period marked by the responsibility and realism I have just discussed can provide the foundation for a new era of long-term growth and prosperity.

Conclusion

In conclusion, let me again thank you for your important leadership and support in the initiative to reestablish and strengthen investor confidence and integrity in our Nation's capital markets. Throughout the massive directed rulemaking project under Sarbanes-Oxley, the goals of the Commission and its staff have been to protect investors and restore confidence in our securities markets. While it may be a bit too early to judge the impact of all of the various provisions of the Act, the Commission will monitor carefully the implementation and effects of the new rules and requirements, and we will take actions as appropriate to ensure that the objectives of the Act are achieved. We will continue our strong tradition of cracking down on corporate wrongdoing. And thanks to the Act and your efforts, we have the tools and resources we need to carry out these important objectives.

Thank you again for inviting me to speak on behalf of the Commission. I would be happy to answer any questions that you may have.

Michael Schroeder
The Wall Street Journal

Cleaner Living, No Easy Riches

Critics Say Sarbanes-Oxley Law Hobbles Stocks, Chills Risk Taking, But Upshot Is Far Less Dramatic

JULY 22, 2003

Washington—Critics blame the Sarbanes-Oxley Act for everything from slowing the stock-market recovery to draining the pool of corporate-board directors to undermining capitalism itself.

But the real-world effect of the year-old legislation that ushered in sweeping new accounting and boardroom rules hasn't been so dramatic. "A lot of urban myths," dismisses Patrick McGurn, vice president at Institutional Shareholder Services, a research firm that advises large mutual funds. "There is little substance behind the complaints."

Warren Neel, director of the University of Tennessee's Center for Corporate Governance, says the center is preparing to evaluate the bill's impact, but so far has found a dearth of data largely because major parts of the bill's 68 sections aren't even in effect yet.

That data gap hasn't kept the critics quiet.

William Niskanen, chairman of the libertarian Cato Institute, argued at a recent forum that the accounting changes have caused so much uncertainty that investors have shunned the stock market.

His evidence? "My remark that Sarbanes-Oxley delayed the recovery of the stock market by about 6 months was strictly a conjecture, without any study or directly relevant quantitative evidence," Mr. Niskanen acknowledges. His criticism springs from Cato's view that government regulation is largely unnecessary.

Top executives have been wringing their hands about Sarbanes-Oxley's potential to create a shortage of candidates to fill board seats. Boards now must have more independent directors who work a lot harder; audit committees are expected to have at least one member with professional financial expertise. "A supply crunch is emerging as boards attempt to comply with Sarbanes-Oxley," says Tom Neff, head of Spencer Stuart, a large executive-search firm. The law has been good for his company. Mr. Neff says Spencer Stuart is now looking for candidates to fill some 300 board seats, up 50 percent from a year earlier.

Still, there seems to be no shortage. The National Association of Corporate Directors has a registry of 2,000 potential candidates for board seats. The Financial Executives Institute also has a list of 300 corporate financial officers qualified to serve on audit committees.

Others predict permanent economic damage. Robert Elliott, former partner of KPMG LLP and former head of the American Institute of Certified Public Accountants, says Sarbanes-Oxley has resulted in "the criminalization of [corporate] risk taking, which is the same as criminalizing capitalism."

When companies are discovered cooking the books, directors and management no doubt will feel more heat, including stiffer criminal penalties. As a result, Mr. Elliott contends that a wrong bet on an acquisition or new product that prompts a write-down of an investment could trigger a flood of class-action lawsuits or an investigation by an overzealous prosecutor.

Treasury Secretary John Snow offers a blunt defense of the new rules: "Nothing in Sarbanes-Oxley changes the fundamental norms of good corporate governance." As for the notion that management will become timid, he chides, "the management team is entrusted with a critically important function in our society: to take risks." He adds, "You are never going to bat 1.000. It is the nature of uncertainty."

J.T. Battenberg, chief executive of Delphi Corp., the largest auto-parts supplier, with $27.4 billion in sales, says the increased liability from the legislation won't affect his company's investment strategy. "Does that inhibit you from making good, tough decisions?" he said. "No. It may slow you down a bit. It may cause you to probe a little deeper."

One point of universal agreement: Thanks to Sarbanes-Oxley, fees for director and officer insurance as well as lawyers and outside auditors are on the rise.

Audit fees represent the lion's share of added expense. A survey by Johnsson Group, a Chicago-based auditing consultant, found that fees for outside auditors are tripling this year for companies with at least $3 billion in sales. The typical $2 million expense is now $6 million. For companies whose sales exceed $15 billion, fees are expected to skyrocket to $8 million from $2 million.

"Price gouging!" declares Johnsson Group Chairwoman Marge Johnsson, who traces the problem to opportunistic accounting firms. "I am upset about the exploitation of the legislation for the benefit of four companies I thought were supposed to be getting their hands slapped," she says of the Big Four accounting firms who audit most public companies.

William Ezzell, AICPA chairman, says "the law requires additional work, responsibilities and obligations on the part of the outside auditor, management and the audit committee" to meet the goal of increasing investor confidence.

To be sure, Sarbanes-Oxley sets high hurdles for small, publicly traded companies. Securities and Exchange Commission member Cynthia Glassman said, "We have heard that some companies—especially smaller companies, including small banks—are avoiding public offerings or going private, to avoid having to comply" with Sarbanes-Oxley.

Still, there is no sea change. Of roughly 15,000 public companies, only 83 went private in 2002, 63 percent more than the year earlier—but slightly fewer than the 89 companies in 2000, according to Thomson Financial, which compiles market and investment data for corporate clients.

So far this year, 41 companies have announced plans to revert to private ownership. "Sarbanes-Oxley is not even among the top 10 reasons" that Lillian Vernon Corp., the big direct marketer based in Rye, N.Y., is going private, says spokesman David Hochberg. Similarly, Susan Hauke, vice president of finance at InvestorsBancorp of Waukesha, Wis., says Sarbanes-Oxley did not weigh heavily in the decision to go private. Instead, the chairman wants to buy the thinly traded bank, which has $178 million in assets, Ms. Hauke says, adding that the move will save $115,000 in annual SEC financial-reporting expenses.

The seeds of Sarbanes-Oxley were sown in mid-2001—before the spectacular accounting scandals piled up one after another—by House Financial Services Chairman Michael Oxley (R., Ohio), who began holding hearings into whether Wall Street research analysts were really independent.

A few months later, with Enron Corp. and its auditor, the now-defunct Arthur Andersen LLP, engulfed in an accounting scandal, lawmakers in the House and Senate were up in arms, pushing for broad legislation to force Wall Street and corporations to clean up their acts. But by the spring of 2002, Capitol Hill was preoccupied with terrorism, anthrax and Afghanistan, leaving corporate-overhaul efforts stalled.

In April, the House passed a modest bill sponsored by Mr. Oxley. But a stronger version offered by Senate Banking Committee Chairman Paul Sarbanes (D., Md.) bogged down until a wave of scandals—Global Crossing Ltd., Tyco International Ltd., WorldCom Inc. and others—propelled it out of the legislative doldrums.

Fearing a backlash in 2002 midterm elections from voters who had lost their nest eggs as the market plunged, Republicans embraced the Senate measure's tough line on business. As he requested, President Bush had legislation on his desk before Congress's August recess. A first step required companies to certify each quarterly financial report.

But Sarbanes-Oxley hasn't been the last word.

State politicians have been jumping on the bandwagon—so much so that John Olson, a securities lawyer at Gibson, Dunn & Crutcher in Washington, says companies are exasperated.

California and Connecticut have already adopted additional certification requirements, and 35 states have approved or are considering legislation to regulate corporate accounting and other behavior, according to the North American Securities Administrators Association, which represents state securities regulators.

* * *

Fighting Conflicts With a Pen: What Has Changed?

Below, some major provisions of the Sarbanes-Oxley Act of 2002, which aims to reform accounting firms' practices, corporations' boards and Wall Street stock analysts.

Better Governance: Companies must disclose whether a board's audit commitee has at least one "financial expert" and if not, the reason for the absence. In a subsequent rulemaking, the Securities and Exchange Commission said companies must disclose the financial expert's name, define his qualifications and state whether the expert is independent of management.

Independence Day: It will be generally "unlawful" for an accounting firm to provide any major nonaudit service (bookkeeping, for example) to a client while completing that company's audit.

Taking Responsibility: The CEO and CFO must swear to the accuracy of the company's quarterly and annual financial reports. An officer who certifies a report that does not conform to the act's requirements of Sarbanes-Oxley faces a fine of not more that $1 million and a sentence of not more than 10 years in jail or both.

Watchdog: The act established the Public Company Accounting Oversight Board, or PCAOB—quickly nicknamed Peekaboo. The board of five "financially literate" members answers to the SEC.

Cleaning Up Wall Street: New rules separate Wall Street's stock analysis from its deal-making side—and punish companies who "retaliate" against analysts who criticize them.

Jail Threat: Makes tampering with corporate records a crime. Maximum penalty for mail and wire fraud increased from five to 10 years.

DEBBIE STABENOW
MICHIGAN

COMMITTEES:
AGRICULTURE, NUTRITION, AND FORESTRY
BANKING, HOUSING, AND URBAN AFFAIRS
BUDGET
SPECIAL COMMITTEE ON AGING

United States Senate

WASHINGTON, DC 20510–2204

August 5, 2003

Chairman William H. Donaldson
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Dear Chairman Donaldson:

I am pleased that, having recently observed the one-year anniversary of the passage of the Sarbanes-Oxley Act, the Securities and Exchange Commission has made great strides in implementing the new law. I appreciate the many positive steps you have taken in your role as Chairman of the Commission and I also appreciate the good work of the many employees at the SEC.

It is so essential that we remain vigilant in ensuring that any and all accounting fraud and corporate mismanagement in our nation's publicly traded companies is both detected and quickly addressed. The efficiency of our securities markets requires that investors have reliable, comprehensive information about the financial health of the companies in which they may choose to hold stock.

One of the lesser noted, but I believe critically important components of the Sarbanes-Oxley Act is Sec 301's whistleblower reporting mechanism. I offered the amendment that ultimately became this provision of the law because it became obvious to me during the ten Banking Committee corporate accountability hearings we held in 2002 that, in the case of Enron and other troubled companies, people in many of these companies knew there were problems. They, however, had nowhere to turn to report these problems. They were trapped in a corporate culture that silenced them. When they raised concerns with their superiors, they were either ignored or told not to worry about it.

To rectify this problem, I offered language that would ensure – for the first time – that the audit committees of public companies would establish a mechanism for the confidential anonymous submission by employees of concerns regarding questionable accounting procedures.

It is my hope that my amendment will serve as an important means whereby we can prevent future wide-scale accounting scandals. Indeed, as you may know, research has shown that the most common method for detecting company fraud is through information provided by an employee, customer, vendor or another source; over 46 percent of workplace frauds are uncovered this way.

It is also interesting and encouraging to look at the comments submitted to the Commission by Michael Chenkin and Gregory Warren during the recent Sarbanes-Oxley Act rulemaking. They stated: "We have performed an analysis of approximately 480 instances of serious accounting irregularities (or outright frauds) that the Commission has acted on over the last fifteen years. We have found that employee reporting would be effective or highly effective in stopping inappropriate Financial Statements in 56% of cases analyzed, quality audits in 24% and strong Audit Committee oversight in 39%." Such data clearly shows the value and necessity of an effective reporting mechanism.

If the audit committees of companies get information early on, they will have a responsibility to do something about it. They cannot pretend that they were not aware of the problems.

In order for this new provision to be successful, however, it is essential that the law is effectively implemented. I was disturbed to see in a July 22, 2003 Wall Street Journal article, "Boardrooms Under Renovation," that observers of the law's implementation feel that "there still isn't an easy way for corporate whistleblowers to communicate directly with board members."

The article goes on to state that "Many executives have set up hotlines to take complaints from employees, investors, and others about ethical misdeeds. But executives often screen those confidential complaints before sharing them with directors." The pre-screening of confidential concerns by employees clearly does not comply with my intent nor the intent of the greater Congress in passing the corporate whistleblower mechanism.

Finally, the article concludes that "Few board audit committees have the procedures required by Sarbanes-Oxley to receive inside complaints about accounting problems." This article confirms for me the reports I have heard from other sources, including from the CEO of a major accounting firm, that the rule is not having the full effect intended.

I am disappointed that the Commission did not craft a clearer, more extensive rule implementing Section 301's whistleblower reporting mechanism; the language adopted by the Commission closely mirrors the law without sufficient additional guidance. I am also concerned that the rule will not take effect sooner. Waiting until the Fall of 2004 is too long a window of time to implement this critical component of the Sarbanes-Oxley Act.

I believe that the Commission was correct in eschewing a proscriptive rule. Variations in publicly traded companies exist and it could be counterproductive to proceed with a one-size-fits-all approach. However, in the current rule, too much ambiguity persists.

In light of the reports about the delay by many companies in implementing the reporting mechanism, or to do it in a way that does not comply with the spirit of the law, and because the final rule is too vague and is likely to lead to incomplete implementation, I am urging you to act to clarify the rule. (Some of the following concepts were already

submitted to the Commission during the comment period, but regrettably were not acted on.) In particular, I believe that the Commission should:

1. Ensure that, in order to make the law as effective as possible, publicly traded companies shall make information about the confidential anonymous reporting mechanism widely available. The rule does not instruct companies to do this and I believe this is a serious shortcoming to effective implementation. The concept of "widely available" should include publishing information about the reporting mechanism in the employee handbook, a company's code of conduct, and/or its code of ethics. I also believe that all employees should be reminded via memo, email, or special training of the reporting mechanism, its functions, and its employee safeguards, not less than once a year.

2. Clarify that, in order to conform with the spirit of the law, publicly traded companies' audit committees must carefully examine all submissions. Consequently, to reduce undue burden on the audit committee members, audit committees should be able to engage outside independent assistance to assess the validity and consequences of any and all alleged accounting and auditing wrong-doing. Such outside help may be necessary, because it is, most certainly, not sufficient to remand the employee submissions back to management for further study. And, in no cases, is it acceptable for management to pre-screen, edit, or censor what is sent to the audit committee through the anonymous confidential submission mechanism. Audit committees must have direct unfettered access to these concerns and they must retain their ultimate responsibility to investigate these concerns thoroughly.

3. Ensure a truly anonymous and confidential exchange between employees and the audit committee. This would mean that, under no circumstances, would the audit committee or any person investigating an employee submission on behalf of the company seek to discover or reveal the name of or possible identifying information about the employee submitting information to another party other than an appropriate investigative entity whose employees understand their confidentiality obligations. To be effective, reporting mechanisms also should be developed in such a way that audit committees will be able to follow up with the anonymous submitter to seek additional information, as warranted and that the audit committee can and should ultimately report back to the submitter about what actions were taken in response to the submission and the rationale for those actions.

4. Instruct publicly traded companies that they should share with shareholders on, at least an annual basis, how the company is implementing the corporate whistleblower reporting mechanism. Absent a proscriptive approach to complying with the reporting mechanism established in Sarbanes-Oxley, different companies will take varying approaches to complying with the law. Making certain that shareholders understand how a company has established and is operating its confidential anonymous reporting mechanism is one way to allow shareholders to ascertain if they believe the company has strong corporate governance procedures in place.

5. Keep the definition of employee as broad as possible. Individuals who may not technically fall under the category of "employee" but who are engaged in company business are often just as well positioned as employees to identify and report fraud. An example of this would be investment companies who rarely have direct "employees."

6. Instruct companies to retain all submissions for at least seven years. Failure to retain these submissions for a sufficient period of time will make it more difficult to identify and root out corporate malfeasance and culpable actors should problems develop later on. Seven years should be a sufficient period of time to reflect back on an accounting or auditing problem and ascertain if any employees attempted to address the problem early on, but were ignored by the audit committee.

7. Move to implement this portion of the rule more quickly. Waiting well over another year to see this rule take effect means that, in the interim, many employees will not have sufficient means to report concerns about accounting and auditing problems. Potential problems may significantly worsen over the next year. I believe that the reporting mechanism provision of the law should take effect at least six months sooner than originally planned.

I believe strongly that these seven steps will go a long way toward making the Section 301 reporting mechanism an effective and useful tool. I know you share my goal of allowing every employee the ability to act anonymously in protecting the interests of him or herself, his or her fellow employees, the company, and the company's shareholders at large. The successful implementation of this portion of the law could avert any number of Enron-like scandals in the future, but only if done properly.

I look forward to working closely on this and other issues important to investors and our securities markets. And, I look forward to learning about what actions you will take to strengthen Section 301's reporting mechanism.

Sincerely,

Debbie Stabenow
U.S. Senator

cc: Commissioner Cynthia A.Glassman
Commissioner Harvey J. Goldschmid
Commissioner Paul S. Atkins
Commissioner Roel C. Campos

THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

September 3, 2003

The Honorable Debbie A. Stabenow
United States Senate
702 Hart Senate Office Building
Washington, DC 20510

Dear Senator Stabenow:

Thank you for your August 5th letter concerning implementation of the whistleblower reporting provision of Section 301 of the Sarbanes-Oxley Act of 2002. At the outset, I appreciate very much your leadership and support for this initiative. I share your view that this is a critically important provision of the Act. At the open meeting this past April to adopt final rules on this topic, I remarked that the audit committee listing standards called for by Section 301 represent perhaps the most important set of rules the Commission has faced, and faced up to.

We solicited and received extensive public comment on our proposals regarding the whistleblower reporting procedures, including the comments referenced in your letter. For your reference, a summary of these comments is available on our website. As discussed in the adopting release for the final rules, comments were mixed on the amount of specificity we should require as part of the final rules, with some advocating great specificity and others advocating a principles-based approach to the rules. We carefully considered every comment received on this matter and concluded that we should follow a principles-based approach. As a result, the final rule mirrors the requirements called for in the Act.

With respect to your concerns regarding the rule's implementation, I appreciate and understand your concerns. We have been closely monitoring the rule's implementation, both through the efforts by the stock markets to incorporate the requirements into their listing standards and by observing how companies are preparing to comply. We also were aware of the Wall Street Journal article referenced in your letter. I believe that, at the present time, it is appropriate to continue to monitor implementation of the rule to gain experience with its application before we consider any changes to it. However, please be assured that, through its interactions with public companies and the stock markets, the Commission and its staff will continue to pay heed to the rule's implementation and will not hesitate to consider issuing amendments or interpretations as necessary or appropriate.

With this assurance, I would like to address briefly the specific concerns raised in your letter.

Implementation period

While you raise this concern last in your letter, I will address it first. As you know, the requirements in Section 301 represent a somewhat novel approach to federal securities regulation. Most of the requirements of the federal securities laws focus on disclosure, not on substantive corporate governance regulation. Section 301 does not mandate disclosure, but instead imposes direct changes on internal corporate structure as a condition to public market access. To effectuate these changes, Section 301 requires the Commission to direct the nation's stock markets to prohibit the listing of any security of an issuer that does not comply with Section 301's requirements. This approach is consistent with the historical approach of including such substantive corporate governance requirements in market listing standards.

As a result, in order for Section 301's requirements to take effect, each of the nation's stock markets must engage in public rulemaking to incorporate the final requirements into their own listing rules. The Commission established ambitious deadlines in the final rules for the nation's markets to effectuate this process. The nine affected markets were required to submit proposed listing rules by July 15, 2003, and all nine met that deadline. Final listing rules must be approved by the Commission, after a regulatory period for public comment, by December 1, 2003.

Also, many commenters believed significant time was needed for audit committees to implement the changes that would be required by these new listing rules. These commenters explained that designing and implementing an effective whistleblower reporting process involves many steps, such as drafting procedures that are tailored to the company's particular circumstances; hiring a third-party provider, if necessary; establishing the procedures once approved; and disseminating the procedures to employees and making them widely available.

For these reasons, the Commission decided against an earlier compliance date for the whistleblower reporting procedures. Further, implementation of the whistleblower reporting procedures before implementation of other features of the rule, such as the independence requirements, could frustrate the purposes of the rule as not all members of the audit committee would be independent by the time the whistleblower procedures were instituted. This could have the effect of dissuading employees at the outset from using the procedures.

One final note is that the implementation period for the vast majority of listed companies is the earlier of their first annual shareholders meeting after January 15, 2004, or October 31, 2004. This time frame was selected to coincide with a company's next annual shareholders meeting to facilitate any elections for new audit committee members that may be necessary to meet the rule's independence requirements. As most listed companies have their annual meetings in the Spring, implementation of the reporting procedures will occur much earlier than next Fall for most listed companies.

Making information about the procedures widely available to employees

Although the final rule does not set forth any specific requirement for dissemination or public disclosure of a company's procedures, we believe that implicit in the rule is a requirement that companies broadly disseminate the procedures. Our proposals specifically requested comment on this point and whether specific dissemination procedures should be required. After carefully considering the comments, which were split on this point, the Commission elected to follow a principles-based approach to this aspect of the rule in lieu of a national "one-size-fits-all" approach. As you noted in your letter, variations in publicly traded companies exist and it could be counterproductive to proceed with an overly proscriptive approach.

As you may know, the Commission recently issued proposals requiring disclosure of methods for security holders to send communications to the board. These proposals are based on a more "rules-based" approach requiring specific disclosure of the particular procedures selected by a company. These proposals are currently out for public comment. We will study carefully the comments we receive on this approach, and we will stand ready to propose a similar clarification for the audit committee whistleblower procedures, if appropriate.

Examination of complaints

You mention that audit committees should be able to engage outside independent assistance to assess the validity and consequences of alleged accounting and wrongdoing. I wholeheartedly agree, and the unfettered ability to do so was expressly provided for in Section 301 of the Act and our final rules, despite several comments that urged us to limit this ability.

The Commission specifically mentioned in the adopting release that outside advisors may be needed to independently investigate financial reporting questions. Our final rules went further and strengthened the Act's requirements by requiring companies to not only provide for appropriate funding, as determined by the audit committee, for the compensation of these advisors (as called for by the Act), but also for appropriate funding for ordinary administrative expenses of the audit committee itself. An audit committee's effectiveness, including its administration of the whistleblower reporting procedures, could be compromised if it was dependent on management's discretion to pay for the committee's expenses, especially when potential conflicts of interest with management may be apparent.

I also agree with your proposition that management should not pre-screen, edit or censor what is sent to the audit committee. We do recognize that it could be possible for an audit committee, which has sole discretion in this matter, to determine to utilize administrative personnel of the company, such as existing ethics personnel, to assist in the procedures process, but again only under such circumstances and instances as the audit committee determines and in

keeping with the principles-based mandates of confidentiality and anonymity for employees. Audit committee members as board directors are not full time employees of the company, and the whistleblower reporting procedures must be both effective and consistent with the role of audit committee members. However, the audit committee's procedures should not result in a delegation of the audit committee's authority to management, nor should the audit committee be disassociated from the actual review, evaluation or review of complaints.

As with our approach to the requirement overall, we believe this principles-based approach to allow the audit committee to develop procedures that work best consistent with its company's individual circumstances will result in the most effective implementation of the rule. However, as with your other concerns, we will remain vigilant to the rule's implementation and will quickly act to provide any additional clarifications as will be necessary to fulfill the Congressional mandate.

Ensure a truly anonymous and confidential exchange

The Commission's final rules did not alter the Congressional mandate that the procedures for employees must provide for the confidential and anonymous submission of complaints. The final rules do not contain any exception that would allow an audit committee or any person investigating an employee submission to breach those obligations. From the public comment we received on our proposals, we understand that there are multiple approaches to achieve these goals. For example, certain technological approaches designed to ensure anonymity may be appropriate for some companies, but may be inappropriate for others as they may be inaccessible to employees who are in the field or who otherwise do not have access to or who are not comfortable using computers or other technological devices. As with the other aspects of the rule, the Commission determined that the decision as to the specific procedures that should be selected for each of the more than 7,000 affected listed companies to effectuate the rule's requirements should rest with the independent audit committee of that listed issuer.

Companies should share their implementation plans with shareholders

Similar to your concern regarding dissemination of the procedures to employees, the final rule does not set forth any specific requirement for public disclosure of a company's procedures, although we believe that implicit in the rule is a requirement that companies broadly disseminate the procedures. Commenters were split on whether specific public disclosure should be required. As noted above, this is an area that we will continue to monitor. The Commission's recent proposals requiring disclosure of methods for security holders to send communications to the board take a more "rules-based" approach of requiring specific disclosure of the particular procedures implemented by a company. We will study the comments we receive on those proposals to consider whether a similar clarification is appropriate for the audit committee whistleblower policies.

Keep the definition of employee as broad as possible

The Commission's final rules do not in any way restrict the use of the term "employee" used in the Act, despite the urging of several commenters on our original proposals to limit the scope of this term. You also raise the example of investment companies. The adopting release for the final rules includes a specific discussion of the application of the whistleblower procedures to investment companies. In the release, the Commission encouraged the stock markets to consider the appropriate scope of the requirement with regard to investment companies. We have been working with the stock markets on this point in conjunction with the required changes to their listing rules.

Retention of complaints

The Commission's proposals requested specific comment on whether the final rules should proscribe how long complaints should be retained. As with the other aspects of the rule, after carefully studying the views of the various commenters on this point, the Commission elected to not establish a national "one-size-fits-all" retention period. The Commission requires very few explicit record retention periods in its rules. Section 802 of the Act did require the Commission to promulgate specific rules related to the retention of records relevant to audits and reviews of financial statements, which could be used as a frame of reference for audit committees for the whistleblower procedures. The Section 802 rules provide for a seven year retention period.

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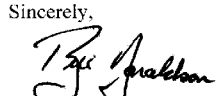
I hope you find this information useful. This is a critical time for our nation's investors and the capital markets, and it is immensely helpful to understand your concerns. Thank you again for your leadership in this area and for writing and sharing your views.

Sincerely,



William H. Donaldson
Chairman

Ameet Sachdev
Chicago Tribune

New Rules No Bar to Mergers in Accounting

Consolidation for a Sector in Flux

AUGUST 11, 2003

Accountant Dan Fensin feels like he has a target on his back in more ways than one.

For the past year, the managing partner of Chicago firm Blackman Kallick Bartelstein LLP has had to deal with public outrage over the profession's role in the massive financial scandals that pummeled investors.

But the litany of new regulations and increased scrutiny hasn't stopped some accounting firms from growing through acquisitions, putting a bull's-eye on Blackman Kallick, one of the city's largest locally owned firms.

But so far the numbers do not add up for Fensin and his 28 partners.

"We are not interested in joining any of these groups," he said. "We are happy with our position in the marketplace."

Still, the growing interest in consolidation reminds him of the mid-1990's, when financial-services powerhouses like American Express Co. targeted markets like Chicago for acquisition blitzes of midsize firms. The consolidators were interested in finding new small-business customers for their financial products and services, from retirement planning to investment advice.

This time around, regional accounting firms have expanded to neighboring cities or beefed up existing services—like tax consulting or internal audits—to attract new clients. The Big Four could be vulnerable amid the industry upheaval.

Since January, there have been about 10 deals, led by New Jersey-based J.H. Cohn's acquisition of the Videre Group to create a Northeast firm with about $100 million in revenue, the largest merger since March 2001, according to Public Accounting Report.

In the Midwest, there have been some smaller transactions, such as Indiana-based Crowe Chizek and Co.'s purchase of Kruse & Associates of Nashville.

It is not exactly the merger mania of a few years ago when four major consolidators acquired more than 100 firms, but the tide is building, industry experts said. Now, there are approximately 65 midsize firms, which average 20 to 25 partners, that 10 to 15 larger regional firms could be eyeing for acquisition.

"As bad as the publicity has been for the accounting industry, merger prospects are bullish," said Alan Koltin, chief executive of PDI Global Inc., a consultant to accounting firms. "That is the No. 1 topic right now."

The deals are happening against the backdrop of the most dramatic changes in the accounting industry in decades. Last summer's Sarbanes-Oxley Act created an entirely new system for regulating accountants in an attempt to transform them into better watchdogs who could prevent the kinds of massive financial fraud that occurred at Enron Corp. and WorldCom Inc.

The four largest firms, which audit about 78 percent of all U.S. public companies, have responded by increasing auditor training, enhancing fraud-detection techniques and setting tougher standards for accepting and retaining clients.

During the past year, for instance, Ernst & Young LLP has parted ways with about 200 public and private clients. Some left after fee disputes—fees have risen as much as 20 percent in some cases. In other cases, the major firms have stopped working with some clients voluntarily because of the law. Sarbanes barred auditors from performing technology consulting work and from doing internal audits for clients.

Whatever the reason, regional firms say the climate has never been friendlier for competition in audit and consulting services.

"Traditionally, clients have been afraid to go to someone other than the Big Four," said Jim Smart, managing partner of Smart and Associates, a Philadelphia firm that last fall entered Chicago by purchasing small CPA firm Glenn Ingram & Co. "Now, I think the marketplace is looking for new players."

He added with a bit of glee: "Sarbanes is a wonderful thing from our perspective."

But Smart is not looking to add any public companies as audit clients. In fact, his firm does not audit any public companies.

Indeed, smaller firms like Smart's face significant barriers to break into the audit market for multinational public companies, according to a U.S. General Accounting Office study on competition in the public accounting industry released last week.

Among the barriers the study found: a lack of staff and technical expertise, and increased litigation risk and insurance costs.

Despite the industry forces working against them, Smart and other regional firms are gunning for consulting work from clients who have conflicts with their auditor and work from larger private companies. To do that, they figure they need to bulk up and are finding some willing suitors, especially smaller firms where the partners are nearing retirement age and may be looking to cash out.

Crowe Chizek, one of the nation's top 10 public accounting firms, acquired Kruse last month in an attempt to build a national practice advising building contractors and other construction-related companies, said Chief Executive Mark Hildebrand. The expansion in Nashville also allows the firm to market its expertise in auditing and consulting with midsize manufacturing companies.

Midwestern regional firms, such as Virchow Krause & Co. of Madison, Wis., and BKD LLP of Springfield, Mo., have made no secret of their desires to blow into the Windy City. So far, they have found slim pickings.

Many of the local midsize accounting firms were swept away during the consolidation wave of the 1990's. For instance, Friedman, Eisenstein Raemer & Schwartz, which had $40 million in yearly revenue, sold out to H&R Block Inc. in 1998.

The remaining independent firms, including Blackman Kallick, have shunned their more recent advances. But Blackman Kallick's managing partner left the door open, albeit slightly.

"There is always somebody calling up," Fensin said, "and the fact of the matter is, I will eat lunch with anybody."

MEMORANDUM

October 29, 2003

TO: William H. Donaldson, Chairman

FROM: Division of Enforcement

RE: Request from Chairman Shelby for Enforcement Program Statistics

During your testimony before the Senate Committee on Banking, Housing, and Urban Affairs on September 9, 2003, Chairman Shelby requested statistical information concerning the pace of the Commission's enforcement activities since the passage of the Sarbanes-Oxley Act. This memorandum provides data responsive to Chairman Shelby's request. Specifically, it provides statistics in several key categories for the Commission's fiscal year 2003 (which ended on September 30) in comparison to prior years.

Total SEC Enforcement Actions Filed

- In FY 2003: 679
- In FY 2002: 598
- In FY 2001: 484

Financial Fraud and Issuer Reporting Actions Filed

- In FY 2003: 199
- In FY 2002: 163
- In FY 2001: 112

Broker-Dealer Actions Filed

- In FY 2003: 137
- In FY 2002: 82
- In FY 2001: 65

Insider Trading Actions Filed

- In FY 2003: 50
- In FY 2002: 59
- In FY 2001: 57

Investment Adviser Actions Filed

- In FY 2003: 63
- In FY 2002: 48
- In FY 2001: 37

Enforcement Actions Against Public Company CEOs

- In FY 2003: 60
- In FY 2002: 56

Officer and Director Bars Sought

- In FY 2003: 170
- In FY 2002: 126
- In FY 2001: 51

Temporary Restraining Orders Filed

- In FY 2003: 35
- In FY 2002: 48
- In FY 2001: 31

Asset Freezes Sought

- In FY 2003: 39
- In FY 2002: 63
- In FY 2001: 43

IMPLEMENTATION OF THE SARBANES-OXLEY ACT AND RESTORING INVESTOR CONFIDENCE

TUESDAY, SEPTEMBER 23, 2003

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met, at 10:02 a.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

I would first like to welcome today's first witness. We will have a second panel that we will introduce later. Our first witness is Chairman William McDonough of the Public Company Accounting Oversight Board. That is a mouthful, as we know.

Accurate financial reporting and disclosure are the foundations of our capital market system. And in order for our markets to operate fairly and efficiently, investors must have faith that a company's audited financial information is reliable, accurate, and timely. Without this trust, investors will abandon the markets for fear that they will be the unknowing victims of a financial scheme.

Following the collapse of Arthur Andersen and the announcement of billion-dollar restatements, investors quickly lost faith and confidence in the accounting profession. Many investors regarded the auditors as co-conspirators in corporate schemes and believed that auditors simply rubber-stamped the financial statements that management prepared. Revelations about companies' purchasing millions of dollars of nonaudit services from their auditors furthered the perception that the accounting industry was rife with conflicts of interest, and that auditors were profiting at the investors' expense. Although the corporate scandals of the recent past tarnished the image of the accounting profession, the industry is now presented with an opportunity to rehabilitate its reputation, reassuring investors that auditors are carefully reviewing corporate books without conflicts.

A primary focus of the Sarbanes-Oxley Act is to restore confidence in the accounting profession by improving the integrity of the audit process and financial reporting through vigorous oversight of audit firms and new rules defining auditor independence. The Act creates the Public Company Accounting Oversight Board to supervise the accounting firms that audit the books of public

companies. Audit firms are now accountable to a regulator rather than operating within a self-regulatory structure. The Oversight Board is tasked with registering accounting firms, developing inspection and disciplinary programs, and drafting new auditing and attestation standards.

Under Chairman McDonough's leadership, the Oversight Board has successfully begun the process of registering domestic and international accounting firms and started inspections of the Big Four accounting firms themselves. Although the Oversight Board is in its infancy, investors should feel confident that it will continue to grow and implement reforms that will restore integrity to the audit process.

While creating a new regulator for the accounting industry, Sarbanes-Oxley also mandates new rules establishing greater independence between auditors and their clients. Prior to the Act, many accounting firms treated audit services as a loss leader for securing more lucrative consulting contracts, and many audit partners were compensated for procuring engagements for consulting services. Concern existed that auditors are all too often willing to overlook questionable accounting practices in order to retain profitable consulting business for the firm. The Act addresses these conflicts by, among other rules, prohibiting a company's auditors from performing certain nonaudit services, requiring a company's audit committee to preapprove all audit and nonaudit services that the company receives, and mandating audit partner rotation. These rules were necessary to address conflicts of interest that caused investors to doubt the credibility of auditors and the accuracy of financial reports.

Sarbanes-Oxley has laid the foundation for the accounting industry to earn back the trust of investors. By cooperating with the Oversight Board and complying with the auditor independence standards, audit firms can prove to investors that they are committed to reinvigorating the audit process and restoring faith in financial reports. Accounting firms must also demonstrate that they will force public companies to comply with proper accounting rules, even after the focus on reform has diminished. By ensuring that public companies maintain adequate internal controls and sound audit committee practices, audit firms can further serve the investors who rely on them to serve as financial gatekeepers.

As the Oversight Board continues to develop, it must stand strong in the face of industry criticisms and remind both the accounting firms and the investors that there is a new watchdog for the industry. Chairman McDonough and his team have a difficult task ahead of them, one that is crucial to restoring investor confidence in our markets. Mr. Chairman, we look forward to your testimony here this morning.

Senator Enzi.

STATEMENT OF SENATOR MICHAEL B. ENZI

Senator ENZI. Thank you, Mr. Chairman, and thank you, Chairman McDonough, for being with us today to discuss the Public Company Accounting Oversight Board, PCAOB. And I think you have come up with a word for that, some way to say that in one——

Mr. MCDONOUGH. "Pea-cobb," but it does not seem to be selling well, Senator.

Senator ENZI. Oh, okay. I am sorry to hear that. At any rate, I am anxious to hear about the implementation, and I appreciate all of the people that are testifying today for getting their testimony in so that we would have an opportunity to read that in advance, and probably much fuller than you will be allocated time to be able to present that information.

I know that you and your staff have accomplished a great deal in a short period of time. Last week, Chairman Donaldson of the SEC testified that the primary rulewriting phase of the SEC is virtually complete and that now the primary focus of the rulewriting and implementation of the law will be on PCAOB. I will try and help promote that name.

While the Sarbanes-Oxley Act established a new regulatory oversight body for the auditing industry with registration and enforcement authority, I believe the single most important mission for the Public Company Accounting Oversight Board is establishing the auditing standards for the industry. The future of our securities markets are dependent on how these standards are developed, how they are implemented, and how the auditing firms put them to use. And we are having a little deviation from how it used to be done, and I am certainly hoping that AICPA will be a voice in helping with that.

It is my understanding that PCAOB intends to work in an open process with a broad cross-section of the accounting, financial, and investing communities to develop these standards, and I applaud you for that.

Another area of concern for me is the ability for small auditors to stay in the business of conducting audits for small, publicly traded companies. One key question on the passage of the Sarbanes-Oxley Act was whether the small-auditing community would be able to weather the increased regulatory climate and the increased administrative requirements. Now, the recent GAO study on consolidation in the accounting industry was inconclusive on this; however, it may be that the study was too premature to capture the full effect of the law on the industry.

The survival of small auditors is important not only for the community but also for the small companies that strive to reach those public markets, and we have had quite a decline in IPO's being filed. Mr. Chairman, I know that you have been a strong supporter of the small auditor, and we have had conversations about it, and I look forward to hearing how the PCAOB is working with the small accounting industry.

I would personally like to thank you for taking such quick and firm control of the reins as Chairman of PCAOB and for working with Congress to ensure the implementation of the provisions of the Sarbanes-Oxley Act, and that is done with investor respect and confidence in mind. I congratulate you for your efforts.

Thank you, Chairman Shelby.

Chairman SHELBY. Senator Dodd.

STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Well, thank you, Mr. Chairman, and let me begin by commending you once again for—this is our second hearing now on looking back at Sarbanes-Oxley, and this is very worthwhile. I spoke to a group in Boston yesterday and spent a good bit of time just talking about this in the Q and A period. This was with some of the leaders in the financial services sector in Boston, and I was interested in how they thought things were working. And I had a tremendous response. They were very upbeat and very positive on how this was working so far. Obviously, they are monitoring it carefully and watching it closely from their perspective. But I think having oversight hearings like these really helps us take a look back, since we did enact this legislation rather rapidly, much more rapidly than one would have anticipated given the sweep of this legislation. And so having this oversight is tremendously worthwhile.

We have done this in the past, but it deserves being repeated. Certainly our colleague from Maryland, Senator Sarbanes, Mike Enzi as well—who deserves a great deal of credit for being a principal author of Sarbanes-Oxley. His name does not appear when the name gets said, but history should record that he and Jon Corzine played a tremendous role in this. And it would not have happened without their leadership, and so I thank them for their work.

And I am delighted Bill McDonough is here. He has been an old friend for many, many years, someone whom I have a high regard for, enjoyed working with him on numerous occasions on a variety of issues, not only from obviously financial services issues, given his background, but also on Latin America, in which we share a strong common interest.

He speaks wonderful Spanish, Mr. Chairman, by the way.

We are very lucky and fortunate that you agreed to take on this responsibility, and we thank the Chairman of the SEC for imploring you to do this and for your willingness to take it on and for your family's willingness to take it on. So we thank you very, very much for taking it on.

I keep on asking, how do we pronounce this thing? And I have just listened to Mike Enzi, and since he is a principal author of the bill, I am going to ask—PCAOB, is that what it is? It sounds like some rare fruit that you have here. But thank you for taking on that responsibility.

Obviously, our Nation's first securities laws enacted in the 1930's established the foundation, Mr. Chairman, by which our Nation's free markets function, and that foundation that is built on rules, rules that give investors worldwide the confidence that investing in America is safe and secure. In my almost 24 years now on this Committee, and in almost that length of time being either the Chairman or the Ranking Member of the Securities Subcommittee, that has been the byword, "investor confidence." And that is why the world comes here. There is always a better deal someplace else in the world. If you are looking for a fast buck, there are plenty of other places around the world that will offer you a potentially greater return on your investment. But the reason the world comes here is because we are fair. The rules are fair. It does not guar-

antee you a great win, but you know that when you invest your money, it is fair. There are rules and we operate by them. And when that gets shattered for any reason at all, then it is a great loss to our Nation and a great loss obviously to our economy.

And so it is critically important that we do everything possible to restore investor confidence, and we are very hopeful that this legislation, particularly the creation of the Public Company Accounting Oversight Board, will lend itself to that result. We need rules that uphold the basic principles of any market competition, credibility, responsibility, and honesty, and rules that have helped make our economy the strongest and the most vibrant one the world has ever seen. Sarbanes-Oxley is one of those defining rules, and I believe it will have a lasting positive impact on our financial reporting system.

The creation of PCAOB as prescribed in the bill with a new regulator for the accounting profession has already restored, I think, some of that integrity lost in the recent accounting scandals. And it is my fervent hope that we are on the path to restoring greater investor confidence in both the accounting profession and our system of financial regulations. By nearly all accounts, the establishment of PCAOB has gone exceptionally well. I am anxious to hear what our witnesses have to say about that this morning and getting a status report.

So, Mr. Chairman, I am delighted to have been a part of this effort as well over the last number of months, and again, thank you for holding these hearings, and I look forward to hearing from our witnesses.

Thank you.

Chairman SHELBY. Thank you.

Senator Reed.

COMMENTS OF SENATOR JACK REED

Senator REED. Thank you very much, Mr. Chairman. Welcome, Mr. McDonough. And Senator Dodd said it very, very well. I will not repeat it. But I, too, want to thank you, Mr. Chairman, for holding these hearings. I think it is important after we pass landmark legislation like this that we continue to revisit it and to make sure that we have taken the right steps and we make improvements where necessary.

Again, I would also like to commend Senator Sarbanes for his efforts and Senator Enzi, my colleague, classmate, whatever, who was instrumental in doing this and brought great wisdom from his own experience as an accountant to the process.

Thank you very much, Mr. Chairman.

Chairman SHELBY. Thank you.

Mr. McDonough, your written testimony will be made part of the record in its entirety. You proceed as you wish. Welcome to the Committee.

STATEMENT OF WILLIAM J. McDONOUGH
CHAIRMAN, PUBLIC COMPANY
ACCOUNTING OVERSIGHT BOARD

Mr. MCDONOUGH. Thank you, Chairman Shelby. Gentlemen, I am pleased to appear before you today on behalf of PCAOB. I think

we could say New Englanders would say it "pea-COBB" and Midwesterners would say it "PEA-cobb." But, at any rate, it is a great improvement over anything else that has been heard.

Senator DODD. Irving Berlin.

Senator REED. No. Cole Porter.

Senator DODD. Cole Porter. Thank you.

Mr. MCDONOUGH. This is the first appearance of a PCAOB member before the Committee. On behalf of the Board, I would like to begin by commending the extraordinary leadership of this Committee in response to the crisis to public confidence brought on by some devastating failures in financial reporting and in auditing. The legislation—now law—that you worked so hard on is a landmark reform of corporate governance, financial reporting, and auditing, and you should be proud.

I am both proud and humbled to appear before you today as Chairman of one of the products of your hard work. Among the many reasons I was willing to take on this job were my own strong convictions about the need for an aggressive response to the corporate scandals and the lack of leadership in the private sector. It is an honor to have the opportunity to act on those convictions by helping to build an organization, in the form envisioned by you, to restore the linchpin of the American financial system—trust in the integrity of financial reporting.

When I joined the PCAOB on June 11, I found four outstanding colleagues, all as dedicated as I am to the Board's mission. Those colleagues—Acting Chairman Charlie Niemeier, Bill Gradison, Kayla Gillan, and Dan Goelzer—had already made tremendous strides in writing the unprecedented new rules that are required by the Sarbanes-Oxley Act. We have a rapport and a collective will to maintain that momentum and fulfill the mandate you gave the PCAOB to protect the interests of investors and the public in the preparation of informative, fair, and independent audit reports for public companies. The Board started from scratch in January. We are now up to 84 full-time professional staff.

As provided in the Act, the Board received an advance from the U.S. Treasury to fund its start-up expenses. Yesterday, we repaid the advance in full, $20,300,000. Fees assessed on public companies will fund our operations going forward as we perform the four primary functions that the Act set out for us: Registration, inspection, enforcement, and standard setting. Let me start with registration.

Under the Act, any accounting firm that audits a company whose securities trade in U.S. markets and any firm that plays a substantial role in those audits must be registered with the Board in order to continue that work. Under the law, they must be registered with us by October 22. We have received almost 500 registration applications from U.S. accounting firms. The Board approved the first 38 of those applications last week, and we will continue our review of the remaining applications.

The Board also voted to require non-U.S. accounting firms to register if they audit companies whose securities trade in U.S. markets. And we recognize the special issues that arise with that requirement, so the deadline for non-U.S. firms to register is well into next year. In addition, we have begun a dialogue, a fruitful one, with our counterparts in other jurisdictions in order to find

ways to coordinate in areas where there is a common programmatic interest. Registration is not only a prerequisite for accounting firms to continue their work as auditors of public companies, but it is also the foundation for us to perform the important functions of inspection and enforcement.

With the cooperation of the four largest firms, we have already begun limited inspection procedures at those firms in advance of registration. Going forward, our inspection staff, made up of experienced, skilled audit professionals, will annually inspect each accounting firm that audits more than 100 public company clients. Smaller firms will be inspected every 3 years.

The fundamental goal of our inspection program is to assess and thoroughly test whether they are improving the quality of the firm's audit work. We will review selected audits, but we will also look closely at firm-wide policies and practices that bear on integrity and judgment.

We will look at what we call the tone at the top. We want to know the nature of the communications coming from the highest levels of a firm. We want to know that the leaders of the firm and of audit teams get the message that Sarbanes-Oxley sends about the firm's responsibilities. We want to know that the message is reaching the firm's rank-and-file. We want to know what kinds of work the firm rewards through its compensation system. And we want to know how a firm decides to fire a client.

Registered accounting firms are subject to PCAOB inspections, and they are also subject to our enforcement authority. We are empowered to investigate possible violations of our rules, securities laws, and professional standards. If we conclude that a firm has violated the rules, we have the authority and the responsibility to impose sanctions, even to the point of revoking a firm's registration or barring an individual from participating in audit work.

The Board has proposed rules for investigation and disciplinary hearings that are intended to implement our authority in a fair way, preserving all appropriate rights for the persons subject to our jurisdiction. We expect to adopt final rules next week.

And, finally, I want to outline our progress with respect to audit standards. The Act charged the Board with establishing auditing and related attestation standards, quality control standards, ethical standards, and independence standards. The Act gave the Board the option of setting standards on its own or designating any professional group. Before I joined the Board, the decision was made that the Board would do it itself, and I firmly support that decision.

To assist the Board in developing standards, we have begun recruiting a talented in-house staff of professional auditors. Because of our access to information from our inspections and investigations programs, the Board and our standard-setting staff will be in a unique position to understand and head problems in practice. We will also tap the expertise of standing advisory group and ad hoc task forces made up of experts from a variety of fields.

The first standards to come from the Board will be those prescribed by the Act relating to auditors' attestation to management's assessment of internal controls. We held an excellent public roundtable discussion on internal controls in late July, and we intend to

have final rules in place by early 2004, in time to meet the SEC's June 15 deadline for management to begin filing internal report forms. We will hold another roundtable next week to discuss audit documentation as we prepare to set standards in that area.

With your vision in establishing authority for independence standard setting, registration, inspection, and discipline, you have given PCAOB the responsibility and the tools to build a new future for auditing. I have faith that our staff and my fellow Board members will live up to your expectations.

I have not been shy about telling members of the accounting profession that we expect a lot from them and that they will have to work harder than they could have imagined before Sarbanes-Oxley. Through a succession of scandals, the entire profession came to be judged harshly. But you and your colleagues, through the Act, did not merely judge them; rather, you gave them a meaningful shot at redemption.

In my mind, facilitating that redemption, and not just punishing miscreants, is a key objective, one that the Board must not lose sight of even when we are, as we will need to be, tough on the profession.

As we look forward to that objective, my fellow Board members and I look forward to a long and constructive relationship with the Committee, and I do like the idea, Mr. Chairman, of coming up to see you periodically to tell you what we have been doing.

Chairman SHELBY. I think that is a good idea.

Mr. MCDONOUGH. Thank you.

Chairman SHELBY. Thank you.

Mr. Chairman, can you please describe briefly the process to the Committee for addressing some of the concerns raised by European governments and companies concerning the application of the Oversight Board's registration and oversight rules?

Mr. MCDONOUGH. Thank you, Senator. It is very clear that the sense of Congress, even though the Act itself said that we could have exempted the audit firms outside the United States, that it was the intent of Congress—and two Members, Senator Corzine and Senator Dodd, wrote a letter to the SEC making it very clear the intent of Congress—that foreign firms should be registered. I think they should be.

The question is: What are we trying to achieve under Sarbanes-Oxley, and can we achieve that so that it, in fact, spreads the Sarbanes-Oxley philosophy worldwide?

We are trying to protect investors in securities sold in our markets. Many of the people whom we are protecting are not Americans. They are foreigners. At the same time, there are a lot of Americans who invest in securities issued by and sold in foreign markets. So what we have been trying to do is to reach out to other entities—the European Community beginning with, the Canadians, the Japanese, beginning the conversations with the Swiss—and saying it is required under the Act that registration take place. But the Act does not say that the registration has to be exclusively with us. We could have a joint registration, for example, in which a firm could register with its local authority and us. With all that Sarbanes-Oxley requires, we get everything we want, but the home country also has the dignity of the process including them.

As I pointed out, registration is just the beginning. It is how you get started. It has taken on a bit too much of a life of its own in the discussions abroad and some of the reactions.

Once we actually get the registration past us, then I think we would look at what if a foreign PCAOB wanted to have an inspection of one of its auditing firm's activity in the United States. Well, I would volunteer to say we will do it for you, just tell us what you want done.

We think that in jurisdictions where there is really up-to-snuff inspection capability, rather than send 15 Americans who speak wonderful English over to a country where that might not be the local language, if we could have a combined inspection where a lot of the work would be done by the local people, as long as I could assure you we are enforcing the Sarbanes-Oxley Act just as much through that process as we are in the United States, I would suggest we would have reached a point where 2 plus 2 equals lots more than 4. That is what we are working on.

Chairman SHELBY. But, after all, it is the substance you are after, not just the form.

Mr. MCDONOUGH. Precisely.

Chairman SHELBY. Mr. Chairman, beyond rulemaking, regarding oversight of accounting firms' attestation standards, what issues do you think that the Oversight Board will address in the next year?

Mr. MCDONOUGH. Mainly what we are hoping to achieve, to be most generic, is to restore the faith of the American people in the accounting profession. And everything I am hearing from sensible people in the accounting profession is they want that at least as much as I do.

Now, their interest is in improving the quality of their own profession and its reputation, and improving their own firms. I represent the public interest. PCAOB represents you, represents the American people. If they are doing a very good job, we can work hand in glove with them. If they are not doing a very good job, we will push and prod, and do what is necessary. That is, I think, the biggest challenge.

Chairman SHELBY. But it is in their best interest to do that, and I think most of them know that.

Mr. MCDONOUGH. I think so.

Chairman SHELBY. Mr. Chairman, we are down to four big audit firms with the demise of Andersen. There has been some concern regarding market concentration because of this. Are you concerned about this consolidation? And do you see a role for the Oversight Board in facilitating competition?

Mr. MCDONOUGH. Mr. Chairman, there was a very good, highly realistic report by the GAO that I think leads one to the conclusion that there are four big accounting firms and there will continue to be four big accounting firms. It is very difficult to see exactly how you get number five, six, or seven—in fact, number five is represented on your second panel—up to that size. I would love to have it happen if it took place because I would like to have more than four. But I think we must be realistic.

Something I think the PCAOB can do, however, is to nurture and cherish the firms, the small and medium-sized audit firms, because they audit the small and medium-sized companies. My whole the-

ory of economic development is small and medium-sized companies is what makes America great. The creative construction of a market economy comes from small and medium-sized companies. We want them to have good auditors who are helpful and cost-conscious so we are not pricing these small and medium-sized companies out of business. We are enforcing Sarbanes-Oxley but with a very high degree of common sense governing how we apply it.

Chairman SHELBY. Thank you.

Senator Reed.

Senator REED. Thank you very much, Mr. Chairman. Thank you, again, Mr. McDonough.

When the legislation was being considered, many small accounting firms in my community, perhaps with one or two public clients, expressed some concern about the requirements. Could you comment on the receptivity of the industry, not the Big Four but the smaller firms around the country, to the changes?

Mr. MCDONOUGH. It is really a little bit early to tell. A lot of the foreign small and medium-sized firms have registered. Some of them have groaned very loudly because the registration form is pretty much set out in the statute, and although we tried to make it kinder and gentler, there was very little we could do about it. So it is a pretty elaborate form for a small or medium-sized auditing firm to fill out, but they filled it out.

We have a very busy time between now and October 22 because of all these registrations that the Board has to look at. But as soon as that is behind us, and then by that time we will also have some visitors from other countries to continue the dialogue, but I see October 22 as Freedom Day for Bill McDonough to do what he likes to do, which is to go out around the country and start meeting, probably with the help of, say, in your case, the Rhode Island overseer of public accountants or their version of the certified public accountant group and ask them to organize a meeting, and then sit down and just listen and talk and learn and see how I can be most helpful.

Senator REED. Part of the Sarbanes-Oxley Act calls for a study of a principle-based system of accounting, and I know that the SEC has completed their study on July 25, and they recommended the approach. The FASB has also I think taken an endorsement of that approach. Can you comment, your views, and also will in fact PCAOB take a position with respect to this issue?

Mr. MCDONOUGH. I am not sure, Senator, that PCAOB-cum–PCAOB has to take a position, but I will.

I think that the study that was done by the SEC is really very good indeed because it says that rules-based accounting has gotten to a point where it is really very questionable as to whether it is doing the right job. The most infamous one is the literature on hedges and derivatives which has 800 pages of prose. But the theory is that you are supposed to find anything that you want in the 800 pages, but if you are devious you can also find a way to do anything you want to in the 800 pages. That is not good. The pure principles based, "thou shalt not steal," that is very easy to understand, but as an accounting principle it is a little hard to be that clear.

I think what the SEC is suggesting is that you would have something pretty straightforward like "thou shalt not steal," but then you would have some explanatory language which would say to a reasonable person what does that mean, so that maybe the 800 pages of prose on hedge and derivatives might be replaced by 25, 30, 35 pages, but at least that is an enormous step in the right direction. I think that as a very good piece of work and a very good place to start, the SEC study is really first class.

Senator REED. Thank you, Mr. Chairman.

A final question. The issue of auditor independence. Are you considering additional functions that you would proscribe for auditors and with respect to certain tax services and other issues? That is an ongoing inquiry by PCAOB?

Mr. MCDONOUGH. It is an ongoing area of interest to us. I think however when we are trying to reform the U.S. private sector, which is what Sarbanes-Oxley is all about, we do not want to keep changing the ground rules. The SEC, early this year, came out with what I thought was a very balanced statement repeating their traditional view that accounting firms can in fact do a considerable amount of tax work. A lot of it really just flows right out of the audit, and if you had somebody else that had to come in and do it, without any question, it would increase costs and I am not sure what you benefit.

The very most important thing is the role of the audit committee and the time-honored test of auditor independence. Once you get to the highly creative end of how you can reduce your taxes to very little or zero, I really kind of question whether auditors should be doing that work anyway, but certainly you could not be doing that work for an audit client, because without question you would break independence by auditing your own work. I think short of that there is a lot of tax work that can be done, and although we have not formally considered it, I believe I speak as the consensus of the Board, that it is very likely that we will say that that which the SEC decided is the right decision.

Senator REED. Thank you very much, Mr. Chairman.

Thank you, Chairman Shelby.

Chairman SHELBY. Senator Enzi.

Senator ENZI. Thank you, Mr. Chairman.

I appreciate the effort that you have made with the small auditing firms, and I understand that we have 500 auditors registered as of last week, and then your staff made telephone calls even to remind them of the need to register, and you even have an electronic register system. I am interested if there are any problems you are having with that electronic registering system. I also appreciate the fact that you did town hall type meetings with industry representatives. Again, along this line of the small auditors, are you going to be holding any of those for small auditing firms to cover some of the problems?

Mr. MCDONOUGH. Senator, in response to the last question, as I mentioned in response to Senator Reed, I do really plan, and I am sharing this with my staff right now, that we will be getting out to the territories to see as many people as we can.

I am really very worried about the undesirable and unintended consequences of having Sarbanes-Oxley get too expensive in its ap-

plication. We have to really make sure that that which is done needs to be done and is not done just for the sake of having bells and whistles, which might make all the sense in the world for General Electric but does not make a whole lot of sense for a smaller company. When we get into internal controls that will certainly apply.

I think that auditors have to question not can I justify testing everything in sight, or is there a level of reason at which I have tested enough to form an opinion? The idea of cost effectiveness we have to get out there, and I think that is best done by just going out and talking to people. If you are bouncing back and forth as I do between New York and Washington, one is deprived of all the wisdom in the rest of America, and I am really looking forward to getting out there.

Senator ENZI. Good. Rhode Island is real close. Wyoming is a long way away. We will look forward to hosting you out there.

One of the concerns of the auditing industry is how the SEC and PCAOB will conduct investigations, and they are worried a little bit about whether there will be two separate investigations, one by PCAOB and one by the SEC, when there is a single enforcement incident. Can you explain to me how this joint authority will work?

Mr. MCDONOUGH. I think, Senator, there we are back into the rule of common sense. We have an excellent working relationship with the SEC at all levels. The Chairman of the SEC is the man who convinced me that I should be in front of you today, and I think that just working together. It would be really unfortunate if we were doubling up both the resources from the SEC–PCAOB, and then one might say with some trepidation, wasting the time of the entity being investigated by just having too many people crawling around the premises. So we will make every effort to avoid that.

Senator ENZI. I appreciate that answer and look forward to seeing it in action. A final question here. When PCAOB adopted the rules that established the criteria for the advisory group, they announced that it was putting together an advisory group with a broad cross-section of accounting, financial, and investing communities, and you have explained a little bit about the status of the advisory group. I guess what I am interested in is how the Board and the advisory group would seek professional guidance from the AICPA. That was a major concern when we were drafting the bill.

Mr. MCDONOUGH. Since we have not yet formed the advisory group, Senator, it could very well be that one or more people associated with the AICPA could be on it. I think it is very important for us to work with the AICPA. We have taken over an important part of what used to be their responsibility because we set the audit standards for public companies. Since private companies not infrequently become public companies, one would hope that the audit standards for public companies have a great similarity with the audit standards for private companies. I would hope that without duplicating effort and therefore costing the accounting industry unnecessary expense, that the PCAOB and the AICPA could work together. We have had a number of meetings. It is certainly my intention to avoid having them take over some of the responsibility that you in fact gave PCAOB. If I were they, I would think that

a pretty neat thing to do, but we cannot let it happen. At the same time they have a very noble purpose of lots of other things to do, and I am hopeful that as adults we can figure that out and have—my favorite statement to say again—if you can ever have 2 plus 2 equal more than 4, that is the way to go. That is what we will try.

Senator ENZI. I appreciate all the effort that you are putting into it and have a lot of confidence based on your leadership. Of course, one of our concerns was the potential trickle-down effect into the private companies of having some excessive things, but I am confident that you will watch out for that and I thank you for the answers and this opportunity.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you, Senator.

Senator Corzine.

STATEMENT OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman. I welcome Chairman McDonough. It is great to see you again.

I am going to take a little bit of step toward overall assessment of Sarbanes-Oxley. I was interested to read a *Business Week* review that went through the various groups. I do not know whether you are familiar with it. It gave regulators high marks and CEO's not such good marks, and most of the others in between. Also, it did assign the view that the accounting industry has been quite cooperative in the process of working with the PCAOB and others in moving to accomplish the audit of auditors and fulfilling its responsibility. I want to get on record, your clear view that you are generally seeing the kind of cooperation that anyone would reasonably expect in this whole process of implementation of Sarbanes-Oxley.

Mr. MCDONOUGH. The cooperation, Senator, that we are getting from the accounting profession so far is even better than I had hoped it would be. The Big Four firms voluntarily agreed to be inspected before they were registered. They could easily have told us that, "You have no business in our premises until we are registered." They did not do that. I thought that showed good judgment. But there was no twisting of arms or anything else. We just said: Is that agreeable? And they said yes. That is a big positive.

The other firms throughout the profession with whom we have been in contact are taking a very similar attitude. I think part of the reason for that is I have been as explicit as I can. If *X* number of years from now the American people think that the accounting profession is the great thing that everybody thought accountants were when I was a kid, that will be wonderful, and if the PCAOB has not hanged anybody in public in the meantime, that is great. We really want to achieve something and the more the accountants can figure it out that they are going to do it themselves with PCAOB watching and making sure it is happening, that is best for the American people. So far their record is just fine.

Senator CORZINE. Let me flip that. It gets at the issue of internal controls, which I think is one of the more difficult rubs in Sarbanes-Oxley, at least in the minds of the private sector. I hear a lot of complaints about it, and then I also hear and see surveys that show CEO's are overwhelmingly thinking that this is a box-checking exercise as opposed to an exercise in moving forward and

putting in place the disciplines and the checks and balances that I think was intended by the legislation.

Is there any evidence that there is that same element of cooperation going on broadly in public companies to embrace this as a constructive element that I think we see in the accounting industry? I am sure there are highs and lows among different institutions. Why are we seeing so much resistance to putting in place a framework that was designed actually to put in checks and balances? Internal controls actually are good things for companies, and even though there is nothing going wrong at a given point in time that does not mean 2 years from now or 5 years from now something will not come up that actually would damage a company. We have seen that with the New York Stock Exchange and other things. Why is this resistance continuing to exist in your view?

Mr. MCDONOUGH. Senator, I think it is extremely difficult to understand because it simply makes no sense. Any firm that does not have good strong internal controls should have them, and if the heads of those firms are complaining that it is expensive to have them, I think the answer is, well, you should have had them a long time ago. We do not feel sorry for you that you have to invest in them now. I cannot imagine being a CEO of even an 85-member gang like PCAOB without having some very good internal controls.

One of the things I think that may be happening is that I believe there are a great many CEO's that are being advised by counsel that you have to be very careful in saying that you did not have it quite right before you can say, and I am going to fix it, because they are concerned about litigation. It would seem to me that the sensible thing to do would be to say, it is my intent, because of Sarbanes-Oxley and running my company very well, that I am going to do the following things. I do not think you have to refer to the past and be contrite about it. There might be a little of that included, and it might be very appropriate. But I do think that it is important for the American business leadership to say: The American people passed Sarbanes-Oxley by vast majorities through the Congress of the United States because the American people were angry with the private sector with very good reason, and it is now time for the private sector leadership to get itself together and lead the way to restore the faith of the American people in our economic system, and it is not going fast enough.

Senator CORZINE. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman. I apologize, but the roads are flooded all over the place this morning. It was difficult getting in. I want to take some moments of my question period to in effect give a statement that I would have made when I first came in.

Chairman SHELBY. Go ahead.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. I want to thank Chairman Shelby for these oversight hearings on the implementation of last year's legislation. We have already heard from SEC Chairman Donaldson, and next week we will be hearing from representatives of the corporate community and other interested parties.

Today's subject is the ongoing changes in the way U.S. companies are audited and how those changes affect the confidence of the U.S. investing public. Markets cannot function without accurate and trusted financial information. Markets depend on investor confidence, and of course the whole purpose of last year's legislation was to alter the system in such a way that we could contribute to the restoration of investor confidence.

Mr. Chairman, I believe a strong team is now in place to address these issues: SEC Chairman Donaldson; William McDonough, who is with us this morning, the Chairman of the Public Company Accounting Oversight Board; and Bob Herz at the Financial Accounting Standards Board. They are all making good progress, and are moving I think on a fast timetable.

The Public Company Accounting Oversight Board now has responsibility for registration, inspection and investigations, and disciplinary proceedings involving auditors of public companies. I am looking forward to hearing about its work. The Board has met its statutory deadlines, has already received, as I understand it, online registration applications from just under 500 accounting firms, and has begun its inspection programs.

I am looking forward to the testimony we will hear this morning from the representatives of the accounting industry. Public company auditors are now subject to outside oversight for the first time through the Public Company Accounting Oversight Board. Public company auditors are also facing basic changes in their relationships in many instances with their audit clients. They will be hired by and report to independent board audit committees rather than management, and their nonaudit activities for audit clients will be limited and reviewed.

SEC Chairman Donaldson told the Committee last week that true change is less about complying with rules than about building into companies the mindset to do the right thing. I am prompted to recognize what Senator Corzine was just talking about. Auditors, in a truly effective independent audit system, obviously must have the same mindset.

Finally, I am pleased that we are going to hear from representatives of the large institutional investors through which savings of ordinary Americans are invested. Institutional investors have been in the forefront of calls for change in the framework for auditor oversight, auditor independence, and corporate governance. The perspective of the Nation's institutional investors on the extent of our progress in restoring investor trust is especially important because of the pool of savings for which they have responsibility.

I want to close my statement by repeating a unanimous Supreme Court decision some 30 years ago, an excerpt from it, about the role of auditors in our free market system. The Committee actually made reference to this last year in considering the legislation, and I now quote the Supreme Court again.

In certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility. That auditor owes ultimate allegiance to the corporation's creditors and stockholders as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

That summary provides the best single statement of the mindset we are all seeking to put into place as we deal with the problems that we were confronted with in recent times.

If I have time, I would like to ask Chairman McDonough——

Chairman SHELBY. Go ahead.

Senator SARBANES. You may have already done this, but could you just lay out for us a little bit the issues that you see ahead of you in the next year or two, the work program of the oversight board, how quickly you will be up and in, "full operation," so we have some sense of what lies ahead.

Mr. MCDONOUGH. Senator, we are sufficiently, even with 85 people, we are sufficiently staffed now to be able to go in to the four big firms and to do a limited inspection this year, which is going very well, by the way.

Senator SARBANES. By this year you mean this calendar year?

Mr. MCDONOUGH. Yes Senator, 2003. And by December we will have I think a good feel for whether the four big accounting firms, not just at the top—they are definitely saying the right things at the top—but whether the troops are getting the message. That is I think the single most important thing to look at. Although we will not comment on what we saw at individual firms, we will have something to say publicly on that.

By 2004, we have the requirement to inspect annually in a much deeper inspection any firm that audits more than 100 public companies. There are seven such firms. Other firms we look at every 3 years, but we will have to get started with some of those next year as well. I expect to be able to be up to do that fully.

In the auditing standards area we have adopted the AICPA standards. As I mentioned earlier, we will be putting out the internal control attestation standard, a very important one, early next year, well in time to have it implementable in mid June.

I discussed at some length, before you came in, the ongoing negotiations that we have with some of the European community, the Japanese, the Canadians. Those are going quite well, and my test will be, which you among others have made sure I understand is the test, that we will have to be fully applying Sarbanes-Oxley, have no negative effect on the application domestically, but rather I think what we can have is the spreading of the philosophy of Sarbanes-Oxley internationally. There is quite a lot of receptivity to that. I really think we can make that a win-win.

Senator SARBANES. Where are you on putting the fee structure into place, and the assessments on the public companies, in order to provide the monies for your budget and for the budget of FASB?

Mr. MCDONOUGH. The system is running very well. It brought in enough money that we were able to repay the U.S. Treasury in full yesterday. It was a monumentally complicated——

Senator SARBANES. That is an opportune question for me to ask. [Laughter.]

Mr. MCDONOUGH. Yes. Monumentally complicated information technology challenge, which we managed very successfully, so that the money is coming in for both—it is coming in very well to finance both FASB and the PCAOB this year. In both cases, FASB and the PCAOB has to have budgets approved by the SEC before

the end of the year, and then from that we can figure out what the assessment has to be for next year.

Senator SARBANES. Does the PCAOB set the assessment?

Mr. MCDONOUGH. It is set in relation to the budget of FASB and the PCAOB. By and large everybody pays both except since the FASB budget is smaller, there is a cutoff, so there are a relatively small number of companies that just pay us but not them. There are two bills sent out. FASB has asked us to be their agent in the collection process, but somebody gets two bills and sends in two transfers.

Senator SARBANES. So the system is up and running now?

Mr. MCDONOUGH. Working beautifully.

Senator SARBANES. And you no longer have to draw advances from the SEC?

Mr. MCDONOUGH. Correct.

Senator SARBANES. I want to just ask a question—do I have time?

Chairman SHELBY. Yes, sir.

Senator SARBANES. On the convergence of standards. There is an attempt of course to produce convergence of U.S. GAAP and International Accounting Standards, and that is something that FASB and the IASB are working on. Have you been approached about a convergence project with respect to auditing standards? As one thinks about that, I just want to raise this question. It strikes me it might be a little more difficult because the International Auditing Standards are still promulgated by a board that is part of the industry.

Mr. MCDONOUGH. Yes.

Senator SARBANES. Whereas the IASB, the International Accounting Standards Board is separate and apart, has an independent status, as does FASB. So you have two independent groups working there in order to get the convergence of standards. We do not yet have the same structure with respect to auditing standards. Do you have any thoughts on that question?

Mr. MCDONOUGH. I do, and I think that you explained the issue very well. If there were a PCAOB International, that is, not within the profession but at a Government-approved level, I think actually as a technical matter it would be easier to agree on audit standards than on accounting standards. However, as you know, I spent about 3 days in Brussels a couple of weeks ago working with the European Commission. That is very much a work in progress.

Senator SARBANES. Let me just interject right there. Senator Shelby and I were there in August, and of course every time they asked a hard question, we would say to them, "Just wait. Chairman McDonough will be here very shortly."

[Laughter.]

Mr. MCDONOUGH. That was very kind of you gentlemen.

[Laughter.]

Mr. MCDONOUGH. But I think we are working in a direction in which, by 2005, the European company law could evolve—I am not saying it will—but it could well evolve in the direction of having standard setting in the auditing area in a PCAOB look-alike. And that I think would be a step very much in the right direction.

Senator SARBANES. That would be very helpful.

Thank you very much, Mr. Chairman.

Chairman SHELBY. Mr. Chairman, we appreciate your appearance. We know you are going to be coming back and working with us, and we also appreciate your meetings with a lot of us on the Banking Committee, Senator Sarbanes, myself and you have a lot of work to do, but we believe you and Chairman Donaldson are up to the task. Thank you very much.

Mr. MCDONOUGH. Thank you, Mr. Chairman.

Chairman SHELBY. We have a second panel. We will go ahead and call them up. We have on the second panel Mr. Sam DiPiazza. He is a CEO of PricewaterhouseCoopers. I might add he is a native of Birmingham, Alabama and a distinguished graduate, Senator Sarbanes, of the University of Alabama, and of course we are proud of what he has achieved as the CEO of PricewaterhouseCoopers. Mr. Ed Nusbaum, CEO and Executive Partner, Grant Thornton, LLP; Mr. Sean Harrigan, President, CalPERS Board of Administration; and Ms. Sarah Teslik, Executive Director, Council of Institutional Investors.

We welcome all of you as our second panel, and we appreciate your patience here this morning. All of your written testimony will be made part of the Banking Committee's record in its entirety, and we will hope you would sum up your testimony as briefly as possible. I must tell you, we are in session in the Senate, and we are expecting a vote a little later, and at that time we will have a recess so Senator Sarbanes and I can vote and return.

Sam, we will start with you.

STATEMENT OF SAMUEL A. DiPIAZZA, JR.
CHIEF EXECUTIVE OFFICER, PRICEWATERHOUSECOOPERS

Mr. DIPIAZZA. Thank you, Chairman Shelby, Ranking Member Sarbanes, and the Members of the Committee. Good morning.

My name is Samuel DiPiazza, Jr., and I am the Global CEO of PricewaterhouseCoopers. On behalf of the many thousands of PricewaterhouseCoopers professionals in the United States and around the world, it is a real honor to be here on behalf of the profession discussing the implications of the Sarbanes-Oxley Act.

The Act laid the foundation for significant improvements in corporate governance and accountability, and it has also reinforced confidence in the U.S. capital markets. I applaud Congress for its actions. The Act created three fundamental areas of change for those responsible for protecting the interest of investors.

First, there has been a very beneficial shift of power and governance from the executive suite to the boardroom and, notably, to the audit committee. This has significantly enhanced the audit process because the audit committee is much more attuned to investor protection and in turn supporting the efforts of the audit firm. Second, and most importantly, auditors who perform public audits, like PwC, are now regulated with Government oversight, rather than a self-regulatory system. Third, public entities and auditors are now more transparent in the information they disclose.

The challenge for all of the market participants now is to implement the necessary reforms in the interest of the investor above all else. Therefore, in addition to complying with the letter of the law, we must be especially diligent in implementing the spirit of the

law. My comments today will be how PwC has embraced this changed environment, the impact of future requirements, and maybe some issues out to the future.

We, at PwC, are sincerely embracing the call for renewed focus around the interested investing public. We are changing the culture of the firm, and that starts with me, right at the top of our organization. My dialogue with our people is about our responsibility and accountability to the public, about our audit quality and our central role in the capital markets. At the same time we have developed new policy systems and methodologies to comply with both the letter and the spirit.

For example, we have improved our audit methodology and procedures to help detect fraud. We have employed forensic and technology specialists on audits to determine whether there is a higher risk of fraud, and we have placed greater emphasis on controlled environment. We have made significant investments in upgrading our compliance and independent systems. We have resigned or refused to take on high-risk clients, clients with an overly aggressive management of business model or an absentee board. To date, we have terminated relationships representing over 250,000 audit hours. We have enhanced our communication with audit committees. We now test the information that management uses to run its business and we reconcile that information with external reports to test transparency, and we have realigned our partner compensation system to ensure their appropriate behavior. We have made significant investments around training to change cultural change and increase the knowledge of our people, and to address questions concerning the Act and regulations we have been aggressive with webcasts, white papers, articles, both internally and externally.

The impact of the new requirements have been significant. Our audit procedures have expanded. Audit committees are asking us to do more. Our senior people are spending more time on complicated accounting issues. Audit scope increases and an increased emphasis on fraud detection and clear and transparent disclosure has increased the time on engagement. All of this adds additional cost, but I am confident that the benefit greatly outweighs the cost. We need to get it right the first time to protect investors.

The provision of tax services to audit clients continues to be a focus in the market. There is a continuing drumbeat that auditors who provide tax services to audit clients are not independent even though Congress and the SEC considered the issue and concluded to the contrary. As a result our U.S. tax practice has experienced a decrease of over 20 percent. I believe that tax services are an integral part of the services provided by an accounting firm and better audits are performed when tax professionals are involved with complex and difficult judgments around tax. It is also important to note that our liability costs have now become our second largest cost, second only to compensation of our people.

In terms of regulatory oversight, we fully support and are committed to the success of the PCAOB. Our profession is at a critical juncture. We can no longer count on a proud history to speak for its importance. We must stand up and be counted, and in doing so establish a professional reputation that ensures we are recognized

as leaders in the capital markets. Our integrity must be beyond question.

In addition to conducting business in an appropriate manner, a number of other matters must be addressed. Our firm must have the right tone at the top and a commitment to quality, excellence, and restoring investor confidence; recruiting, attracting, and retaining the best and the brightest; converging, auditing, and accounting systems; and making sure our business model balances risk.

In conclusion, Benjamin Franklin once said, "That which hurts instructs." Undoubtedly, our profession has learned from painful lessons of the last few years, and we have engaged and returned wiser and invigorated.

Thank you for inviting me to speak.

Chairman SHELBY. Mr. Nusbaum.

Senator SARBANES. Mr. Chairman, could I just interject?

Chairman SHELBY. Sure.

Senator SARBANES. I understand Mr. Nusbaum's train from New York was flooded out at Landover, and he left the train and took a cab in order to get here, and we appreciate that extra effort.

Chairman SHELBY. You were traveling parallel routes to get here, through flooded roads in Maryland.

STATEMENT OF EDWARD NUSBAUM
CHIEF EXECUTIVE OFFICER, GRANT THORNTON, LLP

Mr. NUSBAUM. Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, thank you for inviting me to testify today concerning the impact of the Sarbanes-Oxley Act. I appreciate the opportunity to discuss this important subject with you.

We have seen the effects of the Act firsthand and our chief conclusions are, number one, that the Sarbanes-Oxley Act has had a positive influence on corporate America, financial reporting, and the accounting profession. Grant Thornton congratulates you on having had the courage and foresight to adopt this Act. Number two, a principles-based approach is necessary for the successful implementation of the Act. Number three, there is more that needs to be done. Grant Thornton and other accounting firms must work with the PCAOB to improve the audit process. The business reporting model and the quality and transparency of information used by investors and creditors needs to be improved.

Before I get started, a quick word about Grant Thornton. Since our founding in 1924, Grant Thornton has focused on providing audit and tax services to mid-size companies, generally those with revenues between $25 million and $2 billion, although we have clients both larger and smaller. Grant Thornton International is the world's leading accounting, tax, and business advisory organization, primarily dedicated to mid-size companies. Through our network of 585 offices in 110 countries, including 50 offices in the United States, partners of the member firms of Grant Thornton audit multinational companies by providing personal attention and seamless service delivery to public and private clients throughout the world.

I believe that the tone of an organization starts at the top. As I wrote in *Chief Executive* magazine this past year, which was cited in the House Committee on Financial Services' recent publication

on the Act, the role of the CEO has taken on new dimensions as numerous new responsibilities and potential for penalty for corporate wrongdoing, including prison, now stop directly at the desk of the CEO.

In the past many CEO's did not worry about the state of their internal control systems. Many CEO's, absent a specific regulatory mandate, came to believe that their control system was adequate even though they had no way to prove that to be the case. Today, because of Sarbanes-Oxley, CEO's must back up that fact with a signature and actual evidence. The increased role of the CEO in financial reporting has been, based on our experience, a positive step.

The Act has clarified and, in some cases, strengthened the role and responsibility of boards of directors and audit committees. Boards can no longer blindly rubber-stamp the actions of management. They must now work side-by-side with the auditors to ensure that the shareholders' interests are protected. Audit committees must be more independent and expert in carrying out their vital duties. Again, our experience has been that most audit committees and boards of directors have increased the number and quality of meetings, and the members of most audit committees and boards appear to be taking their role more seriously since the adoption of the Act.

The Act is forcing public companies and their auditors to make sure that the financial statements are clean. Restatements, as you know, have jumped 30 percent over the past year.

Thanks to Sarbanes-Oxley, the quality of information provided to investors from corporations has improved. We also believe that changes mandated by the Act prohibiting auditors from providing consulting services, such as consulting, to their public audit clients has helped in restoring trust in the accounting profession. In fact, a recent Gallup poll found that the image of the accounting profession has significantly improved over the past year, more than any other profession tested.

We believe that accounting firms must not only cooperate with the PCAOB, but also act as thought leaders to improve the audit process. Likewise, the PCAOB should not only monitor and discipline accounting firms, but also should work with the firms to improve audit quality. This cooperation between the new board and the accounting firms should result in further improvements in the quality of financial information.

Although there have been several well-publicized allegations of accounting misdeeds and auditing failures, there are many more instances where auditors have properly discharged their professional responsibility.

I am proud to say that in February 2002 we issued a five-point plan to restore the public's trust, and three of the five of our proposals were included in the Sarbanes-Oxley legislation. We are one of the first global accounting firms to advocate the need to a principles-based approach to accounting standards. And that same principles-based approach should be used in adhering to Sarbanes-Oxley. There are areas in the legislation that are clear, and some of them might be interpreted differently by others, but the guide

in the gray areas should be the spirit of reform and protection of investors that you, the bill's authors, intended.

Last month, Grant Thornton became the first and only one of the six global accounting organizations to go on the record publicly and prohibit services for its public audit clients related to the documenting of internal controls. Consistent with our guiding principles, we will not provide these services because we believe to do so violates the spirit of Sarbanes-Oxley. On the other hand, we have developed tools and trained our people to independently test the internal controls designed and documented by management.

Going forward, there must be a renewed effort to improve the current business reporting model. In December 2002, the AICPA formed a special committee on enhanced business reporting, chaired by our managing partner of strategic services, Mike Starr. This committee will establish a consortium of investors, creditors, regulators, management, and other stakeholders to improve the quality and transparency of information used for decisionmaking.

Working as a team, Grant Thornton and the other accounting firms, together with regulators and standards setters and leaders of the business and financial community, can continue to improve the quality and transparency of information used by creditors and investors.

In 1933, Congress passed the Securities Act that led to the creation of the SEC, designed to restore investor confidence in our capital markets. Now, 70 years later, Sarbanes-Oxley has further protected American investors. I know that I speak not only for Grant Thornton and the other accounting firms, but also for many Americans in thanking you for the countless hours spent in bringing this landmark legislation to fruition, resulting in improvements in our financial reporting system in the past year and for many years to come.

Thank you.

Chairman SHELBY. Mr. Harrigan.

STATEMENT OF SEAN HARRIGAN
PRESIDENT, BOARD OF ADMINISTRATION, CalPERS

Mr. HARRIGAN. Good morning. Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, it is a pleasure to be here today to discuss Sarbanes-Oxley. It is a topic that is of extreme importance to investors.

My name is Sean Harrigan. I am President of the CalPERS Board of Administration. CalPERS has been a strong advocate for corporate governance for more than a decade now. When we recognized the depth and magnitude of the financial crisis in recent years, we were one of the first investors to embark upon a financial market reform initiative.

Now, almost 2 years later, we have accomplished what I believe is a great deal. The primary vehicle for reform has been Sarbanes-Oxley. We know that the full implementation of the Act is a long-term goal, but I think it is safe to say that this historic legislation was an excellent first step toward restoring investors' confidence and improving the credibility of our financial markets.

It is to this Committee's credit, and Senator Sarbanes in particular, for whom we have the utmost respect, that we have this

Act. On behalf of CalPERS and its members, I want to thank Senator Sarbanes and each of you for your courage and leadership on this most important issue. We are proud to have supported this effort with you.

Today, I want to offer one perspective on the effectiveness of the Act. I would also like to offer some suggestions for the next steps that are critical to completing the job, restoring the public's trust and confidence in our financial markets.

We believe the Act accomplished three important reforms:

First, auditor independence. Without question, the independence of the auditors in corporate America is returning.

Second, it provided accounting industry oversight. A new independent body was created to oversee audit firms so structurally we will never be as bad off as we were before. The Public Company Accounting Oversight Board is up and operating. I think it is making progress toward its inspection and disciplinary programs. I am especially pleased that the Board is preparing its own auditing standards and standards related to the signing off on a company's financial statements.

Third, the Act strengthened the enforcement of Federal securities laws. It provided a number of enforcement tools to strengthen the ability of the SEC to regulate the securities market and compensate injured investors.

Let me turn to what I believe are some of the next steps. Please do not get me wrong, there are many other provisions of the Act that have helped investors. The three I have mentioned are the ones that paved what I believe was new ground.

Where should we go from here? We need to strengthen even more auditor independence. The Act does not address two significant types of nonaudit services. Auditors may still under certain circumstances be paid providing tax planning and consulting services as well as certain information technology consulting.

We feel that an outright ban on nonaudit services is necessary. We analyzed proxy disclosures and found approximately 50 percent of the total revenue to audit firms was nonaudit related. About 40 percent can be attributed to consulting, advisory, or planning services that include tax-related work. This is a deeply troubling situation that has significant potential to impair the objectivity of the so-called independent auditor. We have taken steps to communicate our concerns directly to companies in which we invest. In fact, during the 2003 proxy season we withheld our votes for audit committee members when they used their auditors for nonaudit services. We plan to do the same in the upcoming proxy season.

We urge you to pursue tougher rules through the Securities and Exchange Commission and the Public Company Accounting Oversight Board to address this important issue. Let me return to the accounting industry oversight. We need internal controls over financial reporting. We do not accept the criticism by some in the business community that the focus of PCAOB in this area is misplaced or that the cost for improving internal controls is not worth it. We rely on financial statements, and we believe controls are critical.

Next, I think strengthening the enforcement of the securities laws is in order. We urge you to study whether the SEC should

have additional authority to ban individuals when it is proper to do so from serving as officers or directors at public companies convicted of misconduct. You may also want to study additional authority for the SEC to claw back gains from executives that are in any part attributable to misconduct.

Large payouts that follow corporate failure due to poor financial performance adds insult to injury for damaged investors. This is especially true in any portion of the gain realized by an executive can be attributable to malfeasance.

Next, I think it is time to examine the role of market participants. The SEC, as well as other organizations, are continuing to conduct analysis of the role of various industries within the financial system. The audit industry, and many other industries, has a role in maintaining the market's integrity. Some industries have significant structural conflict that are contrary to the interests of investors and the markets, such as firms that provide investment banking and equity research.

We urge you to continue to examine all industries that can have conflicts. We ask you to balance their needs to operate in an effective manner with the public's need for integrity in the financial markets. Greater focus has to be placed on increasing the resources for the SEC, but that is only half the problem. To ensure that the SEC can be an objective market regulator and continue to build a sustainable and consistent program, it should have a greater degree of independence from the Federal budget process. Investors need open access to the proxy. This is the crown jewel of reform. At the heart of many problems that face investors, is the lack of accountability of board members to the owners of the corporation.

The root cause of problems like abusive executive compensation, lack of oversight that helps permit fraud, and plain old poor financial performance, is the lack of accountability of board members to their owners. A reasonable and balanced approach to providing investors with greater access to management's proxy statement will directly address this problem.

Last, but not least, is the topic of NYSE reform. Today, we stand on the verge of transforming the New York Stock Exchange into the world's best model of corporate governance. I hope that they will find a permanent chairman with impeccable credentials who can meet the needs of the New York Stock Exchange ultimate consumer, the investors. We believe we need to form a much smaller and accountable NYSE Board made up of 50 percent from the investor community. Once that is done, the New York Stock Exchange needs to adopt a permanent corporate governance structure that will serve as a model for the world's financial markets, and include independent nominating committees and transparency, transparency in compensation, and transparency in financial statements. I think they will need all of our support.

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, I would like to once again offer my sincere gratitude for all that Sarbanes-Oxley has done for investors. You have done more to restore investor confidence with your act of courage than you might well imagine. We need your help. We need your leadership. Working Americans who rely on the financial markets for their retirement benefits will benefit from your leadership, and

they will count on it for decades into the future. Together, we have achieved some early successes with Sarbanes-Oxley. I hope you will build upon this landmark accomplishment, known as Sarbanes-Oxley.

And on behalf of the 1.3 million members whose retirements have become safer as a result of your leadership, I want to say again, thank you very much.

Chairman SHELBY. Ms. Teslik.

STATEMENT OF SARAH TESLIK
EXECUTIVE DIRECTOR, COUNCIL OF INSTITUTIONAL INVESTORS

Ms. TESLIK. I realize that as the last speaker on the last panel, what you mainly want from me is an executive summary. I think the executive summary for this hearing about the status of a bill passed 14 months ago, was actually stated a few decades ago during Nixon's historic trip to China. As you, I am sure, are very familiar with this story, when Kissinger at a state dinner asked the legendary Cho En Lai what he thought of the French Revolution, Cho En Lai paused for a moment and said, "Too early to tell."

Although I think it is genuinely way too early to tell how Sarbanes-Oxley will affect business worldwide, there have nevertheless been an awful lot of people whining loudly, and I suspect that is one of the reasons we are here today, about how this Act is stifling corporate ingenuity. It is making it impossible to fill board seats, which is a really funny allegation when you think about it. And it is requiring American companies to reincorporate on the Moon to avoid incredibly astronomical compliance costs.

In fact, one of my favorite legal memos that came out right after the bill was passed and circulated to many American companies, told them that it was now illegal to have corporate credit cards because Sarbanes-Oxley bans loans to executives, and credit cards are, of course, a loan. I got a call from a CEO who got the memo when I did, and he asked what I thought, and I said, "Ditch the firm, keep the cards, and get a grip." I think a lot of the hysteria that we are seeing over the bill comes from that kind of thinking or lack thereof.

There is no question that there are a number of new costs incurred because of Sarbanes-Oxley, but I think there are five things to keep in mind. First, whenever you change a system from one to another there will be change-over costs. If the U.S. adopted the metric system, we would have costs changing over, and that does not mean the metric system is a bad system, it means we are changing systems.

Second, a lot of the costs come from conflicting advice that has nothing to do with the bill. I asked the chairman of a major oil company on Friday what his main costs were because of Sarbanes-Oxley, and he said different law firms are giving us different bits of advice, and we are paying $700 an hour for them to contradict each other. I think that kind of thing will sort itself out as people figure out that you can have corporate credit cards despite what advice you are given.

Third, I think a lot of the costs that are being incurred are potentially unnecessary. I asked the head of a major pharmaceutical

company last week what their major problem was, and he said, well, actually, law firms, consultants, and accounting firms are trying to sell us elaborate packages that we need to adopt, and the fact is we do not need to adopt them, because of internal controls that we have. Good internal controls should not cost any more because to divide up functions does not mean you duplicate functions. It means you separate them. So, I think as the hysteria dies down, there will be companies recognizing they do not need to spend what they have been told and still comply fully with the letter and the spirit of the law.

Fourth, I think that most people are forgetting to talk about how most of the provisions in Sarbanes-Oxley entail almost no changeover costs. It does not cost any more for the board to hire the auditor than it does for management. It is just a different group. It should not cost much more for the PCAOB to do its job than the entities that did it before, it is just that it will be more independent. There is an entire list I could go through, but I will not.

And fifth, it is good that some new costs are being incurred. As was mentioned before, if a company does not have internal controls and it needs to learn to get them, then I am happy to spend that kind of money and I am sure all Americans are.

Finally, I think the whining fails to take into account the fact that there are already measurable benefits from Sarbanes-Oxley, and that is remarkable because Sarbanes-Oxley is basically an effort to strengthen safety nets. So you have to wait a period of time before enough bad behavior that might otherwise have occurred gets caught before you can, in fact, measure the net effect. But I should remind the Committee that in the 2 years leading up to Sarbanes-Oxley, if you look only at the thousand largest firms that lost 75 percent or more of their value, $66 billion of that money went into the executives' pockets of those companies. It was not money just lost because someone made a dumb decision, it was value transferred from shareholders to insiders, and that $66 billion is not being repeated since Sarbanes-Oxley.

I think it is also important to note in closing the more important long-term value of Sarbanes-Oxley which was alluded to earlier but I think not specifically enough. Everyone likes to say that our markets are the best in the world, and for the past several decades it has been true. It will not necessarily always stay true. The reason people invest here is that our markets are perceived to be cleaner and more efficient.

Both of those two things can change and change quickly, particularly when special interests have an ability to come to you, the regulators, and get favors when the average Americans, who we represent, cannot.

I think the importance of Sarbanes-Oxley was that it was a statement to the rest of the world that we will do a great deal, including standing up to some terrific pressure—and let us not pretend that did not exist—to say that we are going to take some actions that keep our markets more efficient and cleaner, and unlike any other industry in which America is dominant, markets can flow overseas almost instantly. I think for that reason alone, which affects all Americans, including Americans who do not have pensions because actually our jobs, our houses, our entire democratic

system depends on the wealth generated by these markets, Sarbanes-Oxley was a major step in the right direction.

Thank you.

Chairman SHELBY. I understand that the Oversight Board has already initiated its annual inspection of PricewaterhouseCoopers. Could you describe this process and provide for the Committee the perspective of the Oversight Board's inspection procedures?

Mr. DIPIAZZA. Yes, Senator Shelby. The process has begun, and I think as the Chairman of the PCAOB said, it has been very constructive at this point. We began with a discussion around the tone at the top of our organization. The inspection included a review of our communications, our policies from the top of the organization to our partnership. Beyond that, interviews, extended interviews with our leadership are ongoing at this point. Then in October/November, there begins a process of a review of specific engagements.

I can only second Mr. McDonough's comments. I think the PCAOB is bringing a high level of professionalism, and I am very confident that this process will make us better as a firm. So far, so good.

Chairman SHELBY. Mr. Harrigan, pension funds lost millions of dollars in the recent corporate scandals over several years. Would you give us your perspective of the state of corporate governance and whether you have observed any renewed investor confidence because of corporate governance changes, or is it a work in progress?

Mr. HARRIGAN. I think it is still a work in progress. Obviously, I think there has been some restored confidence in the financial markets, and then all of a sudden something happens like the problem with Mr. Grasso's compensation at the New York Stock Exchange, and I think it takes a turn downward.

As I mentioned earlier, I think the most important reform—and Sarbanes-Oxley was important and I think it did make a difference and will continue to make a difference—but the most important reform is the reform that the Securities and Exchange Commission is reviewing right now and that is access to the proxy. It is time for the managers of America's corporations to be accountable to the owners. The only way that that can occur is through access to the proxy. I think that if we want to effectively deal with the problems that have been evident in this market over the last several years, we have to create more accountability, more transparency, and I think that is the one reform that I would urge the Members of this Committee to be supportive of because I think it can make a huge difference in terms of the integrity of America's corporations.

Chairman SHELBY. Mr. Nusbaum, we recognize that accounting firms have had to expend greater costs and resources like it was alluded to, to comply with Sarbanes-Oxley because there has been a change. Could you describe the compliance costs that Grant Thornton has absorbed or passed on or both during the implementation of Sarbanes-Oxley?

Mr. NUSBAUM. We have taken several steps to make sure that we are not only complying with the actual Act but also the spirit of the Act. We have certainly improved our quality throughout our entire organization. We have added professional standards personnel to help ensure that quality. We have increased the number

of people that are in the quality control process. We have already adopted the auditing standards for fraud. We have revised our audit approach to ensure that we do a better job detecting fraud going forward.

In addition, we have spent a considerable amount of money, as I alluded to earlier, on tools to test and audit the internal controls of corporations. We have developed new software and conducted training for all of our audit personnel to make sure that they know how to test internal controls that are designed and documented by management. And that has been quite an endeavor, but one we are proud of and pleased with the results.

And while it is additional cost, some of which we will certainly absorb, unfortunately, and maybe some of which we can pass on to clients—it will be a blend, I am sure. But, regardless of who absorbs the cost, it is a positive step in the right direction, and I think it benefits corporate America.

Chairman SHELBY. Ms. Teslik, as time moves on following the enactment of Sarbanes-Oxley, are you convinced that reform efforts will continue if we have a bull market?

Ms. TESLIK. Memories are short, and I think that some of the changes which have occurred in corporate boardrooms, among other places, have occurred not necessarily because of the Act, but because these people do not want to see their names in the papers the same way as the Enron directors, and those memories fade.

And so, I think it is not appropriate to let one's guard down. I do not know that any additional legislation is needed, even in a bull market, although the regulatory follow-up that Mr. Harrigan mentioned is important.

Chairman SHELBY. Ms. Teslik, what do you see as the prospect of reforms coming in the next 12 to 18 months internally?

Ms. TESLIK. I think there are two very important ones. Sarbanes-Oxley was passed in a very short period of time, in a lot of heat and with frauds happening every week. I think there are two main areas left unaddressed.

One is that the first line of defense against fraud and against mismanagement is the board of directors, and the ability of shareholders to elect the board is critical to the board's being effective. The SEC is currently addressing that.

The second area, which is being addressed but needs to be addressed more broadly, is that for some reason, some decades ago it was considered a wise thing to take Government regulatory authority and delegate it to a number of private sector companies. Obviously, that was reversed in Sarbanes-Oxley with respect to the accountants when the PCAOB was established. It was reversed by Sarbanes-Oxley with respect to FASB by giving it independent funding. It has not yet been addressed with respect to the stock exchanges, and they do have a lot of rules which affect our capital formation process.

I think those two things easily trump everything else.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman. I know there is a vote on.

First of all, I want to thank all members of the panel for their testimony. We appreciate it very much.

Before I ask this question, I want to observe that there are a number of efforts to raise standards that are taking place separate and apart from the legislation itself. First of all, the SEC has now been given resources which would better equip it to carry out its various authorities, which are quite extensive when one examines the statutes.

But the exchanges are introducing new requirements, although, of course, the New York Stock Exchange itself is now in the spotlight with respect to its own governance. Clearly, that is another arena in which we may succeed in getting improved standards.

Then there are a number of efforts going on within the business community for best practices, and I want to focus on one of them. The Conference Board's Commission on Public Trust and Private Enterprise recommended in January, "Against public audit firms performing services that put it in an advocacy position such as proffering novel and debatable tax strategies and products that involve income tax shelters and extensive offshore partnerships or affiliates."

Now, this was an issue we wrestled with when we did the legislation. The legislation, of course, does not prohibit tax activities, and the argument was very strongly made to us that there is a range of normal tax activities that has always been a part of accounting activities. In a sense, we were not in a position to draw the line with respect to these activities that I just mentioned, which were not the whole range of them. I repeat it again, "advocacy positions such as proffering novel and debatable tax strategies and products that involve income tax shelters and extensive offshore partnerships or affiliates."

Now, there is authority in the PCAOB to address this question, and my question to the members of the panel is: Is this a matter which you think needs to be addressed? Mr. DiPiazza, why don't we start with you and we will come right across the panel.

Mr. DIPIAZZA. Thank you, Senator Sarbanes. Let me begin by stating that I am a tax partner in our firm. I have served 20 to 25 years serving clients throughout the country, gaining an understanding of their business, and being deeply involved in the audit process in turn of doing that.

Tax is a central piece of an accounting firm. It is traditional. It is a very important part of the quality of an audit. And, in fact, it has enhanced my career and my ability to serve as an auditor and as a tax partner.

Today, you have board preapproval for any transaction involving tax consulting. You have full disclosure in the public domain. The discussion of tax shelter has been one that has had a forefront in governance issues. And I do believe that, frankly, exotic tax shelters, the question is really one of policy. Should anybody, whether it is accounting firms, auditors, lawyers, investment banks, be promoting exotic tax shelters?

We exited that business as a firm because we did not see it as a moral place to be, long before Sarbanes-Oxley. I think the debate has been had. I do believe boards today understand it and we get it. So, I think today the landscape is pretty clear on the point?

Senator SARBANES. Mr. Nusbaum.

Mr. NUSBAUM. Well, I am an audit partner, not a tax partner, but like Mr. DiPiazza, I agree that tax is an integral part of what accounting firms do, an important service that should continue to be provided. However, like Mr. DiPiazza, we have also exited the sale of these abusive tax shelters and exotic strategies.

So, I think there is a question that should be addressed here and something that more research should be done to define exactly what should be banned, and if appropriate, I would support and I think we would certainly support the banning of these. We certainly do not offer these to our publicly traded audit clients, and, in general, do not offer them at all. So, I think that it is something that should have a little further research to make sure we do not cross over into general tax services. But as long as we can draw that line, I would support the action completely.

Senator SARBANES. Mr. Harrigan.

Mr. HARRIGAN. My prepared comments, I think, addressed exactly where CalPERS is. We do not believe any nonaudit-related services should be allowed. As I mentioned, about 50 percent of the revenue generated by audit firms is based on nonaudit services, mainly in the tax area and the IT area. We believe that it does create a conflict and that it should be prohibited.

Senator SARBANES. Ms. Teslik.

Ms. TESLIK. I can only speak for the Council, and we do not have a policy, and members are not of one mind on this subject.

Senator SARBANES. If I could ask one quick question, and then we have to go.

Chairman SHELBY. Go ahead.

Senator SARBANES. I know we have to go vote.

The GAO recently reported to the Committee about the extent of concentration in the U.S. audit industry. Very quickly, how serious a problem is this? And if it is a serious problem, how might it be addressed? Very quickly.

Mr. DIPIAZZA. You have to reflect on how we got here. When there were eight firms, they simply did not have the coverage and the depth around the world to provide the audit quality that the investor needed. And that went from eight to six to five. Going from five to four was the tragedy. We did not need that to happen.

There is plenty of competition in the marketplace, and there is capacity in the marketplace. I think the GAO study said it well.

Senator SARBANES. Mr. Nusbaum.

Mr. NUSBAUM. I disagree with those comments, and I disagree with the GAO report in this particular area. The report is very long, and I support the vast majority of the report.

We certainly believe that there are many accounting firms, obviously Grant Thornton and other international firms, that can audit multinational companies and have the capability, skill set, and resources to do that. In fact, I believe we have the capability to audit the vast majority of public companies out there. And, again, it is not just Grant Thornton, but if you look at the AICPA major firms group, there are probably at least 25 and maybe more accounting firms that should be encouraged to audit public companies. We think that consolidation is an issue and that the PCAOB as well as the Government should do everything it can to promote smaller CPA firms to audit publicly traded companies.

Senator SARBANES. Mr. Harrigan.

Mr. HARRIGAN. I would agree with those comments. I think that it is becoming a problem and that we should do everything that we can to promote the opportunity for smaller firms to participate in the audit process.

Senator SARBANES. Ms. Teslik.

Ms. TESLIK. A number of our corporate members have complained that there is no place else to shop, and they believe that the cost of an audit, which has skyrocketed, has gone up in part because the competition has gone down.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman SHELBY. I have one observation. All these firms had to grow from something, did they not, over time? And so if we grow, if it is Grant Thornton or someone else who continues to grow—and I hope they do—more competition is good for everybody, is it not?

Mr. NUSBAUM. Absolutely.

Mr. HARRIGAN. Yes, it is.

Chairman SHELBY. We appreciate your appearing here today. As Senator Sarbanes has just reminded us, we do have a vote and we hope to make it. Thank you.

The hearing is adjourned.

[Whereupon, at 11:43 a.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF WILLIAM J. McDONOUGH

CHAIRMAN, PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

SEPTEMBER 23, 2003

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, I am pleased to appear before you today on behalf of the Public Company Accounting Oversight Board (PCAOB or the Board). This is the first appearance of a PCAOB member before this Committee. On behalf of the Board, I would like to begin by commending the extraordinary leadership of this Committee in response to the crisis in public confidence brought on by some devastating failures in financial reporting and auditing. The legislation—now law—that you worked so hard on is a landmark reform of corporate governance, financial reporting, and auditing and you should be proud.

I am both proud and humbled to appear before you today as Chairman of one of the products of your hard work—the Public Company Accounting Oversight Board. Among the many reasons I was willing to take on this job were my own strong convictions about the need for an aggressive response to the corporate scandals and the lack of leadership in the private sector. It is an honor to have the opportunity to act on those convictions by helping to build an organization, in the form envisioned by you, to restore the linchpin of the American financial system—trust in the integrity of financial reporting.

Introduction

A little over a year ago, the Congress passed and the President signed the Sarbanes-Oxley Act of 2002 (the Act).[1] The Act, of course, established the PCAOB and charged it with "oversee[ing] the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors."[2]

To carry out this vital charge, the Act gives the Board significant powers. Specifically, subject to the oversight authority of the Securities and Exchange Commission (the Commission), the Board's powers include authority——

- To register public accounting firms that prepare audit reports for issuers;
- To conduct inspections of registered public accounting firms;
- To conduct investigations and disciplinary proceedings concerning, and to impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms;
- To enforce compliance by registered public accounting firms and their associated persons with the Act, the Board's rules, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants; and
- To establish or adopt, or both, by rule, auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers.[3]

Overview of the Board's Organization

Since the initial Board members took office in January, the Board has taken a number of administrative steps to position it to carry out its core programs.

Staffing

Like any other start-up, much of the Board's effort has been devoted to creating an organizational structure and hiring staff members in a manner that will foster our long-term success. One of the Board's objectives in this regard is to foster a working environment marked by enthusiasm for the Board's mission and by commitment to integrity. Starting from scratch in January 2003, the Board has grown to 84 full-time professional staff. While the staffing effort is still underway, most of the top positions have been filled. In addition, our inspections group, which ultimately will be the Board's largest division, has grown to some 21 inspectors.

Office Space

The Board has leased space and opened offices in Washington, DC and New York City, as well as an information technology center in Northern Virginia. The Board anticipates that the space it has secured will be adequate to meet the anticipated growth of the organization for several years.

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[1] P.L. No. 107–204 (2002).
[2] Sarbanes-Oxley Act, Section 101(a).
[3] Sarbanes-Oxley Act, Section 101(c).

Bylaws

To govern its operations and decisionmaking process, the Act contemplates that the Board, like other private corporations,[4] will adopt bylaws. The Board adopted its initial bylaws at its first meeting on January 9, 2003, and amended them on April 25, 2003. The Board's bylaws were approved by the SEC on July 23, 2003.

Ethics Code

The Act also requires the Board to establish ethics rules and standards of conduct for Board members and staff. At its public meeting on June 30, 2003, the Board adopted an ethics code that will apply to Board members, staff, and designated contractors and consultants. The purpose of the ethics code is to ensure the highest standards of ethical conduct within the Board's operations, and to provide the public with confidence in the objectivity of the Board's decisions by seeking to avoid both actual and perceived conflicts of interest. As required under the Act, the ethics code has been submitted to the SEC for approval.

Public Accessibility

The Board recognizes the importance of keeping the investor community, the issuer community, the accounting profession, and the public informed of developments as the Board carries out its mission. The Board has established a general practice of conducting its rulemaking in a public forum and seeking public comment on proposed rules. We also maintain a website, *www.pcaobus.org,* where we provide timely and detailed information about our rules and policies, and where we webcast the public meetings and roundtable discussions that we hold to gather public input on substantive issues.

Budget

Section 109(b) of the Act requires the Board to prepare and submit to the Commission for approval a budget for the Board's first fiscal year. At its public meeting on April 23, 2003, the Board approved a budget for the 2003 fiscal year of approximately $68 million. The SEC approved the Board's budget on August 1, 2003.

Funding

The Act establishes a mechanism for the funding by publicly traded companies of the Board and of the accounting standard-setting body designated pursuant to Section 19(b) of the Securities Act of 1933.[5] To implement this funding mechanism, on April 18, 2003, the Board issued final rules with respect to the allocation, assessment, and collection of its accounting support fee.[6] The SEC approved the Board's funding rules on August 1, 2003. Under the Act and the Board's rules, larger public companies and investment companies are assessed based on their average market capitalization during the preceding year.[7] As a result, about 62 percent of the issuers assessed will pay $1,000 or less in accounting support fees to the PCAOB. The largest 1,000 issuers will pay about 87 percent of the total fees due. Pursuant to its rules, the Board sent notices of assessment to some 8,500 issuers beginning on August 4, 2003.

Registration

The Act and the Board's rules require that beginning October 22, all U.S. accounting firms that prepare or issue audit reports on U.S. public companies, or play a substantial role in the audit of a U.S. public company, must be registered with the PCAOB. To implement the registration of public accounting firms, the Board adopted registration rules on April 23, 2003 and the Commission approved the Board's registration rules on July 16, 2003.[8]

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[4] Under the Act, the Board is a private body with the powers of a District of Columbia nonprofit corporation.

[5] On April 25, 2003, the SEC designated the Financial Accounting Standards Board (FASB) as the authoritative standard-setter under Section 19(b). The PCAOB is serving as the FASB's collection agent for purposes of assessing and collecting its accounting support fee. In addition, a smaller portion of the Board's budget is to be recovered through fees assessed on registered public accounting firms, based on the estimated costs associated with processing and reviewing the firms' registration applications and periodic reports.

[6] PCAOB Release No. 2003–003 (April 18, 2003).

[7] Pursuant to the Board's rules, issuers with average monthly market capitalization of less than $25 million (and investment companies with net asset values, or market capitalization, of less than $250 million) are not subject to the accounting support fee.

[8] In approving the Board's registration rules, the Commission stated:

Title I of the Act assigns the Board the formidable task of designing and implementing a registration and oversight system within a relatively short period of time. The investor protection

Continued

Registration is critical to the Board's regulatory oversight of public accounting firms. As a legal matter, registration is the predicate for the Board's other oversight programs—compliance with auditing and related professional practice standards, inspections, investigations, and discipline. In addition, registration provides the Board with critical information about the public accounting firms that apply for registration. As required by the Act, registration applications must include, among other things, a list of issuer audit clients and fees billed those clients, the number and a list of the firm's audit professionals, a statement of the firm's quality control policies, and regulatory and enforcement actions against the firm and its professionals. This information will both serve as the basis for the Board's registration decisions and help inform the Board's exercise of its authority and focus its limited resources appropriately.

Registration of a public accounting firm is not automatic upon application. In order to approve an application, the Board must determine that registration of the applicant is consistent with the Board's responsibilities under the Act to protect investors and to further the public interest in the preparation of informative, fair, and independent audit reports for public companies.

To make that determination, the Board is committed to a careful and fair review of all applications. Under the Act, the Board must, within 45 days of receiving an application, either approve the application, provide notice of disapproval, or request additional information. To facilitate the registration process, and to support the Board's inspection and other functions, the Board developed its own web-based system for the registration of public accounting firms. Receiving application information from registering accounting firms in electronic format expedites the registration process and allows the Board to maintain a sophisticated database of information relevant to its other processes.

To facilitate registration further, the Board published in July a collection of answers to frequently asked questions about the registration process. We have also established a help line staffed by the analysts responsible for reviewing registration applications. Since its inception, these analysts have responded to over 850 telephone inquiries regarding the registration process. Last month, these analysts also contacted firms known to audit public companies which had not sought access to the Board's registration system to inform the firms of the applicable deadlines for registration. Through this outreach program, the analysts contacted approximately 500 firms.

The Board received its first registration application on August 7, 2003, and as of September 17, 2003, the Board has received almost 500 applications. The Board approved the first 38 of those applications last week and continues to review the remaining applications.[9]

Registration of Non-U.S. Auditors

Under the Act and the Board's rules, non-U.S. accounting firms that prepare or issue audit reports on U.S. public companies, or play a substantial role in the audit of a U.S. public company, must register with the PCAOB by the middle of next year.

Because registration is the predicate to all of the Board's other oversight programs, an exemption from registration for non-U.S. accounting firms would be tantamount to a complete exemption from any oversight by the Board. The Board believes that investors in the U.S. markets are entitled to the same protections regardless of whether an issuer, or an issuer's auditor, is foreign or domestic, and that it should provide investors with confidence that non-U.S. issuers and auditors adhere to U.S. generally accepted accounting principles and U.S. auditing standards.

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goals of the Act justify the need for prompt action, but the importance of the Board's task and its potential impact on the public securities markets demand that it be undertaken in a thoughtful and reasoned manner. After careful review of the Board's proposed registration system, the Commission finds that it is consistent with the requirements of the Act and the securities laws and is necessary and appropriate in the public interest and for the protection of investors.

Order Approving Proposed Rules Relating to Registration System, Exchange Act Release No. 48180 (July 16, 2003).

[9] In July, the Board proposed a rule on procedures by which a firm, once registered, may seek to withdraw from registration. Under the proposed rule, a registered firm may seek to withdraw its registration at any time if it is not engaged in activity for which registration is required. Withdrawal would not be automatic, but could be delayed until the completion of any pending or imminent disciplinary proceedings, or for the Board to complete other relevant processes, such as inspections and investigations. In the absence of a pending disciplinary proceeding, however, the proposed rule would not allow the Board to delay withdrawal for longer than 2 years. The Board is currently considering the comments it has received in response to that proposed rule.

At the same time, the Board has made certain accommodations in light of the special issues raised by the registration of nonU.S. firms. Non-U.S. accounting firms need not provide certain information on their registration application if by providing such information the firm would be violating laws in the jurisdiction in which the firm is located. Moreover, the nature and scope of the Board's oversight over non-U.S. accounting firms that audit the financial statements of U.S. public companies is the subject of ongoing dialogue between the Board and its foreign counterparts. Through this dialogue, the Board is exploring ways of accomplishing the goals of the Act without subjecting non-U.S. firms to unnecessarily redundant or conflicting requirements.

Inspections

As you know, the Act requires the Board to conduct a continuing program of inspections of registered public accounting firms. The purpose of these inspections is to assess the degree of compliance of each registered public accounting firm, and associated persons of that firm, with the Act, the rules of the Board, the rules of the Commission, and professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers.

The Board's inspection program is, perhaps obviously, where we will have the most extensive contact with registered firms and their personnel. It is where we are going to find out about the quality of the audits that have been conducted, and it is one of the places where we will exert pressure to change auditor behavior, when necessary. It will provide us with a direct window into the registered firms to see how they are implementing the standards the Board sets, areas where they are doing particularly well, and areas where improvements are needed.

There are a number of areas on which our inspections will focus that have not been the traditional focus of the peer review process. These include——

- An evaluation of the "tone at the top" of registered firms. We want to know the nature of the messages that are coming from the highest levels of the firms and their frequency;
- We are going to look at partner compensation and promotion. We are going to look into what behaviors are rewarded—and thus reinforced—through compensation and promotions; and
- We will consider the firms' overall communication and training practices with regard to all firm professionals.

On July 28, 2003, implementing the directive in Section 104 of the Act, the Board proposed rules relating to inspections of registered public accounting firms. The comment period has ended on the Board's rulemaking and the Board intends to finalize its inspection rules soon.

Under the proposed rules——

- "Regular" inspections are to take place annually for those firms that issue audit reports for more than 100 U.S. public companies.
- Other firms are subject to regular inspection every 3 years.
- A "special" inspection may be authorized by the Board at any time.

For 2003, limited inspection procedures are already being conducted on the four largest accounting firms, which have agreed to cooperate with the Board prior to their registration. Those inspections are already in process. In 2004, regular inspections will begin for all accounting firms. Inspections of those firms with less than 100 issuer audit clients will be phased in over a 3-year period.

Generally, under the Act, information obtained in inspections is confidential. Portions of a final inspection report that deal with criticisms of or potential defects in a firm's quality control system cannot be made public by the Board if the firm addresses the items to the Board's satisfaction within 12 months of the report. Final inspection reports will be provided to the Securities and Exchange Commission and appropriate State regulatory authorities, however, and the Board may refer information learned from inspections to relevant authorities and commence an investigation or disciplinary proceeding if the facts and circumstances warrant. Moreover, the Board has proposed rules pursuant to which the Board would publish reports about findings from the inspections process to discuss any matter the Board considers of public interest, including criticisms and potential defects in firms' quality control systems. Under that proposed rule, the Board would not identify specific firms in issuing such reports.

Investigations and Discipline

The Act authorizes the Board to conduct thorough investigations when there are indications that a registered firm or an associated person may have violated the Act, the Board's rules, certain provisions of the securities laws and the Commission's

rules, or professional standards. The Act further authorizes the Board to use the results of those investigations as a basis for formal disciplinary proceedings. If a violation is established in those proceedings, the Act authorizes the Board to impose a range of sanctions on the firm or associated person who committed the violation.

On July 28, the Board publicly proposed an extensive set of rules relating to investigations and disciplinary hearings. We received substantial public comment on the proposal. We have been considering the comments and we expect to consider adopting final rules very shortly. We are also in the process of staffing a Division of Investigations and Enforcement, which will have responsibility for carrying out the Board's investigative work and disciplinary proceedings.

Among other things, the Board's proposed rules implement the Act's provisions granting the Board broad authority to demand testimony, production of documents, and other cooperation from firms and associated persons during an investigation. As with inspection materials, the Act provides for the confidentiality of the Board's investigative processes and protects all such information from discovery by private parties. Firms and associated persons must provide the necessary information and cooperation, or risk the possibility of being sanctioned for noncooperation with an investigation. As provided in the Act and our proposed rules, noncooperation with an investigation can result in sanctions as severe as revoking a firm's registration or barring a person from association with a registered firm.

The Board's investigative and disciplinary work will also necessarily involve a need to obtain documents and testimony from public companies and other persons who are not legally required to cooperate with our investigations. While the Act does not authorize the Board to compel cooperation from those persons, it does authorize the Board to ask those persons to supply information voluntarily. The Act also gives the Board the option of working through the Commission to serve legally enforceable Commission subpoenas for any such information that is relevant to a Board investigation but is not supplied voluntarily. Our proposed rules would implement these provisions as well.

The proposed rules also include detailed procedures to govern the conduct of Board disciplinary hearings in order to ensure a balanced process in which the respondent has fair notice of, and a full and fair opportunity to defend against, allegations of misconduct. Like the investigative process itself, disciplinary hearings will be nonpublic unless the Board and the respondent agree otherwise, as required by the Act.

Finally, the proposed rules implement the Act's provisions for imposing sanctions if a violation is established through the hearing process. The sanctions the Board may impose range from the most severe sanctions—revocation of registration and bar on association—to lesser sanctions such as monetary penalties, limitations tailored to the particular violation, requirements to retain consultants for particular purposes, and requirements to obtain additional professional education.[10]

Professional Standards

The Act directs the Board to establish certain standards related to the work done by auditors of public companies. Those include standards for auditing and related attestation work, standards for quality controls, ethics standards, and independence standards. As part of the authority to establish standards related to auditor independence, the Act authorizes the Board to add to the categories of nonaudit services that auditors are prohibited from providing to their audit clients. Early on, the Board made the decision to establish professional standards by creating a standard-setting division of the Board, made up of highly-skilled experts, rather than by delegating the standard-setting function to another body, such as the AICPA's Auditing Standards Board.

The Act required the Board to adopt professional standards as initial or transitional standards prior to the Commission's April 25, 2003, determination of the Board's capacity to carry out its responsibilities under the Act.[11] Accordingly, at a public meeting on April 16, 2003, the Board announced the adoption of certain interim auditing, attestation, quality control, ethics, and independence standards to be used by registered public accounting firms in the preparation and issuance of audit reports, and the Commission approved those standards as part of its April 25, 2003 determination.

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[10] Sarbanes-Oxley Act, Section 105(c)(4). Under the Act, a firm or associated person sanctioned by the Board may seek review of that determination by the Commission. In the event of an appeal to the Commission, the Act provides that the sanction will be stayed unless and until the Commission affirms the sanction or otherwise affirmatively terminates the stay.

[11] Sarbanes-Oxley Act, Section 103(a)(3)(B).

The standards adopted on an interim basis include the standards with which the profession is, or should be, familiar. They include the following standards, as they existed on April 16, 2003:

- GAAS, as previously established by the AICPA, including Statements on Auditing Standards, auditing interpretations, auditing guidance included in AICPA Audit and Accounting Guides, and auditing Statements of Position;
- Attestation Standards and related interpretations and Statements of Position as previously adopted by the ASB;
- the AICPA's Statements on Quality Control Standards and certain AICPA SEC Practice Section membership requirements;
- the AICPA's Code of Professional Conduct on integrity and objectivity; and
- the AICPA's Code of Professional Conduct regarding independence, and the standards and interpretations of the Independence Standards Board.[12]

The Board has not determined that any of these standards should be permanently adopted, however, and the Board has announced plans to review systematically all of the interim professional standards and to determine whether each of the interim standards should be modified, repealed, or made permanent.

The Board has also announced its plans for a general process related to setting the permanent auditing and other professional standards. The process will include the appointment of an advisory group, as envisioned by the Act, including members of the accounting profession, issuers, investors, regulators, and others. The Board has adopted a rule concerning the composition of the advisory group[13] and expects to begin the process of forming the advisory group shortly after the Commission approves the rule.

We expect that the standing advisory group will be comprised of approximately 25 members with a variety of backgrounds. Our intent is that the standing advisory group act at a high level, providing advice and recommendations on policy matters, significant issues related to specific standards setting projects, and our agenda and priorities. The standing advisory group will not be a standard setting committee, in the more traditional sense, drafting and debating all the provisions of proposed standards. Most of that work will be done by the Board's staff.

We also plan to use other means to obtain the expertise and advice of the profession and the public, including such things as *ad hoc* task forces based on our need for specific expertise. We also have the option of convening roundtable discussions, which we have already held on certain issues, public hearings, and other types of public forums to obtain input and advice as needs arise.

The Act itself sets forth the Board's initial standard setting agenda. Section 404 of the Act, which mandates public reporting on internal control over financial reporting, becomes effective for fiscal years ending in June of 2004. On July 29, 2003, the Board held a public roundtable discussion to explore whether revised auditing and attestation standards on this subject are needed. The roundtable included representatives from issuers, auditors, investors, consumer groups, and regulators.

The Act also mandates that we establish requirements in the auditing standards for the retention of audit documentation and for a second-partner review, and we already are working on those subjects.

Conclusion

With your vision in establishing authority for independent standard setting, registration, inspection and discipline, you have given the PCAOB the responsibility and the tools to build a new future for auditing. I have faith that our staff and my fellow Board members will live up to your expectations.

I have not been shy about telling members of the accounting profession that we expect a lot from them, and that they will have to work harder than they could have imagined before Sarbanes-Oxley. Through a succession of scandals, the entire profession came to be judged harshly—but you and your colleagues, through the Sarbanes-Oxley Act, did not merely judge them; rather, you gave them a meaningful shot at redemption.

In my mind, facilitating that redemption, and not just punishing miscreants, is a key objective—one that the Board must not lose sight of even when we are, as we will need to be, tough on the profession.

As we work toward that objective, my fellow Board members and I look forward to a long and constructive relationship with this Committee.

Thank you.

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[12] With regard to independence standards, if the SEC's rules are more restrictive, then registered public accounting firms are expected to comply with the more restrictive requirements.

[13] *See* PCAOB Release No. 2003–009 (June 30, 2003).

PREPARED STATEMENT OF SAMUEL A. DiPIAZZA, JR.

CHIEF EXECUTIVE OFFICER, PRICEWATERHOUSECOOPERS

SEPTEMBER 23, 2003

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, on behalf of thousands of PricewaterhouseCoopers[1] professionals in the United States (U.S.) and my colleagues from around the world, it is a distinct honor and pleasure to appear before you today. My profession and PricewaterhouseCoopers (PwC) are going through dramatic change, and I do not see this change abating greatly in the foreseeable future. We stand at a crossroads today and have a unique opportunity to redefine our profession, ensure our continued relevance, and, importantly, restore a high level of investor confidence.

Introduction

A Profoundly Different Landscape for the Accounting Profession

Two very significant and interrelated events have created a landscape that is far different today than anything my profession has previously experienced. A series of high profile corporate failures raised significant doubts on the part of the investor community as to the reliability of the capital formation process and as to whether auditors deserved the degree of trust historically conferred upon them. This lack of trust, of course, was not just directed at auditors but at all significant players involved in reporting financial information to investors and other stakeholders. As a consequence of these failures and the crisis in confidence that resulted, Congress passed—and President Bush signed into law—the Sarbanes-Oxley Act (the Act) just over 1 year ago.

Following the Act's passage, the Public Company Accounting Oversight Board (the PCAOB) established itself as the primary regulator of public company auditors. Using the Act as a guide, the Securities and Exchange Commission (SEC or Commission) implemented various rules designed to ensure the financial integrity and vitality of our capital markets. We recognize and commend the great effort that the Commission and the PCAOB have made over the last year to enhance investor confidence in the efficacy of our capital markets.

Three Fundamental Areas of Change

The Act created three fundamental areas of change for those with responsibility for protecting the interests of investors. First, there has been a shift of power and governance from the executive suite to the boardroom and, notably, the audit committee. Second, auditors who perform public company audits, like PwC, are now regulated with Government oversight, rather than the self-regulatory system that previously existed. Third, public entities and their auditors must be more transparent in the information disclosed to others—in particular—information relating to the effectiveness of control systems, a requirement commonly referred to as Section 404, which has not yet been fully implemented but will greatly enhance corporate reporting in the future. Today, I want to concentrate my comments on: (1) What PwC has done to lead change in the new environment; (2) how the new requirements are impacting PwC and the profession; and (3) what needs to be done in the future.

Meeting the Rules in Letter and Spirit

Now, the challenge is for all of the market participants to implement the necessary reforms in a manner that places the interests of investors above all others. The Act requires participants in the financial reporting process to take responsibility for their actions and every party must play his or her role. For example, managements, boards, and audit committees need to carry out their fiduciary responsibilities, investors should research companies prior to investing, underwriters should see that adequate due diligence is performed, lawyers should perform as officers of the court, regulators should enforce the rules, and auditors must provide unbiased opinions on the information that is being provided to investors.

The Act clearly intended that investor interests be the overriding requirement. Therefore, in addition to complying with the letter of law, we must be especially diligent in implementing the spirit of the law.

The Act and the rules adopted by the SEC establish clear lines of accountability. Accountability is an important deterrent to objectionable behavior. Behavior drives many of the areas addressed in the Act (such as executives' compliance with ethical

[1] "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

codes), but ethical behavior cannot be legislated. Therefore, public trust will *only* be attained and the goals of the Act achieved if the people with responsibility for implementing the requirements do so with integrity. Where integrity is lacking, neither rules, regulations, laws, concepts, structures, processes, best practices, nor the most progressive use of technology, can ensure accountability or compliance. This will only occur when people of integrity do the right thing, not what is expedient or even necessarily permissible. Ultimately, people's actions are what matter, not what they say or the wording of a particular regulation.

We fully support the PCAOB's mission to refocus the accounting profession to help restore public trust. PCAOB Chairman William McDonough's comments in a recent speech given at a New York State Society of CPA's conference are hard-hitting and appropriate,

> I expect that you, as members of a regulated profession, know what the rules are. I expect that you are following those rules, both in their letter and their spirit . . . If you depart from those expectations—that is, if you break the rules, if you ignore the spirit of the law even while meeting the letter—woe be unto you.

Embracing Change

Many of the Act's provisions have and will require change in the way we do business. Change can be unsettling but also very positive. At PwC, we are embracing these changes, implementing them both in letter and spirit, and doing everything in our power to regain trust in our profession.

Like any profession, we would have preferred a self-regulatory model that worked. Clearly, the former model did not, and it has been replaced with something far different. The PCAOB is now our independent regulator with responsibility for standard setting, quality control, and discipline. We and others in the profession are committed to the success of the PCAOB. Our profession has a critically important role in the financial reporting supply chain, and given the importance of this role, our regulatory system must be effective in fact and in appearance. As an independent body overseen by the SEC, the PCAOB will promote that effectiveness. And we intend to do our part by working constructively with the PCAOB to restore the public trust.

We are implementing the changes brought on by the Act across our global organization. PwC member firms have approximately 120,000 employees and 8,000 partners worldwide, and operate in more than 140 countries. Our firms are generally organized as separate national partnerships, but share a common strategy, common methodology, and quality control system. Many of the provisions of the Act affect our operations outside the United States, especially those firms that audit significant numbers of entities registered on U.S. exchanges. The impact of the Act on these non-U.S. operations is especially challenging because of the interplay among different regulatory and legal systems in the various countries.

Examples of Change within PwC

PwC and many of the other large accounting firms are developing new policies, tools, systems, and methodologies for complying with the letter and spirit of the Act. The following section highlights some of the key changes that are being made at PwC.

Audit Methodology

We have updated our audit procedures to ensure we are addressing today's risks and meeting investors' expectations. To that end, recent policy changes and improved guidance focuses on the following key areas:

> *Helping audit teams develop a better understanding of their clients' businesses and industries, in order to effectively evaluate the risk of material misstatement and the controls that management has in place to mitigate that risk.*

PwC Audit, our global audit methodology, sets forth a framework to help audit teams understand their clients' businesses. This framework includes information about the markets in which the companies operate, their strategy for increasing shareholder value, critical value drivers, and internal performance metrics used by management. Our research shows that this is the type of information investors use to make investment decisions and, therefore, it is an important input for the audit team in forming its point of view on the client's business and risk, including audit risk.

In testing the information that management uses to run and control its business, we reconcile this information with that which management communicates to the investors in its external financial reports. This helps us assess the transparency of financial reporting, as well as the risk of material misstatement. We also provide

guidance to our teams to use specialists when audit risk is increased by the presence of complex information technology systems, or when the risk of material error due to management fraud exists.

In anticipation of next year's reporting requirements around internal controls under Section 404 of the Act, our public company audit engagement teams have been encouraged to take a greater "controls-based" approach to their audits this year. While this level of controls testing is not the same as will be required for an attestation under the Act, it will enable our teams to communicate identified weaknesses in key controls to audit committees in the current year, as part of the financial statement audit process.

Increasing our consideration of the risk of management fraud and our ability to detect a material misstatement in the financial statements due to fraud.

Our audit teams around the world are increasing their emphasis on understanding the risk of fraud in the companies we audit as well as the fraud deterrence controls and procedures within those organizations. They are also performing additional fraud detection procedures as part of the financial statement audit. These procedures include:

- Consideration of key incentives and pressures to commit fraud;
- How best to conduct client interviews regarding fraud;
- Consideration of five key fraud risk areas: (1) Revenue recognition, (2) journal entries and other adjustments, (3) management's accounting estimates, (4) significant unusual transactions and (5) suspense and inter-company accounts.

Engagement teams are required to determine, as part of our annual client acceptance and continuance process, whether heightened fraud risk exists based on specific criteria set forth in our policy. If the team determines there is a heightened risk of fraud, they should consult with a risk management partner and a fraud detection specialist to determine whether additional procedures should be performed to mitigate the risk of error due to management fraud.

Recognizing our changing relationship with audit committees through increased communication.

Communicating effectively and candidly with audit committees is critical in today's environment. We have implemented a required audit committee communications framework that is used throughout the audit, from planning to completion. The framework covers four specific topics: Our audit approach; our views on the company's level of audit risk and management's controls to mitigate key risks; the reliability and transparency of management's financial reporting; and corporate governance. Our public company engagement teams around the world are engaged in a dialogue with audit committees on these topics. This is in addition to the required communications under the Act and U.S. Generally Accepted Auditing Standards (GAAS).

U.S. Partner Compensation System

Many of the key components of our partner compensation system were in place prior to the Act. However, the Act provided the impetus to review the current system to ensure compliance with the rules. The resulting changes have been fully implemented for our current fiscal year.

PwC's reward system is aligned with the behaviors we expect from our partners. Our policy is to reward all partners equitably based upon the partner's responsibilities, role in the firm, and thier actual performance. The PwC U.S. Partner Income System is primarily based on two components of income: The partner's level of responsibility within the firm (Responsibility Income) and the firm's performance (Equity Share Income). In addition, in a year when a partner delivers outstanding performance, he or she may also receive a performance award. We recognize the potential conflict of interest that can arise when a partner is directly compensated for selling nonaudit services, and consistent with the SEC's rule, we do not compensate audit partners for selling nonaudit services. Further, our system is not commissions-based, nor is it tied to audit or nonaudit service revenue targets. The following is an expanded description of our compensation structure:

- *Responsibility Income.* The responsibility component of a partner's income reflects what the partner does and the degree of complexity inherent in that role. Each partner is assigned an appropriate responsibility level with a fixed level of income.
- *Equity Income.* The equity component of a partner's income is based on how well the overall firm has performed and the assigned number of equity units or shares for the partner's level of responsibility.

- *Performance Income.* Performance income is awarded to a small number of partners each year, based on the partner's individual performance against goals established at the beginning of the year.

In compensating our partners, the firm is mindful and fully supportive of the SEC's public policy goals. Most important, good judgment must be exercised in all cases to comply with both the letter and spirit of the Act.

Compliance and Independence Systems

PwC has made significant investments in state of the art systems for independence compliance. We are committed to continuing to provide the resources, systems, and processes that our firms and people need globally to comply with the rigorous auditor independence standards established by standard-setting bodies and regulators in the many different territories in which we operate.

The compliance framework that we have put in place predated the Act, and we have been able to use this robust framework quite effectively to implement the necessary regulatory changes. PwC member firms operate around the globe. Audit engagements performed in any given country (especially those that span borders) involve a complex—sometimes overlapping, sometimes contradictory—web of independence rules. PwC has addressed this challenge by putting in place a global framework of people, policies, processes, and systems to ensure compliance with all standards. Within this framework, PwC firms are responsible for establishing policies and conducting activities to help ensure independence compliance. The global organization establishes baseline standards and monitors territory[2] activity to help ensure compliance. Key elements of this framework include a global organization of independence experts, global independence policies, sophisticated compliance monitoring systems, a global database of restricted entities, periodic training programs and technical communications, and substantive disciplinary processes.

PwC's Global Independence Policy sets forth principles and requirements to be followed with regard to all PwC audit clients, with emphasis given to major independence requirements that apply to certain types of audit engagements, for example, SEC audit clients. The global independence policy is based on the International Federation of Accountants (IFAC) Code of Ethics, since the Code is the only recognized worldwide standard for independence with respect to all audit engagements. The policy sets forth basic requirements that apply to all audit clients, and provides for incremental restrictions and processes with respect to SEC audit clients and such other audit clients as necessary.[3]

In many instances, we have consciously established independence policies that exceed the requirements of IFAC, the SEC, and other standard setters. This remains true even today with all of the additional requirements resulting from the Act. For example, the PwC independence policy generally prohibits partners from investing in any PwC audit client, while the IFAC Code restricts only those partners that have certain direct connections to the audit engagement.

While policies, communications, and systems are important components of the compliance framework, we also conduct compliance reviews of our firms and our people. Beginning this year, we have instituted a global process to formally review and test compliance with independence activities in each territory. In conducting these reviews, we focus on the territory's organization, processes, policies, and compliance with PwC, regulatory, and local professional independence rules.

The PwC disciplinary policy holds persons found to have violated the PwC independence policy accountable for their actions, and discipline is based on the severity of the violation. Partners and staff who violate the independence policy are subject to sanctions including written reprimands, suspensions, monetary fines, and termination.

Selectivity Process

Some clients present us with much more risk than others. The riskier clients tend to have poor internal controls and/or an overly aggressive management. These clients generally have more errors and misstatements in their financial statements. This often carries too much risk for us. Accordingly, during the last year, the PwC U.S. firm chose to reexamine its entire client portfolio—with the primary goal of reducing overall risk. Engagement partners, risk management partners, and firm

[2] "Territory" refers to all of the PwC legal entities within a country. In certain instances, the legal entities in multiple countries comprise a territory.

[3] As an example, the IFAC Code permits an audit firm to have an immaterial joint business relationship with an audit client as long as certain safeguards are applied. The SEC rules prohibit joint business relationships with SEC audit clients regardless of materiality or safeguards.

leadership reviewed all clients that exhibited a higher level of risk as determined by guidelines established by our Risk & Quality Group.

In total, 842 public and nonpublic clients were selected for such review. In each case, the client's risk factors were carefully evaluated as to whether the audit team could effectively manage the risk. For those clients where it was determined that PwC's risk was too high, the situation was discussed with the client's audit committee and/or management, who were given the opportunity to make the necessary changes within their organizations. If we believed the risk profile was still too high, PwC exited the relationship. The U.S. firm terminated relationships with 159 clients—representing about 250,000 annual audit hours.

Our actions have sent a strong message to the business community that PwC is standing firm on audit quality. PwC will continue to reevaluate client relationships in this manner and exit those relationships where the client risk profile is beyond our acceptable limits.

Thought Leadership

When the Act was first passed, many were unclear on how its myriad provisions would impact them from both a technical and practical standpoint. In response, we got out in front of the issues and presented our viewpoints by developing a variety of thought leadership pieces that explored how the Act would impact the various market participants and our profession. These activities included the following:

- Webcasts: We held a series of webcasts designed to explore the implications of the Act——
  - Corporate Responsibility under Section 302 of the Sarbanes-Oxley Act;
  - Discussion on the Hill;
  - Final Rules on Auditor Independence and;
  - Web cast Series on Section 302, Section 404, and Auditor Independence.
- White Papers: We produced three white papers that focused on key issues highlighted by the Act——
  - *The Sarbanes-Oxley Act of 2002: Strategies for Meeting New Internal Control Reporting Challenges—November 2002*
  - *The Sarbanes-Oxley Act of 2002 And Current Proposals by NYSE, Amex, and Nasdaq: Board and Audit Committee Roles in the Era of Corporate Reform—February 2003*
  - *The Sarbanes-Oxley Act of 2002: Understanding the Auditor's Role in Building Public Trust—August 2003*

Learning and Education

In January 2002, the U.S. firm launched PwC University for its partners. The University provided partners with a forum to discuss our business strategy and reinforce a culture of quality throughout our organization. The design is built around several themes, which include driving quality throughout PwC and living our values of leadership, excellence, and teamwork. We also stress the need for personal development and continuous improvement. Since its inception, over 1,700 U.S. partners have attended this program.

In May 2002, we launched the first Quality Lens educational course for our audit partners and 995 partners had completed the course by year-end. Among other things, Quality Lens focused on the underlying behaviors essential for an auditor, including: Professional skepticism, objectivity, and independence. In May 2003, we relaunched Quality Lens for our audit partners and managers to further strengthen our focus on quality. Training included coaching and mentoring; performing investigative interviews; and handling other difficult situations. Finally, partners and managers participated in an audit simulation, which focused on the application of audit methodology and communications with audit committees and management. To date, over 2,000 partners and managers have attended this 3-day program. In addition to the above, we have rolled out training for our partners and staff focusing on the framework for internal controls and testing, business risks, controls that mitigate those risks, fraud, and the use of specialists.

Finally, skills and knowledge related to U.S. generally accepted accounting principles (GAAP) are critical to our profession and, as such, represent a significant area of training for our partners and staff. A core part of the curriculum comprises just-in-time training on Financial Accounting Standards Board (FASB) releases and implementation guidance from the FASB's Emerging Issues Task Force (EITF). Additional classroom training provides a forum for discussion and guidance on complex accounting issues related to topics such as stock-based compensation, derivatives, affiliated entities, income taxes, and revenue recognition.

Impact On the Way We Do Business

The Act has already had a profound impact on our business—from our audit and tax practices to our firm's structure and the regulatory environment in which we operate.

Dramatic Changes to the Audit Relationship

One of the most significant changes arising from the Act is our direct linkage to audit committees. The Act now requires all public company audit committees to accept a higher level of responsibility, and we have begun to see the impact of that requirement. Audit committees are meeting much more often. They are more involved. They are probing much more deeply, and they are challenging what they are being told. This is excellent news for the investing public.

This change is significantly enhancing the audit process because the audit committee is much more attuned to investor protection and is actively supporting our audit efforts. All of this comes at a cost, however, and we should recognize this. We are spending more time on our audits as is appropriate. Audit committees are asking us to do more, our audit procedures have been expanded, and we have more senior people spending more time on audits resolving complex accounting questions. Our audit fees reflect this new environment, but it is a cost that is relatively small compared to the benefit—a greater focus on investor protection.

Another cost is associated with the new Section 404 requirements to attest to the soundness of internal controls. We believe that this is one of the more significant requirements of the Act. When accounting problems occur it is often because the internal controls are weak. I am confident that the benefits of more transparent reporting and improved controls will far outweigh these additional costs.

On average, this expansion in the scope of the audit has increased the time spent on audit engagements by about 10–15 percent. This increase does not include the additional work required for full compliance with Section 404 of the Act. We have invested significant dollars in hiring, training, and retaining highly qualified staff to ensure that the high quality of our audits is maintained. A tight market for auditing professionals has required us to increase compensation more than normal, and we have also spent about 15 percent more in training costs so that our staff has the necessary skills to deal with the new rules and regulations. Finally, our insurance premiums for practice protection have soared due to increased litigation in the accounting arena, fewer reinsurers, unfavorable investment returns for insurance companies, and large insurance company losses. For our U.S. firm, practice protection costs are now the second largest cost of doing business, second only to the compensation provided to its people.

A Significant Decrease in the Demand for Tax Services

One of the more controversial audit independence issues arising from the Act has been the provision of tax services to audit clients. The SEC largely settled the debate on tax services in the accompanying discussion section to its auditor independence rule, which rightfully acknowledges Congress's intent to expressly permit audit firms to provide tax services to audit clients. This was in recognition that these services are an integral part of the services provided by an accounting firm and that better audits are performed when tax professionals are involved with the complex and difficult judgments that need to be made with regard to a client's tax accruals and expenses.

Nonetheless, there seems to be a continuing drumbeat that auditors who provide tax services to audit clients are not independent—even though Congress and the SEC carefully considered the issues and concluded to the contrary. As a result, our tax practice has experienced a significant decrease in demand for these services from our SEC audit clients. The decrease in the United States has been around 20 percent and evidence shows that the trend is continuing. One of the great checks and balances built into the Act is the audit committee's preapproval process. We fully support this process but the continuing rhetoric around tax services may be pushing the pendulum too far from the mark. Precluding accounting firms from rendering tax services to their audit clients and the inevitable long-term consequences of an exodus of tax talent from accounting firms will not serve investors well.

Changes to the Business Model

In recent decades, accounting firms, traditionally providers of audit, tax, and related advisory services, became multifaceted service providers. This development, in my view, commenced in the 1960's with the dawning of the information technology age, and was further accelerated by the removal of marketing restrictions by the Federal Trade Commission. To meet the demand for a broader array of services, accounting firms began to employ a wide range of professionals with varied back-

grounds. Over time, the influence of these professionals grew and, as a result, the cultures within the firms slowly evolved from ones that were built around providing traditional audit, tax, and related advisory services to ones that de-emphasized those areas in favor of consulting services. In the 1990's, these consulting practices grew enormously.

We disposed of our consulting practice in October 2002. In addition, we disposed of certain other businesses such as our human resource consulting group and corporate valuation business.

Today, our practice is made up of three lines of service: Audit, tax, and advisory. Our audit practice is focused on providing assurance on financial information. Our tax practice provides a broad range of tax services from preparing tax returns to providing advice on the optimal treatment of economic transactions. Our advisory practice provides a broad range of services focused in large part on risk assessment and risk management. This practice is built on the core skills found in our audit and tax practices.

New Regulatory Oversight

In August, the PCAOB inspection staff began what they refer to as "limited inspection procedures" for each of the Big Four firms. The first part of the inspection process includes interviews with our national leaders and reviews of internal documents to gain an understanding of our firm's policies and procedures, and gain other insights into our operations. The second part consists of visits to certain practice offices and interviews with professional staff members at all levels. It will also include verification of information accumulated at the national level. Further, the inspection staff has told us that they will perform an in-depth inspection of the working papers in certain areas of selected issuers' audit engagements.

In the letter accompanying their data request, the PCAOB staff confirmed that the procedures they perform this year would focus on behavior, culture, and other important processes including: tone at the top; partner evaluation, compensation, promotion, assignment of responsibilities, and discipline; independence implications of nonaudit services; business ventures, alliances, and arrangements; commissions and contingent fees; client acceptance and retention; our internal inspection program; practices for establishing/communicating audit policies, procedures, and methodologies, including training; and policies/procedures for work performed by foreign affiliates on foreign operations of U.S. audit clients.

Their data request covered a wide range of items: our values and Code of Conduct; organization charts; agendas for and minutes of management and board meetings; policy materials in the areas listed above; client satisfaction survey forms and summary results; staff survey forms and summary results; lists of public company proposals/reproposals; public clients we no longer audited in the last year; descriptions of our current business model and strategic business plans, and the financing structure of the firm; descriptions of industry and geographic programs; communications from leadership to partners and staff; and details about our partner evaluation and compensation process and its outcomes, among other things.

We have provided all of the data requested and are responding to follow-up questions and requests for additional details. The interviews with national leaders have all been scheduled and will be completed by October 1. The first office visit is scheduled for October 6. We understand that the PCAOB's goal is to issue their report in December.

Our interactions to date provide us with a glimpse into our future in this new environment. It is clear that the scrutiny will be intense. We have approached our interactions with the PCAOB and its staff with a mindset of cooperation and openness, with the hope that PCAOB will share our goal of continually enhancing our systems and processes. We hope that the foundation of the inspection process will be the shared purpose of rebuilding the public trust in our profession rather than reprimands for unintentional errors.

Future of the Accounting Profession

Entrants into the Profession and Accounting Education

Much has been said about the need for the profession to recruit the best and the brightest. But the issues the profession faces in this area are really two-fold. First, can we continue to attract the right people into the profession and second, is the quality of education today sufficient to properly train these young people?

One has to be concerned, given the events of the last couple of years, about whether the best and the brightest students believe this profession offers them the long-term opportunity they are seeking. With confidence in the profession at a low point, with the media constantly focusing on the negative, and with the example of

one of the most prestigious firms—Andersen—failing, I am concerned about the appeal of our profession to the next generation.

We cannot fulfill our mission without attracting and keeping the best and the brightest. No profession can. All the best efforts to restore public confidence will fail if independent auditing professionals are not on an equal intellectual and motivational footing with the executives of the companies they audit.

We have some concerns about the curricula. The U.S. firm sponsored a study of the curricula at nine universities that produce a large number of graduates for the large public accounting firms. Completed in late 2002, this research broke new ground in the breadth and depth of its analysis of what is actually happening in the classroom and in understanding the intersection between collegiate education and continuing professional education. To stimulate productive dialogue on the future of accounting education, we distributed our monograph, *Educating for the Public Trust: PricewaterhouseCoopers Position on Accounting Education,* to over 4,000 U.S. accounting faculty and business school deans.

In addition, the firm and its partners and staff commit millions of dollars each year to support various curricula, faculty research, and other accounting educational programs in the United States. We also sponsor PwC conferences and training programs for faculty as well as other initiatives that promote our profession among high school and college students.

Not only do we provide significant financial support, but we also spend a significant time and effort attracting top talent. This year alone, 700 partners will spend 35,000 hours on this effort. Our continuing investment and commitment to accounting education is absolutely critical to our future—it is our future.

The Success of the Profession

The profession is at a critical juncture. We can no longer count on our proud history to speak for our importance. We must stand and be counted; and in doing so, establish a professional reputation will ensure that we are recognized as leaders in the capital formation process. Our integrity must be beyond question. In addition to simply conducting business in an appropriate manner, a number of matters will need to be addressed by PwC, the profession, regulators, investors, attorneys, underwriters, analysts, and others.

The following should be at the forefront of the profession's agenda:

- Ensuring that our firms have the right "tone at the top" and commitment to quality, excellence and restoring investor confidence;
- Recruiting, developing and retaining the best and brightest professionals;
- Converging systems, standards, and regulatory regimes globally and;
- Making sure that our business model appropriately balances our risks.

I also believe that, for the sake of the investing public, the PCAOB needs to set auditing standards that will enhance investor confidence. The PCAOB should seek the advice of professionals who have the practical experience to effectively develop auditing and other technical standards for the profession.

I invite my colleagues in the profession as well as investors, regulators, attorneys, and others to join me in addressing these complex matters. We must remain true to our vision. We must also make sure that we hold one another to the highest possible standard and encourage those seeking entry into the market. Investors will benefit from having a broad range of qualified auditors. In this regard, regulators and others need to recognize how their actions may create barriers to entry.

A Proper Assessment of the Effects of the Act

The Act provides a good roadmap for moving ahead. However, as the most comprehensive piece of legislation affecting corporate governance and financial reporting since the securities laws of the 1930's, the new regulations adopted under the Act must be given ample time to prove their usefulness. It is critically important that we all be patient and not rush to judgment if something does not appear initially to be achieving its goal.

By taking a long-term approach, we will discover the law's true effectiveness in meeting its objectives. Auditors, audit committee members, executives, and others have just begun to work through the many nuances of complying with the new regulations and some aspects are not yet effective. Additional time must pass before we step back and evaluate the effect of the Act to see whether its key objectives—to protect investors by improving the accuracy and reliability of financial disclosures and restoring investor confidence—have been met. It is absolutely critical, however, that we first allow the rules to "sink in" to corporate America's consciousness and truly have a measurable effect on financial reporting and investor confidence. Only then can we make a valid assessment of the law's impact. To evaluate too soon and

launch further rulemaking projects would layer regulation upon regulation and risk further erosion of the public trust.

A Concerted Effort is Needed

Many parties, including corporate managements, boards of directors, audit committees, auditors, investment banks, attorneys, securities analysts, rating agencies, standard-setters, and regulators were accused of contributing to the string of U.S. corporate failures that shocked the world financial community. As SEC Chairman William Donaldson testified recently before this Committee, "The sweeping reforms in the Sarbanes-Oxley Act address nearly every aspect and actor in our Nation's capital markets." Because many viewed the corporate failures to be the fault of so many, Federal lawmakers adopted a law that was intentionally far-reaching in scope and effect. As mandated by the law, the SEC adopted rules that implement several provisions of the Act, and the General Accounting Office (GAO) and SEC launched various studies. Shortly thereafter, the major U.S. stock exchanges proposed new rules for listed companies. The PCAOB worked quickly to establish itself and commence rulemaking and registration activities.

The lawmakers and the regulators have responded. Now it is time for groups and individuals who prepare, communicate, or use corporate reporting information to stand and be counted. Clearly, it is not enough that lawmakers and regulators change the rules; the players must be ready, willing, and able to apply them in the spirit in which they were intended. If they do not, then the effect of the Act will be muted and the desired impact lost. As auditors, we stand ready not to let that happen. As a firm, we have championed the cause of the Act by authoring books, white papers, and articles and making those publications widely available. We have taken every opportunity to spread the message of what needs to be done both inside and outside of the accounting profession to strengthen and safeguard our capital markets and restore investor faith in those markets. We will continue these efforts.

Conclusion

In conclusion, let me thank you for your leadership and support to reestablish and strengthen investor confidence and integrity in the capital markets. Rest assured that, at PwC, we understand the importance of the role that we play in the capital formation process. Further, we eagerly look forward to embracing change in the future as well as today. I have great faith in the market and the private sector. This market is the most effective and efficient ever devised.

Thank you again for inviting me to speak on behalf of PricewaterhouseCoopers. I would be happy to answer any questions.

PREPARED STATEMENT OF EDWARD NUSBAUM

CHIEF EXECUTIVE OFFICER, GRANT THORNTON, LLP

SEPTEMBER 23, 2003

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, thank you for inviting me to testify today concerning the impact of the Sarbanes-Oxley Act (the Act). I appreciate having the opportunity to discuss this important subject with you.

We have seen the effects of the Act first-hand and our chief conclusions are:

(1) The Act has had a positive influence on corporate America, financial reporting, and the accounting profession. It has been a step in the right direction to restore trust and confidence in the capital markets. Investors are the winners from this Act, with greater reliability in financial information. Grant Thornton congratulates you on having the courage and foresight to adopt this Act. With the benefit of 1 year of history, the Sarbanes-Oxley Act has been, in our opinion, a success.

(2) Proper continued execution of the Act is key to restoring investor confidence. The Act contains many provisions that are just now being implemented. Government regulators, the new Public Company Accounting Oversight Board, the accounting profession, corporate America, and all other stakeholders must work together to accomplish the objectives of the Act. A principles-based approach is necessary for the successful implementation of the requirements of the Act.

(3) And there is more that needs to be done. To improve financial reporting worldwide, each of those bodies responsible for accounting, auditing or independence standards must implement principles-based standards and international accounting and auditing standards must converge. Grant Thornton and other accounting firms must work with the PCAOB to improve the audit process. Working as a team, corporate America, investors, the Securities and Exchange Commission (SEC), the

PCAOB, the Financial Accounting Standards Board (FASB), the international standard setters, the accounting profession, and other stakeholders can improve the business reporting model and the quality and transparency of information used by investors and creditors.

(4) Grant Thornton and other leaders in the business community have responded to both the spirit and substance of the Act. We have spoken out on the need for reform and worked hard to support the implementation of the Act. Again, we appreciate your efforts to adopt this important legislation. Grant Thornton is committed to take the steps necessary to ensure its continued success.

About Grant Thornton

Since our founding in 1924, Grant Thornton has focused on providing audit and tax services to mid-size companies, generally those with revenues between $25 million and $2 billion, although we have clients both larger and smaller. Grant Thornton International is the world's leading accounting, tax and business advisory organization primarily dedicated to mid-size companies. Through our network of 585 offices in 110 countries, including 50 offices in the United States, partners of the member firms of Grant Thornton provide personal attention and seamless service delivery to public and private clients around the globe.

How the Act has Positively Impacted American Business and the Accounting Profession

I believe that the tone of an organization starts at the top.

As I wrote in *Chief Executive* magazine this past year—which was cited in the House Committee on Financial Services' recent publication, *The Sarbanes-Oxley Act: The First Year; Rebuilding Investor Confidence, Protecting U.S. Capital Markets*—under Sarbanes-Oxley, the role of CEO has taken on a new dimension as numerous new responsibilities and potential for penalties for corporate wrongdoing—including prison—now stop directly at the desk of the CEO.

In the past, many CEO's did not worry about the state of their internal control systems. Many CEO's, absent a specific regulatory mandate, came to believe their control system was adequate—even though they had no way to prove that to be the case if asked. Today, because of the Act, the SEC requires CEO's to back up that fact with a signature and actual evidence. The increased role of the CEO in financial reporting has been, based on our experience, a positive step.

The Act has clarified and, in some cases, strengthened the role and responsibility of boards of directors and audit committees. Boards can no longer blindly rubber-stamp the actions of management. They now must work side-by-side with the auditors to ensure the shareholder interests are protected. Audit committees must be more independent and expert in carrying out their vital duties. Again, our experience has been that most audit committees and boards of directors have increased the number and quality of meetings, and the members of most audit committees and boards appear to be taking their role more seriously since the adoption of the Act.

The Act is forcing public companies and their auditors to make sure that the financial statements are squeaky clean as restatements have jumped 30 percent over the past year. And despite warnings of increased lawsuits against corporations, that has not happened, as according to *The Wall Street Journal*, "Both the number of class-action lawsuits and the size of settlements are consistent with previous years." (*The Wall Street Journal*, "Sarbanes-Oxley Affects Suits Little, Study Says," by Kara Scannell, July 24, 2003.)

Thanks to the Act, the quality of information provided to investors from corporations has improved, and we believe that changes mandated by the Act prohibiting auditors from providing certain services, such as consulting, to their public audit clients has helped in restoring trust in the accounting profession. In fact, a recent Gallup Poll found that the image of the accounting profession has improved significantly over the last year, more than any other profession tested.

According to the poll analysis, "The one industry whose image has improved the most compared to last year's is accounting, which has risen from a net rating of 0 percent last year (that is, as many people gave it a negative rating as a positive one) to a +31 percent this year. Other industries and business sectors tested include the computer industry, real estate, banking, the legal field, the airline industry, and healthcare." While one could argue that the accounting profession had significant room to improve, we are pleased to see that the Act, combined with the actions of Grant Thornton and other accounting firms, has helped to restore the public's image of our profession. Most important, the Act has helped restore the public's confidence in financial reporting.

Execution of the Act is Key to Improvements in our Financial Markets

The Act established the PCAOB, which is now beginning to execute its provisions. We believe that accounting firms must not only cooperate with the PCAOB, but also act as leaders to help the PCAOB operate effectively. Likewise, the PCAOB should not only monitor and discipline accounting firms, but should also work with the firms to improve the audit process. This cooperation between the new Board and accounting firms should result in further improvements of the financial reporting process. The functioning of the PCAOB will be a major factor in evaluating the success of the Act in future years. The focus of the PCAOB and the Government should not be on increased litigation against accounting firms, but instead on helping accounting firms work with the PCAOB and Government to ensure the successful implementation of the Act into the foreseeable future.

Although there have been several well-publicized allegations of accounting misdeeds and auditing failures, there are many more instances where auditors have discharged their professional responsibilities, uncovering fraudulent acts. It is equally important that the PCAOB, in addition to disciplining auditors, find the means to recognize and reward auditors who act without self interest to protect investors.

Some provisions of the Sarbanes-Oxley Act are crystal clear. Other provisions are subject to interpretation. Grant Thornton believes that any gray areas in the Act must be implemented in the spirit of transparency and investor protection. We believe that was the intent of you, the bill's authors.

The internal control provisions of the Act are also just now being implemented. The degree of an auditor's independence is driven by the separation between management (which produces the financial information) and the users of the information provided by management. The standard for independence is heightened as that separation increases. We firmly believe that the auditors of publicly held companies must hold themselves to the highest possible standard of independence.

For this reason, Grant Thornton will not accept engagements to document, evaluate, or design our public audit clients' internal controls, including engagements to document existing controls, or to perform evaluations of existing controls that management uses to support their conclusions regarding the effective design of those controls. To do so, we feel, is a conflict of interest. Instead, as auditors, we will audit the internal controls as designed, documented, and evaluated by management, in accordance with the provisions of the Act.

What Still Needs to be Done

For the last 20 months, we have been advocating the need to adopt a principles-based approach to accounting standards setting. Enron's former Chief Financial Officer Andrew Fastow created hundreds of "special-purpose entities" to hide Enron's debt. He argued they were within the letter of the law, under the current rules-based approach to accounting. But we must ask ourselves, "Is this right?" Is this what financial disclosure is about? Or is it presenting the truth and transparency to investors and other stakeholders? I strongly believe that the accounting profession and the standards setters (the FASB, SEC, PCAOB, etc.) need to embrace a 'spirit of the law' versus "rule of the law" approach to standards setting. The current rulebook approach for all standards setting fosters a culture of "if the rulebook does not specifically forbid it, it must be okay."

Albert Einstein said, "The problems that we have created cannot be solved at the same level of thinking that created them." A principles-based approach is necessary for the successful implementation of the requirements of the Act. Rather than establishing a new set of complicated rules—which is the approach that fostered the problems the Act seeks to solve—we believe a focus on principles will result in stronger adherence to the spirit of the Act. A principles-based approach would provide greater assurance to the public and investors that management, auditors, and those responsible for corporate governance will do the right thing.

Convergence with international accounting standards will also improve the global quality of reporting. Consistent accounting principles throughout the world will allow global corporations and auditors the ability to improve financial reporting. Further, a principles-based approach to accounting standards would provide greater assurance to the public and investors that management, auditors, and those responsible for financial reporting will provide information that is in the public's best interest.

There also must be a renewed effort to improve the current business reporting model. Grant Thornton has taken a leadership role in this effort. In December 2002, the board of directors of the American Institute of Certified Public Accountants (AICPA) formed a special committee on enhanced business reporting (the special ommittee) and appointed our Managing Partner of Strategic Services, Mike Starr,

as the Chair. Under the leadership of Mr. Starr, the special committee adopted the following mission:

> "To establish a consortium of investors, creditors, regulators, management, and other stakeholders to improve the quality and transparency of information used for decisionmaking."

The special committee has also written a monograph, *Enhanced Business Reporting,* which grounds the project intellectually and guides future activity.

Ned Regan, President of Baruch College and former New York State Comptroller, is set to meet with the special committee to discuss the steps necessary to establish and launch the consortium. Mr. Regan will lead the efforts to recruit a small group of very prominent U.S. business and civic leaders to help put together an Enhanced Business Reporting Consortium. The members will be high-level representatives of prominent business, accounting, auditing, investor, creditor, foundation, and Government groups. This will be done carefully so the Consortium will have representatives from all the key groups necessary to make this significant change in reporting.

It is anticipated that the Consortium members, from their positions of national stature, will be advocates for enhanced business reporting and guide our collective activities to make the project goals a reality. When fully organized, the Consortium will be freestanding, with financial support coming from the AICPA and several foundations. Subject to special committee approval, staff, research, and conference activity is expected to be headquartered at Baruch. Academic and foundation partners in other parts of the country are expected to join with Baruch in supporting the Consortium's activities. The objective is simple; improve the quality and transparency of business reporting as part of the process to rebuild investor confidence and protect capital markets.

The first building block for improving the business reporting model is effective corporate governance, and effective corporate governance starts with a board of directors who demonstrate a fierce commitment to integrity; demand excellence in all efforts; provide leadership, and motivation; and, display respect for people, ethical standards, laws, and regulations. Strong corporate governance is the bedrock upon which high quality, transparent information is built. And executive and director compensation is the litmus test for determining the effectiveness of corporate governance.

The second building block is transparency. However, it must be noted that effective corporate governance is necessary to ensure that there is transparency in the information reported by management. Warren Buffet explained the need for transparency in his letter to the shareholders in the Berkshire-Hathaway, Inc. 2000 annual report, stating that:

> "At Berkshire, full reporting means giving you the information that we wish you to give us if our positions were reversed. What Charlie and I would want under that circumstance would be all the important facts about current operations as well as the CEO's frank view of long-term economic characteristics of the business. We would expect both a lot of financial details and a discussion of any significant data we would need to interpret what was presented."

Investors and creditors should have the right to see an entity through the eyes of management. Competitive disadvantage should not be used as an overarching basis to avoid providing information to investors and creditors. Competitors frequently know a great deal about an entity from former employees, mutual suppliers and customers, market research, industry publications, engineering studies of products, and the marketplace itself.

Globally accepted accounting principles are at the core of enhanced business reporting. In addition to the basic financial statements, management needs to provide users with insight into management's assessment of:

- Competition and industry factors that effect the entity's position in the business environment;
- Current and future regulatory developments that may effect business strategy; and
- Factors such as the general economy or demographics that may effect business performance.

Currently, MD&A is nothing more than a narrative recitation of information contained in the financial statements. Management needs to provide information about the entity's strategy, plans, opportunities, and risks. These quantitative and qualitative disclosures need to focus on key performance indicators and how these indicators compare to industry peers. We need to develop commonly accepted definitions and principles for these performance indicators.

The enhanced business reporting model requires a change in the auditor's role. Auditing standards need to provide guidance on how to provide assurance on the qualitative disclosures required by information transparency. As stated above, Grant Thornton and other accounting firms must work with the PCAOB to improve the audit process. Working as a team, corporate America, investors, the SEC, the PCAOB, FASB, the international standard setters, the accounting profession, and other stakeholders can improve the business reporting model and the quality and transparency of information used by investors and creditors. We ask you to continue to support the cooperation and efforts to accomplish this goal.

What Grant Thornton is Doing

I am proud to say that in February 2002, we issued the Grant Thornton Five Point Plan to Restore Public Trust. As a result, Grant Thornton became the first global accounting organization to provide a program of reforms to regain public trust in financial information. The points are:

The policies and reward systems of the major firms must reflect an uncompromising commitment to professional excellence. The actions of the management of those major firms must make it clear that nothing is more important than their professional responsibility. In addition, all the major firms must collectively agree to limit the nature and extent of services provided to publicly held clients. Such agreement should specify that the firms would only provide assurance and advisory and tax services to their publicly held audit clients. For example, certain consulting services such as outsourcing should be prohibited. We must change our business models significantly in response to the demands from the public. To do otherwise ignores a fundamental precept: That businesses set priorities based on those drivers that have the greatest impact on earnings. Assurance and advisory and tax services must once again be the business drivers and focus for the auditors of SEC registrants.

Audit committees must ensure that the auditor's primary responsibility is to the shareholders and that the auditor's relationship with management is clearly subordinate to such responsibility. Audit committees must do a better job of protecting shareholder interests. They must challenge management and the auditors on the treatment of significant accounting issues. They must be diligent in determining that their auditing firms are free of conflicts of interest. The audit committee plays a critical role in this regard. The regulators need to take the steps necessary to reinforce the audit committee's need to be truly independent of management. Audit committees must be vigilant in performing their duties to ensure that the appropriate auditor-client relationship is maintained and that management is challenged on all significant transactions, including the underlying business purpose of those transactions.

The SEC must amend its rules for proxy disclosures of auditor's fees. The amended rules should require separate disclosure of fees for (1) assurance and advisory services (for example, those services that meet the definition for assurance services), (2) tax services and (3) all other services. The current proxy rules for disclosure of the fees paid to the auditors, which resulted from a compromise, are misleading because services that do not give rise to a conflict of interest are inappropriately combined with services that can and, in some instances, have created conflicts of interest.

A principles-based approach should be adopted for all standards setting areas: accounting, auditing, and independence. In addition, the auditing standards should be expanded to incorporate a forensic approach. A year ago, the previous administration at the SEC fueled a public debate that effectively killed the Independence Standards Board and its proposed principles-based independence framework. Those same individuals conveniently continue to ignore that this framework, properly constructed and implemented, would have addressed some of the very issues that we are trying to solve today. The current rulebook approach for all standards setting fosters a culture of "if the rulebook does not specifically forbid it, it must be okay," where there is more concern about the form of transactions than their substance. A principles-based framework for setting standards provides greater assurance to the public that management, auditors, and those responsible for corporate governance will do the right thing.

AICPA should coordinate a review of the audit methodologies of the major accounting firms. We believe that Grant Thornton has an excellent auditing methodology and we are willing to share our best practices with others. We assume that others feel the same about their methodology. The best practices of these firms should be shared with the entire accounting profession. This unprecedented sharing of best practices by the major firms would serve the public interest by ensuring that all auditors of SEC registrants have access to the best practices of the leaders of the profession.

I am pleased that three out of our five proposals were included in the Act.

Grant Thornton with its staff, industry and technical expertise, and global reach has expanded its market share of public audit clients in the last 2 years with the consolidation of the profession. I am proud that Grant Thornton was the first of the major accounting firms to file the registration application with Public Company Accounting Oversight Board. We are anxious to begin working with the Board.

We have also taken actions to implement, and spoken out on the effective implementation of, the Act. Last month, as stated above, Grant Thornton became the first and only one of the six global accounting organizations to go on the record publicly and prohibit services for its public audit clients related to the documenting of internal controls. Consistent with our guiding principles, we will not provide these services because to do so violates the spirit of the Act. On the other hand, we have spent millions of dollars to develop auditCARE sm, our proprietary tool for controls assessment and risk evaluation, and to train our people to better audit the internal controls designed and documented by management. We have discussed our process and tools with the staff of the PCAOB.

We are also very involved in increasing transparency of information providing to investors. As mentioned above, our partner, Mike Starr, is leading these efforts and Grant Thornton has endorsed the entire process.

Grant Thornton has consistently spoken out on the need for reform, the proper execution of those reforms, and the need to continue to improve the financial information used by investors. One of our strategic initiatives is to provide thought leadership to our clients, the accounting profession, and the business and investing community. Grant Thornton is proud and honored to be a part of this hearing, and looks forward to assisting you in any way we can to improve business reporting and restore investor confidence.

Conclusion

In 1933, Congress passed the Securities Act that led to the creation of the SEC, designed to restore investor confidence in our capital markets after an estimated $50 billion in new securities had became worthless to investors.

Now 70 years later, Sarbanes-Oxley has further protected American investors. I know that I speak for many Americans in thanking you for the countless hours spent in bringing this landmark legislation to fruition, resulting in improvements in our financial reporting system in the past year and for many years to come.

PREPARED STATEMENT OF SEAN HARRIGAN

PRESIDENT OF THE BOARD OF ADMINISTRATION, CALPERS

SEPTEMBER 23, 2003

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, it is an honor and pleasure to be here with you today to discuss a topic of such importance to investors.

My name is Sean Harrigan. I am the President of the Board of Administration of the California Public Employees' Retirement System (CalPERS).

CalPERS has long been a leader in corporate governance. It goes without saying that CalPERS has had serious concerns over the crisis in our financial markets. Our organization was one of the fist investors to embark upon an initiative of financial market reform as the depth and magnitude of the crisis facing our markets became increasingly apparent in early 2002.

Now, almost 2 years later, we have accomplished a great deal. The primary vehicle for reform has been the Sarbanes-Oxley Act that was passed just over 1 year ago. While I recognize that implementation of the Act will realistically go on for some time, I think it is safe to say that this historic legislation is to be credited with an excellent start toward restoring investor confidence and improving the credibility of our financial markets.

Today, I would like to highlight some of the important elements of the Sarbanes-Oxley Act which have had a tremendous impact. I would also like to offer some suggestions for the next steps that are critical to completing the job that we have all set out to accomplish—restoring the public's trust and confidence in our financial markets. I still believe that this goal is an admirable one. It will help us as long-term investors to satisfy our obligation to our membership. But it will also help strengthen the efficiency of our markets which is crucial for effective capital allocation and sustainable economic growth.

First, however, I would like to offer my sincere gratitude on behalf of CalPERS and its members for all that this Committee, and in particular Senator Sarbanes,

for his leadership on this issue. As can be expected when industries with a vested interest face real reform, there was significant resistance to the Sarbanes-Oxley Act. We are proud to have been a vocal supporter, and we continue to play a role in implementing the Act and evaluating the effectiveness of reform.

It is from this perspective that I offer our analysis and comments on the impact of the Act over 1 year after its enactment and on what we are focused on going forward. There are several components of the Act that we feel are most important and I will focus on those areas broadly.

Auditor Independence

We believe there are significant conflicts of interest created when an auditor is simultaneously receiving fees from a company for audit services and nonaudit services such as consulting. CalPERS supported an outright ban on nonaudit services for the external independent auditor. The Sarbanes-Oxley Act went a long way toward addressing this issue by establishing a list of prohibited services.

However, from our perspective as a significant investor and user of financial statements, this is perhaps the main area in which the Act can be improved.

Investors rely upon financial statements for accurate and objective information. We have witnessed how much harm can come from inaccurate and fraudulent accounting. Auditors play a crucial and irreplaceable role in ensuring the accuracy of financial statements.

While the goal of the Act was certainly aimed at eliminating the conflicts inherent when an independent auditor receives fees for nonaudit services, two significant types of services remain permitted. Under the rules implementing the Act, auditors may still under certain circumstances provide tax planning and consulting services as well as certain information technology consulting.

CalPERS continues to feel that an outright ban on nonaudit services is necessary. In response to this issue, CalPERS has taken steps to communicate our concerns directly to companies in which we invest. During the 2003 proxy season, CalPERS withheld its votes for audit committee members when they used their auditors for any nonaudit services.[1]

We have also analyzed proxy disclosures in an effort to monitor how companies use their external auditor. Again, it is important to remember the rules adopted by the SEC related to audit independence are still being implemented. However, our analysis indicates that approximately 50 percent of the total revenue to the audit firms in our study was nonaudit related. More specifically, approximately 40 percent can be attributed to consulting, advisory, or planning services that include tax related work. This remains a deeply troubling situation that we feel has the significant potential to impair the objectivity of the independent auditor.

In the coming proxy season, CalPERS will continue to withhold its vote for audit committee members at companies that use the auditor for nonaudit services. Because this remains such a significant concern we urge you to pursue tougher rules through the Securities and Exchange Committee (SEC) and the Public Company Accounting Oversight Board (PCAOB) to address this issues.

Accounting Industry Oversight

In response to the clear failure of the accounting industry to self regulate, the Act created a new independent body to oversee audit firms. CalPERS strongly supported this provision. In particular, we advocated for strong independence, strong regulatory powers (such as the ability to subpoena and discipline), and independent funding.

The PCAOB is now operational and is making progress toward its inspection and disciplinary programs. I am pleased to see that the PCAOB is preparing its own auditing and attestation standards. As you are aware, the Board is currently focused on internal controls over financial reporting. To investors, ensuring proper internal controls over financial reporting is critical. I do not accept the criticism by some in the business community that the additional focus on this area is misplaced or the cost associated with improving internal controls is not worth it. To investors that rely on financial statements and controls, it is completely worth it. The benefits clearly outweigh the costs. I applaud your focus on internal controls in Sarbanes-Oxley.

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[1] CalPERS adopted two narrow exceptions to this rule. Under these exceptions we consider corporate tax form preparation and SEC compliance work to be acceptable services for external auditors.

Strengthening the Enforcement of Federal Securities Laws

The Act provided numerous enforcement tools to strengthen the ability of the SEC to regulate the securities markets and compensate injured investors. It will take a number of years to completely evaluate the effectiveness of these new tools. However, there are some areas where we feel particular attention should be paid to ensuring that the SEC is adequately equipped. The Committee should consider studying whether additional authority for the SEC to ban individuals from serving as an officer or director at public companies is appropriate. In addition, the Committee may wish to study additional authority for the SEC to claw back gains from executives that are in any part attributable to misconduct. The SEC has already exercised new authority (under Section 1103) to escrow "extraordinary payments" during an investigation. In its most recent action under Section 1103, the SEC successfully petitioned the court to escrow for 45 days a total of $37.64 million intended for two former executives of Gemstar International. CalPERS applauds this action and in fact filed an amicus brief in support of the SEC's efforts.

Scenarios in which a significant payment follows corporate failure as a result of poor financial performance adds insult to injury for harmed investors. This is especially true when any portion of a gain realized by an executive can be attributable to malfeasance. Any reasonable authority we can provide for the SEC to rectify these types of situation should be duly considered.

Next Steps

There are too many other detailed provisions within the Act to mention today. At this time, I would prefer to focus on some of the actions we think still need to be addressed.

The next steps that we think are most important are still focused on the same goal, which is to help restore investor confidence in the U.S. financial markets. While there are many issues we feel are important, I would like to focus on five reform items that are among our most important:

Audit Independence

As I mentioned, CalPERS will continue to take action through its governance program and other means to help strengthen the independence of the external auditor. As a major investor and financial statement user, we feel strongly that there should be a bright line ban on nonaudit services. Again, the primary concern we have is that external auditors are still permitted under certain circumstances to provide tax consulting and planning services and certain IT consulting services. These services provide a clear conflict of interest because the auditor may still be in a position to audit their own advice and must maintain a "client" relationship beyond the audit that impairs objectivity.

Examining the Role of Market Participants

The SEC as well as other organizations continue to conduct analysis of the role of varying constituencies within the financial system. Much like the audit industry, many of the remaining constituencies have a role in maintaining the market's integrity. In some cases, these players are proving that their industry has significant structural impediments or conflicts that are contrary to the interests of investors and the markets. For example, CalPERS has been active in helping to curb conflicts inherent in firms that provide both investment banking and equity research. We urge the Committee to continue to examine these various constituencies with a balance in mind that recognizes both their need to operate in an effective manner and yet fill a meaningful role in helping ensure the integrity of the financial markets.

SEC Budget

Congress and the President have dramatically increased the budget of the SEC, and CalPERS has supported this action on numerous occasions. As our primary market regulator, The SEC plays a crucial role in ensuring the integrity of the U.S. capital markets. This has obvious long-term implications for the health of our economy and on our ability as an investor to satisfy our obligation to our members. We feel that the focus on increasing the resources for the SEC is highly appropriate (and a good long-term investment in our market), but it is only half of the problem. To ensure that the SEC can be an objective market regulator and continue to build a sustainable and consistent program it should have a greater degree of independence from the Federal budget process. This position is similar to the support CalPERS has given for independence in funding for the PCAOB and the Financial Accounting Standards Board (FASB). Congress recognized the merits of providing a safe and independent funding source for these organizations, and we believe the same arguments apply to the role of the SEC, and are perhaps even stronger given the SEC's prominent role.

Open Access to the Proxy

The SEC is currently considering action that would provide investors with greater ability to nominate directors and have those candidates appear on the same proxy as management nominated directors. Of all the reforms that have been considered or enacted since the crisis began, this is perhaps the most significant one for investors. At the heart of many problems that face investors is a lack of accountability of board members to the owners of the corporation. We believe that one of the root causes for such issues as abusive executive compensation, lack of oversight that helps permit fraud, and plain old sub-optimal financial performance is the lack of accountability of board members to their owners.

A reasonable and balanced approach to providing investors with greater access to management's proxy statement will directly address this problem. Because we will be able to gain greater accountability we will expect more behavior that is consistent with long-term owners' interests and less short-term decisionmaking and self-interested behavior that has been so damaging to all of us.

We urge the Committee to help us in support of a reasonable open access policy that provides long-term investors with the ability to nominate directors without the prohibitive costs involved in launching a full flown proxy contest.

NYSE Reform

As this Nation's principal securities market and a so-called self regulatory body, the NYSE has a distinctive role in helping to restore and then maintain the integrity of our financial markets. We were appalled with the disclosures that came from the NYSE regarding the compensation package of the former chairman. We feel that the NYSE has a unique opportunity to meet the challenges that it now faces and to set an example for corporate America and indeed the world. I sincerely hope that the resignation of Chairman Grasso does not take the focus away from more substantive reform. Among some specific governance reforms that the Exchange should consider, we feel strongly it is time to have real investor representation on the NYSE. This reform alone would provide a change in perspective that would help ensure that the governance of the Exchange will be responsive to its primary constituency and that any regulatory role it retains going forward is meaningful.

In summary, I would like to once again offer my sincere gratitude for all that Sarbanes-Oxley has done for investors. This has been a truly remarkable time in the history of the U.S. financial markets. I feel strongly that your leadership has been a significant boost in our efforts to recover. We still need that leadership. I hope you take my comments accordingly, and as we celebrate the early success of Sarbanes-Oxley, we also keep a watchful eye on its continued implementation and pursue opportunities to responsibly improve upon its reforms.

Thank you and I would be pleased to answer any questions you may have.

PREPARED STATEMENT OF SARAH TESLIK

EXECUTIVE DIRECTOR, COUNCIL OF INSTITUTIONAL INVESTORS

SEPTEMBER 23, 2003

On behalf of the Council's 300 members, I thank you for this opportunity. The executive summary of this hearing, which examines the effects of the 14-month-old Sarbanes-Oxley Act, was actually written decades ago during President Nixon's historic trip to China. As I am sure you recall, during a state dinner on that trip, Secretary of State Kissinger asked the legendary Cho En Lai what he thought of the 18th century French Revolution. Cho's response: "Too early to tell."

For many reasons it is similarly much too early to write the history of SOXA. But that has not stopped many from whining loudly to anyone who will listen—including all of you—that the Act:

- snuffs entrepreneurial spirit,
- prevents board seats from being filled, and
- forces companies to reincorporate on Mars to avoid killer compliance costs.

For example: law firm memos breathlessly warned companies that company *credit cards might now be illegal* because the Act bars loans to executives. One CEO asked me what I thought of this and I responded, "Ditch the firm. Keep the cards. And tell everyone to get a grip."

Of course there are some new costs. But let us remember 5 key things:

- *Any change will incur temporary change-over costs.* If the United States converted to the metric system, we would have huge change-over costs and that does not mean the metric system is bad; it just mean change takes time and costs money.
- *Some costs arise from conflicting advice.* A major oil company chairman told me on Friday that his company's main SOXA costs came from conflicting advice from consultants, accountants, and lawyers.
- *Some costs are unnecessary.* Remember, consultants, lawyers, and accountants make money if they advise companies that they need to be hired to revamp something or other. The CEO of a major pharmaceutical company told me last week that most of the compliance packages marketed to their company offered unnecessary bells and whistles.
- *Many features of SOXA entail very few additional costs.*
- It is GOOD that some costs are up. Companies that did not have internals controls should spend money to adopt them. If the PCAOB costs a bit more because it does a better job, that is money well spent.

Finally, the whining we hear fails to ignore the *clear financial benefits* that SOXA is producing. Have we already forgotten that at the largest 1,000 companies that lost over 75 percent of their value in the 2 years before SOXA, insiders nabbed fully $66 billion of shareholders' equity and kept it? That is now much, harder to pull off and the number of frauds is declining.

Boards are now acting better. Nearly everyone can tell you that. *Boards are also acting faster.* Does anyone believe the NYSE or Freddie Mac boards would have acted as fast before SOXA? *SOXA strengthens safety nets* so that when wrongdoers attempt to put a spanner in the spokes of our markets, they are stopped earlier.

SOXA could not cover everything in the short time it was enacted. It is essential that the SEC follow up with increased *shareholder access* to the corporate proxy. It is essential that *SRO's and GSE's,* such as the New York Stock Exchange, get restructured so that their regulatory functions are aligned with investor interests. These are critical add ons.

But *SOXA has other value* besides its immediate effects.

I am sure everyone in this room agrees that the fact that our markets have been for the past many decades the cleanest and most efficient in the world has brought great wealth to most of us; even to Americans who hold no shares and have no pensions. People all over the world invest here because they believe that are markets protect their investments best; this creates jobs, pensions, and a vibrant economy.

But we are at very real risk of losing this edge. Increasingly special interests have been successful at rewriting the rules that govern our markets so that they benefit and investors suffer. Special interests visit Washington daily; average Americans cannot.

As soon as it is recognized that our markets are losing their integrity—they can and will flow almost immediately to any other country that maintains a better system. Markets can move overnight unlike other industries so this risk is very real.

What you all did here just over a year ago was to stem this erosion and take a bold stand in favor of clean, investor-protective markets. On behalf of my members' beneficiaries and on behalf of all of our children, who have the most to lose if our markets lose their edge, I ask you—no, I beg you—to stand firm. Our jobs, our pensions, our homes, and our way of life depend on real protection of—not lip service to—clean markets. You hold the key—little else you do here has greater importance. Thank you.

THE IMPLEMENTATION OF THE SARBANES-OXLEY ACT AND RESTORING INVESTOR CONFIDENCE

THURSDAY, OCTOBER 2, 2003

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:05 a.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

Senator Sarbanes is probably stuck in traffic somewhere between here and Baltimore, but I will tell you, he will be here as soon as he can get here, and he wanted me to say that.

This is the final hearing in a series examining the implementation of the Sarbanes-Oxley Act and its impact on investor confidence. A primary focus of Sarbanes-Oxley is to change the "tone at the top" of public companies by increasing the accountability of officers and directors and strengthening corporate governance principles. The Act mandates new audit committee requirements and requires executive officers to certify their financial statements, institute rigorous internal controls, and disclose more information regarding operations. The Act addresses a boardroom culture that for too long was characterized by cozy relationships and the lack of objective and critical analysis of management's performance.

More important than any one provision of Sarbanes-Oxley is the underlying message that corporate America needs to change its ways in order to regain the trust of investors. Even though Sarbanes-Oxley has contributed to a renewed investor confidence, some remain concerned that the Act is too costly and will negatively impact corporate behavior. Many believe that companies have incurred unreasonably high compliance costs associated with increased auditor and legal fees. Others contend that Sarbanes-Oxley has hurt the markets by requiring executives to focus on process at the expense of corporate risktaking.

As with any landmark legislation, companies will experience a certain amount of uncertainty and cost increases as they implement the law and modify their business practices. Although I acknowledge increased compliance costs associated with implementing Sarbanes-Oxley, I also recognize that these costs were necessary to address the surprising erosion of business principles that

became evident with the recent scandals. Further, the Act does require executives and directors to focus on procedure and process in order to ensure that corporate decisions are the result of considered decisionmaking. Attention to process, however, does not have to come at the expense of corporate innovation.

As I have previously stated, the Act does not penalize risktaking but rather promotes transparent and honest business practices. With the enactment of Sarbanes-Oxley, the President and Congress laid the foundation for a new era of corporate accountability and governance. Congress, however, cannot legislate that boards of directors tackle difficult issues or that investors trust the markets. We cannot penetrate the executive suites and boardrooms to ensure that officers and directors have taken Sarbanes-Oxley to heart and have changed their practices. True reform will be manifested in new corporate cultures that adopt the spirit of Sarbanes-Oxley and reflect the shareholders' best interests. I think it will take a great deal of time and effort before investors fully regain their trust and confidence in the markets. Therefore, much needs to be done before corporate America can state that it has addressed the root causes of the recent scandals.

A successful implementation of Sarbanes-Oxley is the first step. Executives, directors, and their advisers must remain vigilant in guarding against conflicts of interest and misconduct that result in corporations' profiting at their shareholders' expense. As corporate governance and financial reporting standards evolve, corporations and their advisers must proactively adopt new guidelines that maintain a high level of integrity.

As we have recently learned, it is all too easy to lose investors' trust, and it is much harder to earn it back. The witnesses on our first panel today play an important role in establishing new standards for corporate governance and financial reporting. The Conference Board Commission on Public Trust and Private Enterprise was convened in June 2002 to address the recent corporate scandals and crisis in investor confidence. The Conference Board issued a set of findings and recommendations addressing a number of prospective reforms that companies should consider to further improve governance and financial reporting.

With us from the Conference Board are its Chairman and three Commissioners. I would like to welcome Chairman Pete Peterson and Commissioners Charles Bowsher, Ralph Larsen, and Dr. Paul Volcker, former Chairman of the Fed.

The witnesses for our second panel will be Brian Anderson, the CFO of Baxter International; John Castellani, the President of the Business Roundtable; Keith Grinstein, the Chairman of Coinstar; and Richard Trumka, Secretary-Treasurer of the AFL–CIO.

Gentlemen, thank you for joining us today. We will start with you, Mr. Peterson. Your written testimony will be made part of this hearing record in its entirety. You proceed as you wish.

STATEMENT OF PETER G. PETERSON
CO-CHAIRMAN, THE CONFERENCE BOARD COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE
CHAIRMAN AND CO-FOUNDER, BLACKSTONE GROUP

Mr. PETERSON. Mr. Chairman, I want to make clear that we speak to you today as individual members of the Conference Board, that Treasury Secretary John Snow and I co-chair. Fellow Commissioners Paul Volcker and Chuck Bowsher will speak on our auditing and accounting recommendations. Mr. Ralph Larsen on my left here, former Chairman and CEO of Johnson & Johnson—widely considered to be one of the most ethical companies in America—and former Chairman of the Business Council, will discuss the critical importance of building an ethical culture within corporations.

In my view, Mr. Chairman—I have been in 50 years now—I have never seen public trust at this low a level. It matters because our savings levels in this country are at unprecedented low levels. We depend on unprecedented amounts of foreign capital, and, therefore, confidence in our markets is extraordinarily important.

I am going to focus my comments today, Mr. Chairman, on executive compensation, which we believe is the most fundamental and most toxic cause of the great breakdown in public trust. The recent example of Richard Grasso at the New York Stock Exchange has only punctuated the need for reform in this area.

Before going getting into our recommendations, I would like to say just a few words about Sarbanes-Oxley and the possible future role of this Committee and the Congress.

As to Sarbanes-Oxley, it is in my view, by and large, a very constructive and much needed piece of legislation. Already, I sense a sea change, Mr. Chairman, in the attitudes toward corporate governance practices to implement better governance. I have never seen boards of directors and CEO's as diligent and as proactively involved as they are today.

Moreover, I believe that the private sector needs some time not only to fully digest Sarbanes-Oxley, but also to make constructive changes in other areas of corporate governance. Frankly, Mr. Chairman, history seems to teach us that, particularly in the area of executive compensation, Congressional action has in times past had some serious unintended and negative effects and resulting in certain very ironic, unintended side effects and rigidities. Let me give you an example. In 1993, the Congress passed the $1 million cap on cash compensation deductibility. It inadvertently set off an absolute explosion, Mr. Chairman, in the awards of what we call fixed-price options and inflating senior compensation dramatically in the process. That was hardly the intent of that legislation. This kind of well-intentioned but unfortunate Congressional involvement is the political equivalent of what the medical profession, borrowing from the Greeks—I thought Senator Sarbanes would be here, so I was going to appeal to him.

Chairman SHELBY. Please repeat it. He will get here.

Mr. PETERSON. The medical profession has something called the "iatrogenic effect"—that is, diseases or ill effects that are caused by the "iatro," the doctor, in Greek.

Now, when we started our work, Mr. Chairman, I, at least, had assumed that these widely reported general increases in compensa-

tion would present the major problem to the public. All of us on this Commission had read the *BusinessWeek* report that showed CEO compensation going up 9.5 times faster than the average worker. We also saw reports that in 1980, the average CEO made 42 times what the average employee did, and then it was, 20 years later, 500 times—far higher than any country in the world, that ratio.

We were also very much aware, Mr. Chairman, of those who questioned management's sincerity in saying that compensation should be related to productivity. Critics asked the question: Has management's productivity grown 9.5 times faster than the average worker? William McDonough, whom you know well, and someone I respect a great deal, head of the Public Accounting Board now but then-head of the Federal Reserve Bank in New York, in a widely publicized speech at the Trinity Church of New York, said the following: "I am old enough to have known both the CEO's of 20 years ago and those of today. I can assure you that the CEO's of today are not 10 times better than those of 20 years ago."

Now, this huge imbalance between the compensation of senior executives and other management and workers has certainly contributed to the plummeting public trust. But as we looked further, Mr. Chairman, into this issue, I came to believe that the more dominant contributor to the loss of public trust were the highly publicized cases of excessive and, I would say, egregious compensation of CEO's in failing or failed companies. You will probably recall a *Financial Times* headline saying, "A Stunning Payoff For Corporate Failure." Who could have not been impressed with the *Fortune* magazine cover showing kind of a rogues' gallery of CEO's, saying, "You Bought, They Sold." These were companies whose stock prices had fallen 75 percent or more shortly after they got big gains and the stockholders had big losses. As the headline of the *Fortune* article said, "Since 1999, hundreds of Greedy Executives in America's Worst Performing Companies Have Sold $66 Billion Worth of Stock." In effect, the *Fortune* article seemed to be asking the corporate version of the Watergate question. It may be ironic that a Nixon Cabinet officer would bring up that metaphor but, nonetheless, it is appropriate: What did these executives know about their companies' declining prospects? And when did they know it?

These kinds of public suspicions led to our recommendation of full, conspicuous, and readily understandable—plain English, plain sight—disclosures of all executive compensation arrangements. In addition, to reassure the public that senior management was not involved in stock transactions involving the company in advance of material information, we recommended that executive officers give advance notice of their intention to dispose of the company's equity securities.

Now, why do I believe that excessive compensation at these failed or failing companies—rather than simply the overall increase in compensation—is the more dominant explanation of the precipitous decline in the public's trust? Mr. Chairman, you know that many Americans believe that the American Dream is a real possibility for them. Witness the interesting statistical anomaly that 20 percent of Americans believe they are in the upper 1 percent of in-

come, and another 20 percent believe they will be someday. Moreover, $20 million salaries for genuine sports stars do not engender anything comparable to the criticism or anger engendered by executive compensation. Their success is perhaps seen as something to be admired as long as they perform, with the hope that they or their kin can someday achieve that success.

In many of the corporate scandals, the public witnessed certain executives reaping unprecedented gains just prior to the time when their shareholders suffered huge losses, and many of their employees lost their jobs and at the same time saw their retirement savings suffer irreparable damage. You know, Mr. Chairman, that the most highly visible publicized case was the case of Enron. You may recall that Dan Yankelovitch, the well-known public opinion expert, reported that Americans were particularly outraged and frightened by widely publicized reports that restrictions that were placed on employees selling their company stock held in their retirement accounts during periods of rapidly falling prices were far greater than those placed on Enron's executives. Employees and the public alike saw this phenomenon as still another example of a rigged system that favored executives over nonexecutive employees.

So after much analysis, our Commission came to this triad of principles that I will briefly review.

Number one, a renewed focus on the long-term—and I emphasize "long-term"—success of the company.

Two, a renewed focus on corporate operating performance, not simply on stock price performance, which can obviously be capricious. With this in mind, the Commission recommended that very independent compensation committees who hired and fired any compensation consultants and suggested they should be unconstrained by industry median compensation statistics or by the company's own past compensation practices or levels when awarding senior compensation. We, instead, thought that the board should establish performance-based incentives that reinforce the corporate performance goals approved by the board, for example, return on equity, profit growth, cost containment, operating cashflow, cash management, and other nonfinancial objectives.

Three, we emphasized there should be a renewed focus, Mr. Chairman, on long-term stock ownership which can validate operating performance and help drive long-term corporate performance, and more truly align the long-term interests of the shareholders with that of management. History teaches us that stock prices and operating performance can deviate a good deal over the short-term. But over the long-term, there is a much higher correlation. That is why we believe that it is critical to focus executive compensation on the long-term.

Our recommendations longer holding periods for equity-based compensation and for substantial stock ownership requirements by senior management and directors that fit into this practice. If you think about it, Mr. Chairman, if we had just had the requirement of longer holding periods and long holdings of stock, many of the scandals that occurred would never have occurred in the first place.

A few words about the fixed-price stock options which came to dominate the entire compensation field. They were not expensed and did not reduce operating earnings. Nevertheless, as I am sure

you know, they conferred substantial tax deductions on employers. As a result, there became a perception, Mr. Chairman, in some companies that they were either free or very low cost. This, along with the 1993 tax legislation that I referred to, led to an absolute explosion in the number of these fixed-price options. For example, Mr. Chairman, in a very short period of time, stock options as a percent of total equity doubled, and in many, many cases, stock option gains came to dominate the compensation of executives. The combination, of one, huge number of options, two, a bull market; and three, short holding periods, led to be highly seductive in some cases and led to the practice of "managing" short-term earnings. This phenomenon also led to unprecedented short-term gains by some executives—gains unrelated to corporate operating performance or, if you prefer, too de-linked from operating performance.

We, therefore, came to believe that the elimination of the accounting bias toward fixed-price options, which we felt had led to an inadequate focus on operating performance, is one of the most powerful reasons to favor the uniform expensing of all forms of equity-based compensation. We would hope that the Financial Accounting Board and the International Accounting Standards Board would adopt a uniform standard, thereby increasing transparency and comparability among companies on an international basis, Mr. Chairman. The uniform expensing of equity-based compensation would also, we believe, improve the comparability of earnings among companies operating across different industries. I, at least, was surprised to learn that, whereas expensing of options in Standard & Poor companies generally would decrease reported earnings by perhaps 10 percent, in the information technology industry the expensing of options would reduce earnings by approximately 70 percent.

We believe that a more level accounting playing field would result in a far greater use of long-term compensation incentive programs that are closely tied to actual operating performance and that would not distort financial results for investors. If all forms of compensation were treated similarly in terms of their impact on profitability, then it seems to me that companies will be much more likely to choose programs that offer real, balanced incentives to help create long-term value.

It pleases me to report that 175 of the Nation's largest 500 companies have announced their intention to expense options. Even greater progress has been made in the important area of achieving better balance of power and checks and balances by either appointing a nonchairman CEO, a presiding director, or a lead director.

Mr. Chairman, I want to assure you that we are not going to stand by and simply hope that the private sector will substantially improve their executive compensation practices. We are now very actively involved in getting a large number of corporate directors, CEO's, large investors, and others to participate in public advertisements and other public statements that pledge their companies and themselves to implement executive compensation principles I have just outlined.

To sum up, Mr. Chairman, we thank you warmly for your constructive efforts in formulating and passing the Sarbanes-Oxley legislation. At the same time, before developing further legislation,

particularly in the area of executive compensation, we ask that you give those of us in the private sector some time to make the changes that are so obviously needed.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you.

Mr. Larsen.

STATEMENT OF RALPH LARSEN
FORMER CHAIRMAN OF THE BOARD AND
CHIEF EXECUTIVE OFFICER, JOHNSON & JOHNSON

Mr. LARSEN. Thank you, Mr. Chairman. Picking up on Pete's comments, I would like to just give you my personal perspective on the reception and impact of the Sarbanes-Oxley legislation and make some other points. I, obviously, cannot speak for other chief executive officers, but in talking with a wide range of business leaders, I sense that the Sarbanes-Oxley legislation has been well received and is well on its way to being implemented.

The legislation has had, I think, significant positive impact in a number of important areas, specifically increased director engagement, awareness, and expertise; increased disclosure and transparency in financial reporting; a significantly heightened sense of personal responsibility and attention to detail. And I think those things are very important.

So, on balance, I think the legislation has been accepted well in corporations throughout the United States, and their directors and senior executives are working hard to fulfill all of its requirements. And I can assure you based on everything that I have seen that Sarbanes-Oxley is being taken very, very seriously.

With that said, I would like to focus my comments this morning on just one point that I think is vitally important, and it is something that I am sure each person in this room has learned through their own life experiences, and that is, the importance of the tone at the top.

Clearly, it is essential that we have a basic structure and framework of laws and regulations to define the boundaries of acceptable personal and corporate behavior. But, I would argue that all of the laws in the world cannot ensure that corporations or the individuals that run them will perform with integrity day in and day out. The reality is there will always be those few souls who are inclined to compromise, or to put it bluntly, chisel or to connive, or who lie awake nights conniving how to circumvent laws.

But after 40 years in business and 13 as a chief executive officer, one of the most fundamental things that I learned is the importance of a values-based culture to the success, the long-term success of the enterprise. A culture that honors integrity and demands it of all.

I also learned that the example set by the chief executive officer of a company has a profound and far-reaching impact on how the entire organization behaves. For better or worse, the tone at the top largely establishes the cultural norm within an organization. It defines what is acceptable and what is unacceptable. I learned that, yes, people listened to what I said in the endless speeches that I gave, but much more importantly, they watched how I behaved, particularly when the going got tough and the stakes were

high. They watched as a management to see whether we made ethical decisions, whether our walk matched our talk. In our company culture, we encouraged people to challenge our decisionmaking process, and we tried to make it as open as possible.

I was particularly struck by how closely they followed and often emulated the processes by which we made our business decisions, particularly when we were wrestling with issues in which there was no clear right and wrong, where we were operating in uncharted waters. They watched whether we strove for ethical solutions to the issues at hand. In the give and take of internal debate, was the conversation and the discussion honorable? Was it honest? Was it transparent? Did we make it clear that integrity, both personal and corporate, were of paramount importance? Or did we somehow signal that we were willing to consider bumping up against the ethical line if the stakes were high enough?

The reality is, and the point I am making is, that individuals and organizations learn most quickly and most memorably by watching the conduct of their leaders. If you have questionable ethics at the top, that tone will permeate the entire organization, and it will poison ultimately the entire organization. To put it plainly, you show me a conniver at the top, and I will show you a corporation headed for big-time trouble.

The good news here is that the boards of directors and chief executive officers are focusing as never before on the importance of personal integrity and a values-based culture. They are focusing on it because they realize that in order to thrive and prosper over the long-term, businesses must be built on trust. It must be trusted by all of its constituency—customers, employees, share owners, and, yes, government. Boards realize that in any large organization with people scattered all over the world, a values-based culture is the only way to ensure that the enterprise for which they stand responsible does not engage in misconduct, does not break trust, and does not become tomorrow's headline.

The scandals of the past few years have once again demonstrated the importance of the tone at the top—a tone that makes it clear through word and personal example that a commitment to the highest ethical standards are the way the business will be run, and nothing less is acceptable.

This point is made well in the Commission's report. We stressed the importance of the board of directors' assessment of ethical values in choosing a chief executive officer and gauging their performance over time. We emphasized the importance of having tools and processes to measure and evaluate their adherence to ethical standards. And we encouraged ways to ensure that those standards were promulgated down through the organization in a clear and effective way. And, finally, we stressed the need for a reporting mechanism to allow employees to safely report their views on misconduct.

In summary, while the well-publicized behavior of a few individuals and companies give us much to be concerned about, the fact is, I believe, that there is much to celebrate. We have the greatest and most inventive economic system in the world. We have a wonderful group of growing and vital companies. And I believe that the vast majority of men and women in senior management positions

in our companies in the United States are decent and honorable men and women who are striving to do the right thing in the face of a very complicated and competitive world. And, by and large, they are men and women who recognize that the most fundamental responsibility of leadership is to set the proper tone at the top.

Thank you very much.

Chairman SHELBY. Thank you.

Mr. Bowsher.

STATEMENT OF CHARLES A. BOWSHER
FORMER CHAIRMAN, PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Mr. BOWSHER. Thank you very much, Mr. Chairman, Senator Sarbanes, and Members of the Committee. It is a great pleasure to be here today.

One thing I would like to do is start out by saying that I think the Sarbanes-Oxley Act is really an excellent piece of legislation, especially in the auditing and accounting area, which I have spent most of my life and career working in. It was long overdue, and many of the things that you have in that legislation really were taken from past efforts in the private sector on various commissions, blue-ribbon panels, and things like that to try to improve the accounting and auditing in this country. But a lot of it did not ever get accomplished, and now it has been codified in the Sarbanes-Oxley Act, and I think things are moving ahead. I agree with Chairman Peterson and my predecessor, Mr. Larsen, and I am sure Paul will agree that we are making real progress here in the private sector at this point in time.

One of the first issues in our report in the accounting and auditing area, which was the third section of the conference report, was the emphasis on the audit committee, because, again, as Ralph points out, the tone at the top really sets the way things go in these big organizations. And what we have pointed out is that it was awfully important to get qualified people—not only independent people but also qualified people—people who were financially literate, serving on the audit committees so they could ask the tough questions not only of management but also of the auditing firm and the internal auditors. And we think that there is progress being made here, but this is one area that the Committee should follow very carefully and maybe have the SEC monitor it and give you updates as to how it is moving along, because I think it is essential to really getting the accounting and auditing scandals behind us to have first-rate audit committees serving on the boards representing the investors of this country.

I have served on some boards here and some audit committees, and I can tell you I see a huge difference between when I first went on in 1997, when I left the Government, and the current time. I am on a New York Stock Exchange company in Chicago where the first meeting lasted a half-hour, and I do not think there were any tough questions asked of anybody. Just a month ago, when we were closing out the fiscal year of June 30, we had 6-hour audit committee meeting. We now have the right people serving on the audit committee. We have the questions being asked. We have the auditing firm identifying the major issues in two- and three-page memos

to the audit committee, and it just is so much more professionally done with everybody playing the part that they are supposed to play. So, I think the audit committee is very crucial, and although progress is being made—I think that General Electric is a good example that Ralph serves on. They set the tone when they made the changes right away.

The first issue we did recommend in the Conference Board report is that sometimes it is not so easy to ask people who have been serving with you to step aside, maybe because they do not have the right qualifications. So we recommended that bringing in a law firm or a consulting firm to evaluate the audit committee membership and to see if everybody should be on that committee is a good way of doing it and making progress.

The second issue we took up was really on the continuing education and the need of education and training for audit committee members. When you looked at the unfortunate gentleman who represented Enron's audit committee, you recognized that this was a gentleman who had impeccable credentials, but probably really was not current on this very intricate world of derivatives and the financial instruments that the investment bankers are selling these days. And so you have to understand the business that you are serving on the board and on the audit committee, and you have to keep up through training and education and everything like that.

The third issue area that we took up is the internal control, Section 404, which is becoming more and more now an important issue, as you indicated, Senator Shelby, in your opening statement. This is to me one of the really most key parts of the Sarbanes-Oxley bill because what it really is saying is that in 1933 and 1934, when the Securities Act was passed, why, you required that all public companies have an annual financial report, management's responsible to produce that, but to have an outside independent accounting firm come in and check it out and give a certificate on it.

Over the years, we have never really had strong requirements to make sure that the accounting systems underneath those financial reports were properly in place, properly documented, or properly checked out. That is what Section 404 says. And it will cost some money as an investment for the companies.

But I would just like to read one paragraph from my prepared statement that says this: "For companies that have adequate and well-documented internal controls and an adequate internal audit function"—which now the New York Stock Exchange requires—"it will not find the reporting on internal controls to be a major or costly effort. However, those companies that have not put an emphasis on internal controls will have a one-time investment to make, but investors will be much better protected once management and outside auditors can attest to proper internal controls. This area is the basic framework for the CEO and CFO certifications regarding the annual financial statements and quarterly reports."

If I could just amplify a little bit on that, once you get your internal controls in shape in the big companies, they are going to ask the division vice presidents and the people down the line to certify, too, so that when the CEO and the CFO are certifying, they are doing it because their senior management has already checked out

things. If you have the right internal controls, the internal auditing checking it out, management certifying, the CPA firm checking things out, then reporting to the audit committee, I think it is going to be very seldom that we will run into the cases like WorldCom where they were slipping through journal entries at the end of the year to cook the books. And that is really what we are trying to change and provide here.

I might also say on the cost, we recommended to this Committee and to the Congress after the S&L crisis that this type of reform be included in the banking reform legislation of 1991. I remember a lot of lobbyists being paid a lot of money to come over here and say this would be the end of Western civilization if you left that in the bill.

Chairman SHELBY. Some of us were here.

Mr. BOWSHER. Yes. But, you know, a few years later, I went on the board of an international bank, and I asked them at the annual presentation, and they said, no, it is fine, it was a good reform, it is working fine. And if you think about it today, we have not had many failed banks, only really a couple scandals with failed banks. But the banking legislation, I think, has contributed dramatically to the success that we have had there of getting rid of the problems that we had in the late 1980's and the early 1990's. And Section 404 really is a takeoff practically from that legislation and that success. And I think when we get it achieved in the corporate world, it is going to make a big difference for everyone. And when you think of the cost, the losses that we had in these scandals, why, the individual costs to the companies to get their things straightened out I think will be very much an economic thing. In fact, I think Chairman Donaldson once said, "Benefits of new rules will outweigh the cost." And I do not think there is any question about his position.

The next issue area that we spoke to was on rotation of auditing firms. Now, this is something that the auditing firms do not like. I want to be upfront with you on that. And I know that in the Sarbanes-Oxley bill you asked the GAO to do a study on rotation, and they have not quite completed that report, and it is coming over to you here, I think, in the next few weeks.

But the one thing we said is the private sector should consider audit rotation, no matter whether it is required or it is not required by the Government, and we laid out just a couple of criteria here. We said any audit firm that has been employed by the company for a substantial period of time, say over 10 years, would be one thing to consider. Another would be if you have former partners or managers of the audit firm employed by the company. If you remember the Enron situation, all of the accounting staff practically had come from the accounting firm. Or if you were still having significant nonaudit services provided by the company, in other words, getting to the independence issue here.

I might say that Mr. Breeden's report recently here on the WorldCom reform did pick up our first item and said that every 10 years the auditors should be rotated.

This is just something, I think, that is awfully important for the audit committees to consider, and they certainly should be considering that after 7 to 10 years. But we have 7 years in our report—

or 10 years, I guess, in our report, but I know some are thinking of 7 years.

The next two issue areas Paul Volcker, my colleague here, will discuss in our accounting and auditing, and that is on professional advisers for the audit committees and also the outside services performed by the accounting firms.

Chairman SHELBY. Thank you.

Dr. Volcker, welcome back to the Banking Committee. You spent many days and hours here when you were Chairman of the Federal Reserve.

Mr. VOLCKER. Indeed. The Committee room is the same. Even some of the Senators are the same.

[Laughter.]

Mr. VOLCKER. It is nice to be back.

Senator SARBANES. The one thing that is different now is we have a no-smoking rule.

[Laughter.]

Senator SARBANES. In those days, the room would be enveloped with smoke when Paul Volcker testified.

Mr. VOLCKER. Some of my valued pictures at home show me behind cigar smoke in this very room. I remember those days.

Mr. PETERSON. Senator Sarbanes, I used to accuse the Chairman that his blowing smoke was his particular technique for the kind of creative obfuscation that some Chairmen used.

[Laughter.]

Chairman SHELBY. Well, Dr. Volcker is not known for that, though.

STATEMENT OF PAUL A. VOLCKER
FORMER CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. VOLCKER. The policies were very clear, despite the smoke. That is my defense.

I am at the end of this distinguished panel here, and I will be short. Chuck just mentioned I have been asked to mention specifically and comment on the recommendations of the Conference Board Commission on access of auditing committees to professional help and the controversial area of the services that auditing firms might perform. But before commenting on that briefly, I just want to join my colleagues here in saying that nothing has happened since this bill was passed to suggest the thrust and the detail of the bill were not appropriate. We are still being barraged, as you well know, week by week, almost day by day, with indications of performance by our big accounting firms that simply do not meet the standards that we expect and must demand and that are required by Sarbanes-Oxley. The quicker we can make that history and not current and future, the better off we will be.

It is maybe a sad story that that great profession has lost its discipline and lost the primacy that the auditing function deserved and needed to be informed by constructive legislation. I congratulate you on doing that.

In areas that I was asked to comment on, Mr. Bowsher certainly made clear the burdens on auditing committees these days, and that is one the primary results of this legislation—in fact, de-

manded by this legislation. It is an entirely different atmosphere for auditing committees. And there is a common-sense—I believe it is common-sense—recommendation that the Commission made consistent with the burden on auditing committees, they should feel free to engage outside professional help, and they should have the authority to do that and feel free to do that in discharging their responsibilities. It sounds to me like common sense at this point, but I am sure it has not historically been the practice in the past where there was not that feeling of professionalism and independence in the auditing committees, or at least too often that was lacking. So that seems to me pretty straightforward.

The other area has been more controversial, and that is the question of what services accounting firms should be providing and the degree to which they may conflict with the primary auditing responsibility. As you well know, the Sarbanes-Oxley bill attacks that head on by indicating some important, almost dominating services that accounting firms were performing for auditing clients would not be permitted and others might be permitted with the careful consideration of the auditing committee, which in turn may ask for outside advice.

That no longer, I think, in terms of what the bill suggests is particularly controversial, but there is one area that remains open that the bill did not deal with that I think very much does deserve consideration and action. That is in the area of tax services. To some degree, auditing firms have traditionally provided tax preparation and other tax services. What is relatively new is the emphasis that these firms have put on a very profitable activity, what I would term as "aggressive tax planning." And that is an area in which I think we have seen dramatic indications since the bill was passed of the potential conflict that that involves. When a firm is involved at one and the same time in advising a firm or, in cases that we have seen, advising the senior officers of that firm, on elaborate schemes for tax evasion. That requires a psychological approach of let's see how we can get around the rules. Then being asked to audit the firm in terms of whether it is following the tax rules and the accounting rules is a rather basic problem.

Fortunately—and I think deliberately—the bill has provided authority to the SEC or to the Public Company Accounting Oversight Board, if I have got all those initials or words straight in order, to review that matter. And the SEC, as I understand it, took a look at it and said, "well, we will pass that on to the Board," and the Board, I believe, has that on their agenda. And I think that is an area that should be followed. It is a difficult and subtle matter, perhaps, to define what is appropriate and what is not appropriate. But at the extremes, I think it is clear enough. I would like to think that there are some very common-sense criteria. If an accounting firm is involved in advising a firm or its executives to use three offshore tax havens and gets a success fee for the tax savings, you begin to get suspicious that that may involve a conflict and be inappropriate.

Let me, if I may, just very briefly talk about compensation. I cannot match the eloquence that Mr. Peterson brings to this subject, but I do want to reinforce the point that I think the root of these egregious excesses has been the increased use of fixed-price stock

options, which happened to coincide in a way nobody expected with this historic boom in the stock market, resulting in compensation amounts beyond earlier imagination. But once you have them, they begin seeming normal. You have seen no greater example of that than in the recent developments in the New York Stock Exchange, which did not directly involve stock options, but it certainly involved a mentality that said everybody else is getting rich in stock options, we should do something for this fellow. And it just is an example of how these things spread because of the stock options.

I think pricing of stock options and expensing of stock options involves some very difficult issues. I am happier about the tendency beginning in some business firms to recognize that fixed-price stock options for big public companies really involves capricious compensation results demonstrably bad and perverse incentives that focus on the short-term stock price rather than the continuing value of the business. And it has led to demonstrable distortions in business behavior.

I am delighted that we are beginning to see even in Microsoft, a great new-technology company, deciding that stock options are not an appropriate method of compensation.

I would make one other point. We have had a lot of concentration on auditing, deservedly so. Auditors have a special responsibility. But I do not think we should lose sight of the fact that the responsibilities of other so-called gatekeepers in the financing process have fallen by the wayside too often. Accounting firms have not been alone in designing and encouraging elaborate schemes to circumvent accounting principles, to dodge taxes, and to embellish and smooth earnings. Far from it—I am quoting from a speech I gave recently:

> Far from it, there were battalions of investment bankers, lawyers, consultants, and financial engineers prepared to go to the edge or even beyond ethical practice. Too often they have lent their professional authority to practices of their own clients that fraudulently misrepresent operating results. In the process, investors are ill-served and the long-term prospects for the business jeopardized.

I say all that to reinforce the importance of what Ralph Larsen is talking about. If the top of the firm is not setting and following ethical standards themselves, you cannot rely upon these professional advisers and their clients to do it for them.

Chairman SHELBY. Thank you. I thank all of you.

Mr. Peterson—or Secretary Peterson, as I remember you—your report proposes alternative means to address what we call the imperial CEO that characterized many of the recent corporate scandals. What is your perspective on the governance issues at the New York Stock Exchange that has been in the news so much lately?

Mr. PETERSON. I will probably get in trouble for saying this——

Chairman SHELBY. Oh, you will not get in trouble, not here.

Mr. PETERSON. I have done it before. The only thing, Mr. Chairman, anybody ever remembers about my service as Secretary of Commerce is an indiscreet comment I made that I could not pass the physiological loyalty test. My calves were so fat I could not click my heels.

[Laughter.]

And that is the only thing that is remembered that I did.

But it is indeed ironic that the New York Stock Exchange that saw fit to have a group of corporate CEO's make recommendations for corporate governance and independence and lack of conflict in the companies that were operating under the New York Stock Exchange would itself indeed practice some egregious negative examples of the very principles that they were espousing.

I chose to talk to you today about executive compensation, and I said there is nothing more important than a thoroughly independent, unconflicted compensation committee.

Now, if you look at the interlocking relationships on the New York Stock Exchange, I think it violates the very fundamental principle that we are talking about. So, again, I would be indiscreet in saying it, but I would not be surprised if someday at the Harvard Business School the New York Stock Exchange will be used as kind of a poster child of things to avoid in the areas of corporate governance.

Chairman SHELBY. Thank you.

Mr. Larsen, it seems like companies evaluate corporate ethics by looking at whether they have complied with the rules in the employee handbook at times. But would you elaborate on how you would move beyond technical compliance to fundamentally change the corporate culture?

Mr. LARSEN. Mr. Chairman, I think it is a difficult thing to do. You cannot legislate morality, and you cannot legislate a good heart.

Chairman SHELBY. Ethics, anything like that.

Mr. LARSEN. It is very difficult.

Having said that, I think it starts with choosing a chief executive officer, a senior management that you know, that you have confidence in that person's character and reputation. I mean, typically, by the time somebody reaches that level, they have been in business for 20 or 25 years. They have developed a track record. You should be able to divine that. Some people may go bad at the end, but not usually. And my experience is that, as you watch young executives coming up, there will be some who have a tendency to bump up against the line. And I have always taken the position of getting rid of them because they will get us in trouble someday. Getting rid of them early before they can cause big-time trouble.

So, I think it is a cultural thing that has to start at the top, but it has to be reinforced by the board of directors making sure that they make it clear to everybody that it is a fundamental requirement. But it is a cultural issue. It takes years to build up, and it is greatly influenced by the tone of the individual that is on top.

Mr. PETERSON. Ralph, if I may interrupt, I think the Senators might profit from a brief discussion of your credo and how you implement it, because I think it is one of the most innovative and basic I have seen anywhere in America.

Mr. LARSEN. What Secretary Peterson is referring to is we have a very simple document within Johnson & Johnson. It was written back in 1940. It was revolutionary at the time. It says that our first responsibility as a company is to our customers, to do what is right by them and provide them with good-quality products at fair prices. Our next responsibility is to our employees, to treat them fairly, with dignity, and respect. Our third responsibility is to the commu-

nities in which we operate, to be good corporate citizens and to enhance the environment. And, finally, we say that if we do a good job in those three things, the shareholder will come out okay. And that is exactly what has happened over all of these years.

But what it has done for our employees and, frankly, for me as a chief executive officer, is I did not have to think too hard about what our principles were. I mean, our first responsibility was to our customers, then to our employees, community, and then the shareholders will do okay. We never focused on the stock price. We never focused on shareholder return in that sense. That was the end result of good management and good ethical behavior. And then we have a whole set of mechanisms where about every 2 or 3 years worldwide, our people fill out an anonymous survey judging their local management on how well they are adhering to the ethical principles of the credo. And it is not healthy for management to get a bad score in that regard.

Chairman SHELBY. Thank you.

Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman, and I apologize that I was detained and was not here at the outset.

Chairman SHELBY. You should have been here. They were saying nice things about your legislation.

[Laughter.]

Senator SARBANES. I caught part of that, so I did not miss it entirely. But I want to take just a couple of minutes to make a statement.

First of all, I want to commend Chairman Shelby for holding this informative and productive series of oversight hearings on the legislation that we developed last year. I think this was an opportune time to do it as we approach the end of this session of the Congress. The legislation was signed a little over a year ago, and while not everything has yet been fully put in place, it was an opportune time to take a look.

We heard from Chairman Donaldson of the SEC, Chairman McDonough of the PCAOB, and leaders from the accounting industry and institutional investors, and we have this panel and another distinguished panel to follow this one this morning.

First of all, I want to particularly acknowledge the work done by the Conference Board's Commission on Public Trust and Private Enterprise. Four of its 12 members are at the table before us, and I just want to mention the names of the others, because it really an all-star group. In addition to the four witnesses here this morning, John Snow, who, of course, is now Secretary of the Treasury; John Biggs, the former head of TIAA–CREF; John Bogle, Founder and former Chairman of Vanguard; Peter Gilbert, the Chief Investment Officer of the Employees' Retirement System of Pennsylvania; Andy Grove, the Chairman of Intel Corporation; Arthur Levitt, former SEC Chairman; Lynn Sharp Paine, Professor at the Harvard Business School; and our old colleague, Warren Rudman. And I have to say this was really an all-star panel, and its charge as it launched into its work when it was convened, was, "to address

the causes of declining public and investor trust in companies that are leaders in America's capital markets."

In undertaking this inquiry, the Conference Board acted on the underlying commitment that dates back to its founding nearly a century ago in an earlier contentious period of market activity, "to create and disseminate knowledge about management and the marketplace to help businesses strengthen their performance and better serve society." And the Commission went on and defined the crisis in stark terms: "A clear breach of the basic compact that underlies corporate capitalism."

The Commission found that in many instances this compact among shareholders, boards, and management has been significantly weakened, diminishing the trust that investors and the general public have in our system of corporate governance.

Of course, the Commission has come forward with a set of recommendations and findings. The Conference Board has also recently published a set of corporate governance best practices. And I think they have made an extremely important contribution to trying to address this issue.

The statute is by no means the be-all and end-all. It is really to provide a basic framework within which activities will take place. But as the Conference Board's Commission has indicated—and we have efforts now on the exchanges with respect to their listing requirements; we have other efforts going on in the private sector with respect to best practice—there is a considerable amount that needs to be done complementary to or in addition to the parameters of the legislation. So, I really want to pay my respects to the work of the Conference Board and their recommendations.

Now, before my time completely expires—and presumably I will get another round.

Chairman SHELBY. You will get another round.

Senator SARBANES. I just wanted to ask just a question or two.

I want to address this internal controls issue for a moment, Section 404 of the legislation, management's annual assessment and independent auditor attestation of the internal controls. We are getting some complaints, of course, about the costs of complying with this. One of the witnesses in the panel to follow you states in his written statement, "My overall concern here is that both reporting companies and external auditors will spend an enormous amount of time, energy, and money to ensure compliance with Section 404 without necessarily achieving the desired outcome of ensuring that companies have systems in place to identify potential weaknesses in their financial reporting."

And another witness on the next panel predicts that "the SEC's rules relating to internal controls over financial reporting may provide to be the most costly of the Sarbanes-Oxley Act reforms."

And I put to the panel: How important are the provisions of Section 404 on the maintenance of sound internal controls by public companies? What is the source of these increased costs that they make reference to? And what is your response to these criticisms?

Mr. Bowsher, let us start with you? Then the others can add.

Mr. BOWSHER. Well, as I said in my testimony there, it is an investment that has to be made. How large is the investment that a company has to make? It depends on what the status of their

controls is right now, and they should be in good shape. But lots of times, unfortunately, they are not.

And so those companies will have to make quite an investment, but it is an investment that they cannot afford, it is not an investment they should be making to protect their investors, their workers, and the pensions for their workers. In other words, you cannot run a large company today and not have a good set of internal controls without sometimes running into big trouble.

I remember I went on one board, a major New York Stock Exchange company, when I left the Government, and I asked all the right questions at the first audit committee meeting about are the controls in place. I was told, oh, yes, they are in place, and the auditors were there, and they agreed with it. The financial statements, I especially worried about the inventory because it was a manufacturing company. Oh, no problem there.

And then two meetings later, why, we found out, we had all kinds of problems in the financial reporting. At the end of the year, the outside auditors even said we had a material weakness in how we closed the books—which we did. They were right. They were just about 5 years late in telling the audit committee or the board about these problems. And we got them cleaned up in 6 months. We spent a lot of money because by that time you are in a crisis mode, and you are trying to get it all done.

But I think if you would go about it in an organized fashion—the SEC and the PCAOB has given industry another year to do this—I think the companies that are in good shape will not have that big of a cost. I think the others need to spend the money to get their controls in place.

Again, it is the underpinning of the certifications that the CFO's and the CEO's have to make.

I was at one audit committee meeting recently where somebody raised the issue of cost because it was costing this firm. And I always remember the CFO and the CEO saying, "well, if we have got to certify, we sure want this work done and we want this in good shape." So, I think that is the issue.

Senator SARBANES. Does anyone else want to add to that on the panel?

Mr. LARSEN. I agree with Mr. Bowsher's observations.

Senator SARBANES. My time has expired and I have other questions, but just let me make this observation. We talk about these internal controls as helping the investors, but it seems clear to me it helps the management. I would think that the management of a corporation of any consequential size would want strong internal controls in order to enable them to really know what is going on and exercise control over their company. So it is not something that management just does to help the investor, although that is an important part of it. It seems to me it is a real tool for management itself.

Mr. BOWSHER. Absolutely. In fact, if you look at a lot of the bankruptcies and companies that have to get acquired, a lot of times it is the fact that management did not have that attitude.

If you remember the Bank of New England, which was one that went under 10 years ago, it had done a lot of acquisitions. It did not get control of their accounting, and pretty soon they did not

know what was happening, and all of a sudden the cashflow ran out.

So management has a huge stake in whether they have good controls or not, absolutely.

Chairman SHELBY. Senator Allard.

COMMENTS OF SENATOR WAYNE ALLARD

Senator ALLARD. Thank you, Mr. Chairman. I also apologize for being late. I have an opening statement I would like to ask be made part of the record.

Chairman SHELBY. It will be included as part of the record in its entirety.

Senator ALLARD. Dr. Volcker, a GAO study completed in July that examined the impact of mandatory rotation of registered accounting firms, concluded that mainly the Big Four were the firms doing the majority of the auditing of public firms, and that the medium-size or smaller firms were facing some significant barriers into the market. Last week, the Chairman of the PCAOB appeared before the Committee and seemed to agree that a disparity did exist, and that the PCAOB could nurture and cherish the small and medium-size companies to see that they enter the auditing market.

First of all, from your observations, do you agree with the GAO and the Chairman of the PCOAB assessment? If so, what do you believe we could do to break down some of those barriers?

Mr. VOLCKER. Your stumbling over these initials matches my own. I would recommend maybe you amend this bill so we would have simpler initials for this board.

I am not familiar with the report of the GAO in this area and the particular contrast that you are drawing. My experience has mostly been with these big companies, and in the area that I have been concerned with, with these conflicts in the variety of services, it is the big companies that are totally dominant in auditing big companies. The big accounting firms are dominating in auditing the big companies, and that is where the problem lies.

I cannot comment on, I think, the typically more specialized firms or firms that deal with very small companies, and I am not aware of so many problems there.

Senator ALLARD. Maybe other members on the panel would like to respond to that comment.

Mr. BOWSHER. Yes, I can comment. What you have is an unfortunate situation where we have too much of a consolidation in our accounting profession. We had eight big firms for many, many years. In fact, when the Moss-Metcalf hearings were held in the late 1970's, it showed that the concentration of the auditing firms was not near as great as maybe the industry was by industry classification. But then they consolidated down to four, and they really were planning to go down to three. KPMG was going to merge with Ernst & Young. And, luckily, they called that off because with Andersen disappearing, we would be down to three now instead of four.

And they do a very high percent of the audits of all the big companies, not only in the United States but also all over the world.

I mean, it is 85, 90 percent when you look at the dollar value. And so this is a problem.

There has always been this wish and hope that these medium-size firms would grow up into being the big firms and small firms could grow up. But it has not happened in the last 20, 30, 40 years because now the investment to come into the business, to have overseas offices and everything like that, is very difficult.

I see this as a potential problem down the road, no question.

Senator ALLARD. Yes, and especially if you have a corporation that is looking at rotating your auditing firm.

Mr. BOWSHER. Right, right.

Senator ALLARD. Pretty soon you run out of choices out there, and I think that has to be——

Mr. VOLCKER. Rotation may not mean very much when you have only got four firms. There are not many people to rotate to.

Senator ALLARD. Yes. I also have talked to a few accountants and understand that some of the smaller corporations that are now public firms may decide to go out of the public realm and go into more of a private realm. Do you see that happening at all? Or is that in your observations? Anybody?

Mr. VOLCKER. I have a great sample of one. I know a friend of mine that runs a small public firm is considering going private because he thinks the auditors have become too tough now. I would not generalize from that particular experience, but in relation to Senator Sarbanes' earlier question, I think this bill was really aimed at big public companies. That is what we are talking about, and the comments Mr. Bowsher made about that are relevant. If you have a really small company—and some are simpler than others—some of this seems a little burdensome. But I think this can be hopefully alleviated by common sense and administration.

Senator ALLARD. So at this point, you would consider that would not be a big concern to——

Mr. VOLCKER. No, I would not think it is a big concern, but I understand that——

Senator ALLARD. I appreciate that. Yes, I do, too.

It has been about a year now since Sarbanes-Oxley was signed into law. After this first year, what observations would you make about Sarbanes-Oxley as far as potential changes that may be needed in the near future? I am not talking about, you know, 10 years out, but maybe within the next 4 or 5 years? Or do you see any? Anybody want to comment on that?

Mr. BOWSHER. I would stick with the Chairman's opening view there, that we should give this enough time, a longer period than 1 year, and let the private sector have time to implement it. I think all of us believe that they are making progress here, but I think in 3, 4, or 5 years it would be worth looking at.

Senator ALLARD. I want to push that a little further. Any potential areas? Yes?

Mr. VOLCKER. I have a special pleading here, which really is not special pleading. But I have responsibilities with the international accounting framework in an effort to get consistency around the world. And the concern reflected in Sarbanes-Oxley about the equivalent U.S. body, FASB, about how they are financed has been dealt with by providing a mechanism for the assured financing of

FASB. I was disappointed that you did not extend that explicitly to an American share of the International Accounting Standards Board, because we have the same problem. We have the same question that arises. I do not think there is really a great substantive problem, but we are financed by voluntary contributions from accounting firms and major international businesses.

I presume we can continue that way, but we have also been looking at alternative methods of financing that might provide greater assurance of independence if necessary. And I would like to think that this bill even could be interpreted as permitting FASB to extend some of their financing to us for the U.S. share of the IASB. It is a relatively small amount compared to what FASB spends, but I think it is a relevant issue given the importance of international accounting standards.

Senator ALLARD. Thank you for your comments. I see my time has run out. Thank you, Mr. Chairman.

Chairman SHELBY. Thank you, Senator Allard.

Senator Corzine, we have a few minutes. Do you want to start?

COMMENTS OF SENATOR JON S. CORZINE

Senator CORZINE. Well, I want to commend——

Chairman SHELBY. We have a vote on the floor——

Senator CORZINE. —you, Mr. Chairman, for bringing such a distinguished panel. There are not four better minds to speak to the issue that we are doing in the review of this, and I compliment all of them for their contributions, not only with regard to corporate governance and ethics and all the other issues that you have addressed, but also for your leadership in the country as well.

I particularly want to say that Chairman Larsen is a person that I am distinctly proud of, being a New Jersey-based company, and the values that he talked about are exhibited by the company that he led very clearly in the community and society in general. A remarkable period of leadership.

All those nice words. Let me ask a couple of questions that you might not interpret quite so nicely.

You know, I look at what happened to the New York Stock Exchange, some of the things that we see in mutual fund practices and governance issues that are associated with that. My own anecdotal feel with regard to the sniping and griping about Section 404 and some of the questions that have come up and resistance to shareholder resolutions and proxies and democratization of boards leads me to wonder whether there really is a buy-in yet from corporate leadership. You know, I certainly believe there has been by some, but is it as broad and widespread?

I would also say another example where I worry about it is I often see some in corporate leadership speak about risk aversion that has been built into the system because of Sarbanes-Oxley, and I would like to understand whether your assessment is generally the view of all of the members. I hope it is because I think this values-based view about how you lead companies is the right approach.

Mr. VOLCKER. If I may comment on that. I think there has been a lot of talk about overkill and in some applications I can understand that. But my concern has been at least as great about what

I perceive as essential denial still in industry generally. Certainly you see it in accounting firms, which are the most directly affected.

You have seen recently an accounting firm having several of its partners disbarred from practice in auditing public companies because of really willful bad behavior over a series of years. These are settled in a noncriminal context with the firm saying, "well, we really did not do anything wrong under the standards that existed at the time." I do not know how they interpreted the standards existing at the time. These are pretty egregious examples of behavior, and people are still employed by the company.

I can only see that as a symptom of denial.

Senator CORZINE. Any other comments?

Mr. PETERSON. Senator Corzine, my needle is probably stuck on this subject, but I have read every public opinion study, I think, known to man on this subject, and before you came, I pointed out I have never seen public mistrust at the level it is today. And I really think the ultimate litmus test that would help answer your question is whether there is a fundamental change in executive compensation, because that is the issue with the American public.

Now, with regard to the questions of these outside advisers, the theory in corporate governance, as you know, was that you not only had directors representing the stockholders, but they also had so-called independent outside advisers. I am talking about auditors. I am talking about compensation consultants. I am talking about law firms and so forth.

Now, the theory was that for their monitoring purposes, their client were the outside directors and ultimately the shareholders. But I think what happened with many of these firms, in their understandable desire to grow, they got into a lot of businesses that had very little to do with the monitoring function, but it was where the big fees were. And you and I were in private firms for a long time, and we know how partners get compensated in private firms. They get compensated, importantly, by the overall revenues that they produce.

If I am an auditing firm and I am getting huge fees for consulting—and in the year 2000, 2001, the consulting fees were 3 times the auditing fees. In the case that Paul Volcker was talking about, these tax planning, tax advantage strategies, the success fees were 3 times, or thereabouts, what the auditing fees were. Or law firms that were getting huge M&A fees that were unrelated to a specific problem that came up. And I have had the painful experience in three public companies where we had to be investigated for some alleged improper behavior. And when the management picked the regular law firm, I can assure you the investigation was not appropriate or independent.

So, I think part of the answer to this problem is for the outside directors to take charge of all other relationships with these outside firms, to hire them and fire them and make it clear that their client is the outside committee and outside directors.

We went so far as to suggest, among other things, aside from tax advantage strategies, that in the case of an investigation you should not use the law firm that is your regular law firm. And I think if we can get that best practice, you are going to see the performance of these independent firms be much more independent.

Senator CORZINE. Chairman Shelby, I have one quick question.

Chairman SHELBY. Quickly, because our time has run on our vote.

Senator CORZINE. The point that Mr. Peterson made in his testimony about the negative consequences of Congress' placing a $1 million cap on cash compensation deductibility, it is a topic that can be discussed long and needs a lot of detail. But do you think we should be addressing that legislatively and go back and correct that? Because I do believe, as I think you believe, it led to this emphasis on options and other types of compensation.

Mr. PETERSON. This gives me a chance to bid Mr. Sarbanes—Paul, I used—excuse me, Senator Sarbanes, I used a word called "iatrogenic effects" from the Greek. I definitely think that was a case where it had unintended effects, and I do not know how my colleagues feel, but I do not think it was a helpful piece of legislation, and still do not think it was helpful.

Chairman SHELBY. Our time has run out. Senator Carper, we are going to recess now to go vote. Do you want the panel to come back?

Senator CARPER. I will move very quickly to the floor and back, but if the panel could stay, I would appreciate it.

Chairman SHELBY. You want to bring them back?

Senator CARPER. If that is possible.

Chairman SHELBY. And if you get back, you can reconvene the Committee.

Senator CARPER. We will move some legislation.

[Laughter.]

Chairman SHELBY. We will be in recess for a few minutes.

[Recess.]

COMMENTS OF SENATOR THOMAS R. CARPER

Senator CARPER. [Presiding.] Before the Chairman returns, I will ask the clerk to report out by unanimous consent legislation affording Delaware special privileges.

[Laughter.]

I just want to say, when we were walking down the hall, Chairman Shelby, Senator Sarbanes, and I were just remarking on what a terrific panel this is. And I know Senator Corzine said this earlier, but just to each of you, thank you for, in some cases, your service to our country, your continued service to our country, and the example you have provided to others in the business community. We are just grateful for all that you have done and that you continue to do. And I very much appreciate your willingness to hang in here with us for a little bit.

First of all, with respect to corporate governance, I want to ask a question on the ability of corporations' boards to attract quality members, the kind of well-qualified members that you speak to in your recommendations. It is a lot tougher to serve on boards these days, at least to do a good job. How are companies finding the difficulty of attracting the kind of people that they need to serve and keep them?

Mr. LARSEN. It is becoming increasingly difficult to find qualified board members. I think most individuals are limiting the number of boards that they are willing to serve on, and I think the issue

is particularly significant in companies that have problems, business problems of one kind or another, or historically regulatory or legal problems. And when they need it most, they are finding it very, very difficult to attract anybody onto that board for fear of being drawn into extensive litigation.

It is an issue, and I do not know what to do about it.

Senator CARPER. There is a statement here in your section on corporate governance that says, "Companies will certainly have to develop ways to motivate and attract such independent directors in an era of rapidly increasing government requirements."

Are you aware of any best practices that are out there that have evolved in the last year or two that we might hold up as examples to other companies? Anybody?

Mr. LARSEN. I do not think there are any simple answers to this. Clearly, what I have seen is that it is taking the combined efforts of many board members to go out and recruit other board members. So it is no longer a simple case of making a phone call and asking somebody whether they are interested, but rather now you have to go visit with them, they often want to do their own due diligence to find out what they are walking into before they get into it. And I think that is healthy because at least they then know what they are getting into.

But I spend a considerable amount of time on a number of boards where I will go out and try to personally recruit another board member and assure them that it makes sense for them and divulge completely what the situation is. So, I think it is taking a lot more effort on the part of individual board members, and that is probably a good thing.

Senator CARPER. Yes, sir, Mr. Bowsher?

Mr. BOWSHER. Yes, I would second the way Ralph ended there about it is a good thing, because I think that they are paying a lot more attention through the nominating committees of the boards now as to who do they need on the board, what kind of skills, what kind of background, and everything like that.

I think also you are seeing some people who maybe would not have been considered in the past that do have the qualifications. I was just out in Chicago talking to a board that wanted me to come on. I could not do it because I am kind of full up right now. But there was a young lady there who is the CFO of a major corporation, and she was describing the two or three companies that she had been asked to come on the board to be the financial expert. And she is highly qualified. She was a partner with a big firm. She is CFO of a major company. And I think sometimes in the past that she would not have been given those opportunities.

So, I think there is a broadening now of looking at the talent base, and the search firms are very much more involved now, in other words, trying to find quality directors and everything like that. And I think that is healthy. I really do.

Senator CARPER. All right. Thank you. Your comment about the woman who is a CFO gives me an opportunity to segue to another question. I was out in Silicon Valley talking with a CFO who is also a female, and a company that had been around for about 10 years. And she was arguing—not arguing, but advocating forcefully that the stock options should not be expensed.

Mr. BOWSHER. That is Silicon's Valley view.

Senator CARPER. Yes. If you can just make the point, put yourself in their shoes, and if one of you could just make their point, and then counter those arguments. Please, anybody?

Mr. LARSEN. I will take a stab at it, Senator. The arguments that I have heard from Silicon Valley—which I am sympathetic with, by the way, and I do not hold quite the same views that Dr. Volcker has on the evil of stock options. But if you look at the Silicon Valley firms and you look at some of the remarkable things that they have accomplished, there was a high, high level of risk for those young men and women who went into those businesses 5, 10, and 15 years ago. Frankly, the only thing—and I have some personal experience with it—that attracted these people in, was the chance to really hit a home run. And I think stock options were an important part of that.

Now, as companies mature and as the upward movement in their stock moderates, it has less pull. But I can understand, if I were starting up a firm and I did not have any money and the only thing I had is to offer a young Ph.D. electrical engineer the opportunity to strike it rich if he hung in with me and built this technology, I can understand where that is an important draw.

Having said that, I think the expensing of stock options is something that needs to happen at some point because it is a real cost and it is diluting the shareholders' equity.

Mr. PETERSON. Senator, you are probably aware of this on stock options, but in the event you are not, let's clarify something.

One of the anomalies of accounting was that if you had a fixed-price option, you did not need to expense it. But if you had a performance-based option or a grant, one that said they vest if you achieve a return-on-equity goal or an operating cashflow or something, that was expensed. So that led to this curious bias against injecting the very performance measures that would have made them far more effective. And that is why one of the great virtues of expensing, and if we can agree with ourselves and foreigners on a common set of standards, is we think it will drive it much more toward performance, which is our basic theme here.

Senator CARPER. Thank you.

Mr. Volcker.

Mr. VOLCKER. I think I better state my position on stock options a little more carefully.

[Laughter.]

Senator CARPER. It was interesting. In the section here, there was a footnote to the section under corporate governance that suggested that you and I think Mr. Grove had a somewhat different view than the rest of the panel.

Mr. VOLCKER. We did indeed. When I state my position, what I say is for a large publicly owned company with diversified ownership, the use of fixed-price stock options needs a lot of careful justification as to why it suits their particular circumstances when I think demonstrably the temptation to abuse stock options is great; it has been demonstrably so clear.

That does not say it—you are a start-up company in Silicon Valley, you have no cash, you want to give away some of your company prospectively, that is your decision. You are the owner; you

can do it. I think there are other ways of giving equity. I am not objecting to start-ups, whether in Silicon Valley or anyplace else—I am not ruling it out for anybody. But I am saying the temptation is so great to give these options away, that do not appear to cost anything that, in fact, often give perverse incentives, not for that young engineer in Silicon Valley but the chief executive of unnamed companies, which we have seen quite a few examples of recently, is a different matter.

Mr. PETERSON. That is particularly true, Senator, if you have short holding periods. You see, one of the things—New York University did a study of what executives did with stock options, and the vast majority of the executives sold the stock right after it vested. So if you have a very short holding period, that creates the short-term-itis and managing short-term earnings. The incentive is terrific because you get huge gains that have little to do with long-term performance.

Senator CARPER. Mr. Bowsher.

Mr. BOWSHER. I have a son who is an MBA and a venture capitalist on Sandhill Road in Silicon Valley, and he has asked me the question that you have just asked more than once, because he believes in stock options. But I really say basically what Ralph and Paul have, that for the smaller company, the private company, it certainly is a viable vehicle, I think, in compensation to get the company off and going and everything like that.

When you become a public company, I think that does really change the ball game, and I think Paul's point is that they were badly used by a lot of public companies, and that is what we are trying to get at here so that we get rid of the bad features of these stock options.

Senator CARPER. One last question, if I could. I am going to quote this. It is from your corporate governance section again. It reads, "The Commission also believes that policymakers"—I think that would be us—"should find ways to create incentives for investors to hold for the long-term perhaps such an increasing"—let me just—yes—"the differential tax rate for the long-term and short-term holders. The Commission believes, however, that any detailed consideration of tax policy is beyond the scope of its current work." This is, again, with respect to attracting investors who are going to hold the stock for the long-term as opposed to the short-term.

I realize this is not part of what you are trying to do as members of this Commission, but any thoughts you have with respect to——

Mr. PETERSON. Senator, I will take a crack at that. Jack Bogle educated me a lot, at least. Corporate governance theory has this notion, you know, of the symmetry of interests between long-term owners and management. That raises the interesting question: Who are these long-term owners you are talking about? The average turnover of a New York Stock Exchange stock annually is about 110 percent, which means it is held about 11 months. On Nasdaq, it is 300 percent. So you have people who are, as Jack Bogle points out, more in the nature of short-term speculators rather than long-term owners, and get here we are talking about your long-term responsibilities as owners of the business.

Warren Buffett has been advocating what you are talking about. Should there be a tax treatment that encourages people to hold

stock for very long periods of time by, for example, in the extreme case, having a zero capital gains rate if you hold a stock 5 or 10 years or something, in the attempt to encourage many more real owners of businesses, because there are a lot of constituencies—there are employees, communities, and so forth, who have an interest, as Ralph suggested, in the long-term viability of the company. And yet we have these financial incentives that are all very short-term and quite speculative.

Senator CARPER. Thank you. And thank you all again for being here today and for sharing your thoughts with us and for continued good work.

Thank you.

Chairman SHELBY. Senator Dodd.

COMMENTS OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Mr. Chairman, thank you, and I apologize for getting here late. But let me thank all of you for your participation today. I know all of you fairly well. Mr. Larsen and I do not know each other that well, but I have enjoyed your advice and counsel on a number of issues over the years, and it has been tremendously worthwhile. And I picked up from my staff some of the comments you made earlier.

Mr. Chairman, I thank you for inviting such a distinguished panel to be here.

Chairman SHELBY. Thank you.

Senator DODD. Mr. Peterson, I enjoyed—I was going to insert in the record here for the benefits of my colleagues your piece you wrote in *The New York Times Magazine,* several months ago I guess now.

Mr. PETERSON. The enthusiasm in some quarters was a bit restrained.

[Laughter.]

Senator DODD. That is why I thought I would mention it here, to try and help. But it was, I thought, a very, very good piece, and let me just say—we have said this in the past, those of us who are here, but Paul Sarbanes and certainly Jon Corzine, Mike Enzi, and Mike Oxley did a great job on this bill. I ask every one of my business groups in Connecticut, large and small, how they are reacting to this. I am very curious. And these are very private kind of meetings, I must say the response has been overwhelmingly positive. That is not to say they are not concerned about some aspects of this and how this will ring out and we are still discovering areas that may need some tinkering with. But overall, from a Connecticut standpoint, it has been overwhelmingly supportive, in fact, welcomed.

I do not want to draw the analogy too tightly here, but it reminded me of the Foreign Corrupt Practices Act which Senator Sarbanes was involved in, and others. There was such opposition to that. Of course, that took a much longer time to get done. But today the reaction to that piece of legislation, generally speaking, has been fairly positive. It has done a lot more good than people thought it would do. Here the response has been more rapid, but overall pretty positive, and giving them an opportunity to clean out boards, get audit committees functioning, doing things that many

of these CEO's wanted to do for years, did not have the—they did not think, anyway—authority to really do it as well, and Sarbanes-Oxley gave them that chance.

Chairman Volcker, I am anxious to you and Mr. Bowsher, given your experience in this—and I haven't had a chance to—I was troubled on the Arthur Andersen issue, and I want to thank you, by the way, for your efforts there. You did a tremendous job, and I do not think it has been publicly recognized as widely as it should be, your Herculean efforts to save what was a great, great company. And just as a layman looking at this, clearly, no one is arguing about what should have happened to those responsible in the Enron issue. I also know there were thousands of other people that worked for this company globally that got swept away in all of this.

Obviously, someone has made the point that in the future it will be very hard to deal with any of the other accounting firms in the sense that you are not going to have any left.

I wonder if you might just share with us your own thoughts in retrospect. Were there things that we could have done or should have done differently that might have created a different situation so that we may be faced with similar problems coming down the road. And I would love to have at least some brief thoughts and comments on what might have been done differently to avoid losing a great company, in my opinion.

Mr. VOLCKER. Well, look, I approach this in a rather romantic frame of mind. Arthur Andersen was a big company, and they obviously had a lot of difficulties over a period of time. But I had this feeling, with the help of Mr. Bowsher and a few others, that we could have reformed that company, and it would have been a different company, and that would have been a good example for the accounting industry in general. We would be better off having that company in a fully reformed mode, so to speak, which we do not now have.

You are absolutely right. As I have observed this process, people are very chary now, seeing what happened to that firm when it got indicted, in dealing with other firms. They are using maybe more kid gloves than is desirable.

So it has had a kind of perverse reaction. I obviously have a special point of view. We did not get the reform done in a way that it could have been done within the private system, and it has also to some degree, I think, affected prosecutorial zeal in other areas.

Senator DODD. From a public policy standpoint—and maybe you would want to think about this some more and get back to us—but was there something we could have done as public policy setters here, delayed this in some way or given you more of a chance to operate?

Mr. VOLCKER. I do not think you in the Congress could do anything at that point. It was not an area subject to legislation. I do not fully understand, obviously I am in no position to understand, why the Department of Justice and the SEC together—the SEC did not make the decision—but wanted to indict. I think they knew what the consequences would be. And I understand, you know, that there were a lot of activities in that firm, just on the auditing side, that were very egregious examples of failure of professional responsibility.

It was not an easy call, but, romantically, I think we could have done it another way and a better way.

Mr. BOWSHER. I certainly agree with Paul. I think we could have easily reformed that. When he asked me to come and have breakfast one morning to discuss trying to save Arthur Andersen, he turned to me and said, "Do you think we can do this?" And I said, "Compared to some of the other things that you and I have been involved in, like the Penn Central and the S&L crisis and things like that, this is going to be a piece of cake."

[Laughter.]

Then, you know, 3 months later, Andersen was gone.

Mr. VOLCKER. He is more of a romantic than I am.

[Laughter.]

Mr. BOWSHER. Paul once said that, you know, we knew our company was a little lame. We did not know that our Government was going to come out and shoot this horse. That is what I think happened. I think it was very unfortunate. I am a retired partner—I was with Arthur Andersen for many years, up until 1981.

Senator DODD. That is why I asked. I know you were.

Mr. BOWSHER. I know a lot of people, the widows and others were really badly hurt, who had nothing to do with the Enron situation. I believe think it does come to one big public policy issue, and that is, do you hold people accountable criminally at the top for a large organization where something happens way out in the organization? You know, if the top is involved in some policy that truly is—but to think that this destroying of the records, which later they produced most of the records, as I understand, from other sources, was so egregious that you had to hold the whole firm accountable for it. It just I think was a terrible overreaching by the Justice Department, and unfortunately, as Paul said, we are now down to four times. We have one less firm, and that firm could have become what it used to be, and that was the gold standard for auditing.

Senator DODD. Yes, it was.

Mr. VOLCKER. Let me just make one comment that does not directly respond to your question, but it responds to Sarbanes-Oxley. You could not get involved with Andersen, for however short a period of time, when they were in crisis and under stress, without understanding the conflict between the auditing side and the services side was so intense, they almost could not make a decision.

Senator DODD. Well, they spent more money. Actually, the contract for the consulting was larger than the auditing contract.

Mr. VOLCKER. Yes. And, you know, every decision they made, how would this affect the auditing, how does it affect the consulting side? And there was no decision that did not affect one side or the other, so they did not make any decisions.

Senator DODD. That is a good point, and that has been, obviously, corrected by steps we have taken here. I appreciate your observations, and, again, I commend both of you for the efforts you made. As I say, all of us have constituents that worked in that company, and I just felt terrible. These people had nothing at all to do with this, and they had their careers—in fact, embarrassed even to mention they were associated with this remarkable firm.

Mr. VOLCKER. One of the ironic experiences of that, I was invited to go out and give a lecture at Northwestern University, in Arthur Andersen Hall, Leonard Spacek Auditorium, about 2 days before they went down the drain.

Senator DODD. And Arthur Andersen, when you think of who he was and what a great contribution he made.

Mr. VOLCKER. He was a great paragon of effective auditing, and other firms told me, whoa, we used to be so jealous of Arthur Andersen because it was so strong and their disciplines were so good.

Chairman SHELBY. I think, Dr. Volcker, if they had just shot the rider or the jockey and not the horse, we would be a lot better off. The aim was too broad. That is my observation.

Senator DODD. Thank you very much, Mr. Chairman.

Chairman SHELBY. Senator Sarbanes, do you have further questions?

Senator SARBANES. I have just one question I wanted to ask because I want to try to develop a record here.

In testimony presented to the Committee last week, the head of PricewaterhouseCoopers stated that his firm's tax practices experienced a significant decrease in demand for tax services from their SEC audit clients. He went on to say that the decrease in the United States has been around 20 percent, and evidence shows that the trend is continuing. And he concluded by arguing that precluding accounting firms from rendering tax services to their audit clients and the inevitable long-term consequences of an exodus of tax talent from accounting firms will not serve investors well.

I would like to get your reactions to that statement.

Mr. BOWSHER. I was surprised when he stated the number the way he did because he did not give you the other half of the situation. In other words, there is no question that each firm is seeing a reduction in the tax services for their audit clients. But that means that most of the companies—and American Express is a good example, where they went out and hired another firm to handle the tax and a lot of its special work, and that was Pricewaterhouse. And so there are millions of dollars of fees coming into these firms that did not used to come in from clients that they do not audit because they now are working with two or three of the firms rather than just one firm.

So, I think that the idea that they were having a big loss but not having the gain in the services, you did not get the total picture.

Mr. VOLCKER. My comment would be whether they have lost some revenues or not, it just is an area, not in the traditional type of tax preparation work, but in the aggressive stuff for which they are paid success fees—whatever they call them, they amount to success fees—which is contrary, as I understand it, to auditing ethics. It just creates dangers that have been highlighted repeatedly now in recent incidents. It has finally disturbed the IRS itself to take action that has embarrassed some of these firms.

Senator SARBANES. We looked at this when we were trying to develop the legislation, but we just did not have the time to come up with the line that would divide traditional tax services, which have always gone with accounting practice, from aggressive tax planning that involved clear potential conflicts of interest. But, increasingly, you know, they have been engaged in providing counsel and devel-

oping an effective exploitation of loopholes, and that I think has created a very real problem.

The other point that I think Mr. Bowsher made which is important—and it applies not only to tax services, but there is also a whole list of consulting activities which, if you are the auditor, you cannot engage in. Other consulting activities you can engage in only if the audit committee approves it. Auditing firms may lose consulting activities, the other ones on that list from thier audit clients, but they may well pick these service up from their nonaudit clients since other firms will have to drop them. So it just shifts it around, and that is particularly the case when you only have four auditing companies that do 90 percent of the public company work.

Mr. BOWSHER. Deloitte Touche just announced their earnings were up 21 percent this past year, and that is a big part of it, the new work that they are getting from clients that they are not the auditors because those firms have decided to work with two or three firms.

Mr. VOLCKER. But I would also say I would like to see the revenues of these auditing firms go up if they are charging more for better audits—not if they are just charging more for the same old audits. But I think auditing has too often been a kind of loss leader a given of things they are willing to do because they are only providing a minimal audit. If they are providing the audit that Sarbanes-Oxley calls for, I think they are going to have to be better paid—for the audit itself, not for ancillary services.

Senator SARBANES. Thank you.

Chairman SHELBY. Thank you, Senator Sarbanes.

I want to thank the panel. This has been a great panel, and we welcome all of you back here.

On options, I think most people believe there is a place for options if properly used. But some nonexpensing options——

Mr. VOLCKER. I may even believe——

Chairman SHELBY. The nonexpensing of options was always troubling to a lot of us.

Dr. Volcker.

Mr. VOLCKER. I may even believe that there is a place for options if properly used, to use your words.

[Laughter.]

Chairman SHELBY. And I believe Secretary Peterson said that in a different way.

Mr. PETERSON. Precisely.

Chairman SHELBY. He explained it in detail, and so did Mr. Larsen and Mr. Bowsher.

We appreciate your appearance here today. We know it has been long, but you add a lot to the record. Thank you very much.

Chairman SHELBY. We are going to call up the second panel now, if we can get started on that.

I want to thank the second panel for your patience here this morning, all of you. Your written statements will be made part of the record in their entirety. You can tell it is afternoon here, a few minutes after 12 o'clock noon. We will start with you, Mr. Anderson, if you could briefly sum up your relevant points. Thank you so much. Welcome to the Banking Committee.

STATEMENT OF BRIAN P. ANDERSON
SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER
BAXTER INTERNATIONAL INCORPORATED

Mr. ANDERSON. Good afternoon, Mr. Chairman. I will definitely be brief.

Chairman SHELBY. Absolutely.

Mr. ANDERSON. I am Senior Vice President and Chief Financial Officer of Baxter International, a global health care company, listed on the New York Stock Exchange, with approximately $8 billion in sales and about 50,000 employees in 100 countries around the world.

I am very pleased to have the opportunity today to join you to look at the implementation of Sarbanes-Oxley 1 year later, particularly from my perspective as the chief financial officer of a large public company as well as the chairman of the audit committee of another large public company. Sarbanes-Oxley represents a bold step toward restoring public confidence and rebuilding trust in the capital markets that is so essential to the proper functioning of our free enterprise system, as the previous panel I think so eloquently stated.

This law seeks to improve investor confidence by requiring CEO and CFO certification of periodic reports, enhance disclosure requirements, and, finally, a redesigned approach to regulations of the accounting profession, including the important aspects of auditor independence. In general, we believe these rules have served their intended purposes extremely well.

One of the most high-profile aspects of the Sarbanes-Oxley Act is the accountability it places on corporate executives to ensure that financial information is complete and correct. Enron and related scandals have placed the leadership and ethical standards of every executive in every corporation on the line, and I was particularly pleased to hear Ralph Larsen's testimony. Our CEO and I absolutely applaud these certification requirements, and we have signed these certificates without hesitation. This is a part of our job, and it is our responsibility.

Issuer disclosure in both financial and nonfinancial arenas has improved significantly under Sarbanes-Oxley, and perhaps more importantly, management's time, energy, and focus on enhanced disclosure has increased.

As a multinational company operating in over 100 countries, we have found that even though we had rigorous reporting and control environments, there were still improvements that could be made.

On the other hand, I believe that it still remains to be seen whether the time, effort, and expense required to comply with Section 404 of the Act will ultimately result in significantly enhanced internal controls and procedures across corporate America. In our case, I believe it will.

I also believe that the increased responsibility and focus that Sarbanes-Oxley has brought upon independent auditors is also a very positive development. The importance of the public's trust in accountants, particularly as it relates to the audits of public companies, cannot be emphasized enough. In that regard, I believe Congress has successfully implemented important changes designed to ensure auditor independence. These include, obviously, limiting the

kinds of nonaudit services that can be performed for audit clients, restricting relationships that can result in a lack of independence, establishing "cooling off" periods, ensuring mandatory audit partner rotation, and, finally, the creation of the Public Company Accounting Oversight Board.

The Act has also solidified an important link between the independent auditors and the audit committee of public company boards. At Baxter, we have had several of these processes in place for many years, including executive sessions between the audit committee and our independent auditors, as well as audit partner rotation. And several years ago, we took the step of actually having our board receive continuing education sessions at each audit committee meeting in areas of financial accounting and auditing, and our audit committee has responded very well to this training as well as the quiz that we give them on these topics. Overall, I believe that the new rules imposed by the Act with respect to public accounting firms and audit committees should result in significant positive change.

In regards to boards, I believe the Act has had and will continue to have a significant positive impact on how boards interact with those of us in executive management.

At Baxter, we are very proud of our strong commitment to maintaining the highest standards of corporate governance. In 1995, we were one of the first companies to adopt formal corporate governance guidelines, long before this became in vogue in corporate America and actually a requirement of Sarbanes-Oxley. Most of the new rules that are now mandated are practices we have had in place for years, and, therefore, the new law has not dramatically impacted our practices.

Therefore, Mr. Chairman, looking back at what has occurred since the enactment of Sarbanes-Oxley, I believe we see, on balance, a very positive and encouraging picture. To those who feel that Sarbanes-Oxley may have gone too far, I would say that the strong medicine is working, and we must not abandon the treatment just because there may be a few unwanted or unpleasant side effects. At the same time, to those who believe that Sarbanes-Oxley may not have gone far enough, I would also urge caution and strongly encourage them to closely monitor the impact of the law to just make sure that we have not tipped the balance too far in any one direction.

Specifically, I believe we must continue to pay close attention to preserving the appropriate balance between Federal and State law, the potential erosion of the business judgment rule, increased liability for directors, and the increasing hesitancy of very qualified individuals to serve on corporate boards, especially the important role of the audit committee.

Mr. Chairman, we very much appreciate having the opportunity to appear before the Committee today to underscore the importance of what you have accomplished so quickly with the enactment of Sarbanes-Oxley and to express our very strong support for the overall goals that this legislation is intended to serve.

Thank you very much.

Chairman SHELBY. Thank you.

Mr. Castellani.

STATEMENT OF JOHN J. CASTELLANI
PRESIDENT, THE BUSINESS ROUNDTABLE

Mr. CASTELLANI. Thank you, Mr. Chairman. I, too, appreciate the opportunity to share the Business Roundtable's view on the Sarbanes-Oxley Act and restoring investor confidence.

I would like to begin by commending this Committee and your efforts and Senator Sarbanes' efforts to strengthen corporate governance and restore investor confidence over the past 2 years. Our organization shares that objective, and we strongly supported the Act when it was being considered, and we have supported the SEC's efforts to implement it. And I think a word of thanks goes to the SEC. Despite a tight rulemaking schedule, it has taken the time to consider every rule, weigh its consequences, and solicit, and listen, to input from investors, companies, and others.

The Act has put a necessary spotlight on corporate governance and financial reporting. Our members have viewed the Act as an opportunity to enhance their corporate governance practices and financial reporting procedures. In addition, the Roundtable companies have implemented, voluntarily at this point, many of the proposed New York Stock Exchange and Nasdaq corporate governance reforms, with independent boards of directors, entirely independent audit, nominating, and compensation committees, and written committee charters.

And I would like to talk about a recent survey that we did of our companies and our members, which we believe shows that they are not only living up to the requirements of Sarbanes-Oxley but also the spirit of these reforms.

For example, 88 percent of the Roundtable companies report increased involvement in board and committee meetings by members of the audit, nominating, and compensation committees. Over 90 percent report increased involvement by the board as a whole. In keeping with the spirit of the reforms, audit committees today have taken on ownership of the relationship with independent auditors, making it clear that the auditors report to the committee and not to the management.

Our companies also report a dramatic increase in director evaluations. Seventy percent of our companies are performing director evaluations this year compared to 44 percent in 2002. As we stated in our own *Principles of Corporate Governance,* directors should only serve so long as they add value to the board, and the recent rise in these evaluations reflect our companies' renewed commitment to board quality and accountability.

We also support enhanced communications with shareholders, and, to that end, we have supported recent SEC efforts to increase disclosure about nominating committee processes and to require disclosure concerning the shareholder communications with the board. In fact, our survey shows that two-thirds of the Roundtable companies have discussed with their own nominating committees a process to communicate and to respond to shareholder proposals and inquiries. An equal number have a process in place to communicate and respond to shareholder nominations of board candidates.

Moreover, we strongly supported the New York Stock Exchange and Nasdaq proposals to require regularly scheduled executive sessions of independent directors. In fact, the independent directors of

55 percent of our companies expect to meet in executive session five or more times this year. The norm has become that they are meeting both before and after the full meetings of the board.

The New York Stock Exchange also proposed to require that a director be designated to preside at executive sessions of independent directors. Our members agree it is important to provide leadership for a company's independent directors. In our survey, 55 percent of the Roundtable companies reported that they have named an independent lead director as either an independent chairman, a lead director, or a presiding outside director.

Finally, 8 in 10 Roundtable companies report their boards of directors are at least 75 percent independent, and 9 in 10 report at least two-thirds of their directors are independent, exceeding both the proposed New York Stock Exchange and Nasdaq requirements.

Although much progress has been made in the implementation of Sarbanes-Oxley, the implementation is not complete. The SEC has provided an extended effective date for its rules relating to internal controls, which were addressed in questions to the earlier panel. And, in fact, those controls and that time period needs to be completed. The CEO's of the Business Roundtable believe that good corporate governance should be equated with a high value for all of our shareholders and our other stakeholders.

We are mindful of the potential for overregulation of corporate governance becoming an overhang on the economy. But we have not reached that point. We need to be careful going forward that we are fair in creating the obligations and restrictions in the name of corporate governance and we do not create, in doing so, an overhang on the economy that eliminates risk-taking and eliminates the ability of our enterprises to create wealth and to create jobs. We do not want directors and managers to be afraid to take risks, but we want them and insist that they have the highest standards of corporate governance.

We are moving forward in other areas to address some of the issues that the earlier panel addressed. First, we are examining how to better train current and future business leaders and to enhance the role of ethics in the decisionmaking process. Second, we are working to bring more sense and transparency to executive compensation. Finally, we are continuing to develop and share best practices in corporate governance so that companies and their boards and management can learn what works most effectively.

Congress did its job in enacting the Sarbanes-Oxley Act, and the SEC is doing its job in implementing the Act. We, in corporate America and at the Business Roundtable, recognize that the rest is up to us.

Thank you.

Chairman SHELBY. Mr. Grinstein.

STATEMENT OF KEITH D. GRINSTEIN
CHAIRMAN, COINSTAR INCORPORATED

Mr. GRINSTEIN. Chairman Shelby, it is a pleasure to be here today.

I am here representing the small and mid-cap, Nasdaq-listed companies, publicly traded companies. Somebody had to do it and they found me.

I am a nonexecutive chairman for one mid-cap Nasdaq-listed company, and I am an independent board director for two other Nasdaq-listed companies. So, I am the independent director that both of these panels have been talking about today.

I am also sitting here before you solely as an individual and nothing that I say today should reflect these companies, which have all gone out of their way actually to enact all of the provisions of Sarbanes-Oxley, and it is an honor to serve on these companies.

I would like to briefly begin by actually referring to the Jackson 5 briefly, where they said that one bad apple does not spoil the whole bunch, but a few bad apples can destroy investor confidence. That was the issue that we were facing in the markets today.

As Mr. Larsen said earlier, you cannot legislate morality, and that is true. But this Act has gone a long way to making sure that if you step over the line, you are going to pay a heavy price for lacking morality.

Horatio Alger, in my view, is the cornerstone of the American capital markets. The fact that any individual can start with very little and can raise themselves up is the key driving force in the American economy. That being said, Horatio Alger thrives on a fair playing field and access to fair and efficient capital markets.

The lack of investor trust and the recent corporate scandals that have been discussed in this room have seriously eroded investor trust and have limited the access, especially when you are talking about small and mid-cap companies, to efficient capital markets. Recently, over the last 6 months, as many companies went private as went public, as it became clear that access to these markets was not available and the costs of remaining public were high. However, I think that this Act has done a spectacular job of beginning the process of turning the tide and bringing investor confidence back, and will allow capital formation so small and mid-cap companies, where much of the productivity gains that we are looking for to drive the economy in the future will rest. I am very pleased to be here strongly in support of the Act today.

Briefly, I would like to say that while I have had no immediate contact with corporate fraud, there is a change in the attitude among board members since the passage of this Act. There is less deference given to management recommendations, more questions are asked, members are better prepared—and I am speaking now for myself—I am better prepared. I felt I was a good board member before; I am a much better board member today.

There are more meetings, more attorneys, God bless them, and there are more auditors and accountants at every turn. It is an unavoidable consequence of increased responsibility.

That increased responsibility does not come without a cost. It has been referred to several times, that in order to restore investor confidence, we are going to pay more money. Chairman Volcker referred here that it is okay if the auditor firms make more money, as long as we are getting better audits. That I agree with. Splitting the audit and the consulting fees was a critical feature here. Audit should not be and cannot continue to be a loss leader to get more lucrative consulting contracts. That has, I think, significantly improved the quality and the length of the audit process.

Let me talk a little bit about the cost of implementation. This is something I am very familiar with, sitting on three, publicly traded, small cap companies. The range is from a small cap of a minimum of $250,000 a year in increased cost, going all the way up to a million dollars a year for a mid-cap, or $500 million to a billion company. These are significant costs for companies that trade between $50 million and a billion dollars. More director time, more director fees, more auditor fees, increased insurance costs, which was not discussed earlier, and ultimately the threat of increased litigation, which is a big concern. We have not yet seen it, but we need to be very wary and keep a watchful eye for increased litigation that will come out of compliance or fuzzy compliance with this Act. There may need to be some safe harbor provisions put into this Act at some point if excessive litigation shows up.

Looking forward. This was the right legislation at the right time. God only knows what investor confidence would look like today if we were facing these corporate scandals, if we were looking at these courtroom battles on a daily basis, without Sarbanes-Oxley Regulation FD, and all of the improvements that have been done over the last 2 years.

In conclusion, there has been a subtle shift of power away from the CEO as a demagogue and toward the fiduciary responsibility of the CEO, the management team, and the board as fiduciaries for the public. It is a little bit too early to tell whether or not we need to tweak the legislation. I stand before you here today and say it was the right thing at the right time, and I think it is up to the SEC and this Committee over time to see where the law takes us. The increased costs are justified because of the increased confidence. Welcome to the "no spin zone" in corporate America.

Chairman SHELBY. Thank you. That was a strong presentation. Mr. Trumka.

STATEMENT OF RICHARD L. TRUMKA
SECRETARY-TREASURER, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

Mr. TRUMKA. Thank you, Mr. Chairman. My name is Richard Trumka, and I am Secretary-Treasurer of the AFL–CIO. The AFL–CIO member unions sponsor benefit plans with over $400 billion in assets, and collectively bargained benefit plans that union members participate in hold over $5 trillion in assets. For working families, our retirement security is, in large part, dependent upon the integrity of our capital markets.

Mr. Chairman, we believe Sarbanes-Oxley is a success more than a year after passage, not just because of the specific provisions of the Act but because of the tone the Act set and the message it sent.

However, the job begun by this Committee last year is not complete. Key elements of the investor protection agenda remain to be enacted here in Congress, at the Securities and Exchange Commission, at FASB, and the Public Accounting Oversight Board. While we are generally pleased with the work done by those agencies, we believe there is still an unfinished corporate reform agenda that they and Congress should turn to.

I would like to lay out some of those elements, Mr. Chairman. First, our legal system continues to suffer from real deficiencies in

the extent to which both individuals and institutions can defraud the investing public and get away with it. Despite your best efforts, in many circumstances lawyers, accountants, and investment banks can still aid and abet companies that commit securities fraud and enjoy immunity from investor lawsuits. That is wrong, and only Congress can fix it.

There are also areas where the Public Securities Litigation Reform Act has made it easier to defraud the investing public and get away with it. Sarbanes-Oxley addressed one such area by lengthening the statute of limitations, but there are others, such as the PSLRA's repeal of joint and several liability for securities fraud and the blanket immunity it grants for forward-looking statements that remain. Again, these problems with the PSLRA can only be addressed by Congress.

However, as important as litigation can be to both deterring corporate wrongdoing and dealing with its consequences, it cannot be a substitute for real working corporate governance and accountability on the part of company management. As long as CEO's dominate the selection process for company directors, we simply will not see at problem companies the kind of vigorous independent boards that we need and that Sarbanes-Oxley calls for.

That is why the labor movement believes the most important effort now underway to address the continuing governance problems at our public companies is the SEC's rulemaking initiative to give long-term investors with a substantial stake in companies the right to have their board nominees included on management's proxy.

Today, it is practically impossible for even the largest long-term investors, the TIAA–CREF's and CalPERS, to nominate and run their own candidates for the boards of public companies, so we have elections in name only.

Of course, CEO's know that investors have limited options. They know that they can ignore shareholder votes on runaway executive compensation or company audit policies, and there is little that shareholders can do about it. So we strongly support the SEC and Chairman Donaldson's efforts in this area, and fervently hope that what will emerge from rulemaking is real access to the proxy for long-term investors.

Finally, I would like to take note that, despite everything that has happened, we will have inadequate disclosure to investors of the facts of executive pay and what financial impact that pay has on the companies that award it. Despite FASB Chairman Bob Herz's hard work in this area, stock options still are not required to be expensed, a state of affairs that amounts to a subsidy to an inappropriate form of executive compensation.

As we have seen over and over again in the last year, investors simply are not given enough information about the CEO's deferred compensation plan. While these matters are properly in the hands of the SEC and FASB, they are key elements of the post-Sarbanes-Oxley agenda.

While much has been accomplished since Sarbanes-Oxley was passed, the work of reform is not complete. In response to Senator Corzine's question, there is no better evidence about the lack of buy-in than the recent comments of one of the most influential people in corporate America, Ken Langone, CEO of Invemed Associ-

ates, a former Chairman of the New York Stock Exchange's Compensation Committee, a Member of the Compensation Committee at General Electric, and three other public companies, and Lead Director at Home Depot.

Mr. Langone, who is actually responsible for the pay package the Stock Exchange offered Richard Grasso and was involved in the pay and benefits offered to Jack Welch, remains unapologetic. He told the press last week that given the chance to vote for Grasso's pay package, he would do it again. As long as that attitude continues, Mr. Chairman, with key decisionmakers in corporate America, there is a lot of work to be done.

One last point, if I might, sir.

Chairman SHELBY. Yes, sir.

Mr. TRUMKA. Fortunately, the independent agencies that are active in the area of corporate governance are, by and large, stepping up to the plate. The SEC, PCAOB, and FASB have all responded admirably to both the specific mandates of Sarbanes-Oxley and the tone set by the passage of that legislation. The labor movement surely urges this Committee and Congress as a whole to recognize that work and to fund it and to protect the independence of those agencies as they go about their vital tasks.

I want to thank this Committee and your leadership, Mr. Chairman, for the wonderful work you have done to try to help restore confidence to our markets.

Chairman SHELBY. Thank you.

Mr. Anderson, could you briefly elaborate on the implementation factors of the internal control provisions of Section 404?

Mr. ANDERSON. Absolutely. Contrary to Mr. Bowsher's earlier testimony, even though I do believe that we have very strong internal controls, this is not without cost. Certainly, if one just took a "check the box" approach——

Chairman SHELBY. Everything costs, doesn't it?

Mr. ANDERSON. Clearly, from our perspective, we are using this as an opportunity, as you said earlier, to improve our business. We are already seeing some benefit from taking a very thorough look at our internal control environment around the world and making changes to improve that environment. I do believe, in the long-run, the increased cost will be justified when one looks at what is at stake from the perspective of restoring trust in the markets.

Chairman SHELBY. Mr. Grinstein, how do you think Sarbanes-Oxley has impacted capital formation for small and medium-sized companies?

Mr. GRINSTEIN. Sure.

Chairman SHELBY. You have had a lot of experience there.

Mr. GRINSTEIN. Yes. Thank you.

It is a hard time to evaluate. This is just a data point, as I think Mr. Volcker said earlier. Over the last 4 or 5 months, as I briefly mentioned—and it is in my testimony—as many companies went private as went public. That was a concerning thing. I think that had more to do with investor confidence, and obviously the turbulence in the markets.

I think that Sarbanes-Oxley has imposed a burden on the small and mid-cap companies. It was discussed at the first panel, too. Because this was really aimed at the large companies. The simpler,

small companies are bearing a burden. When you are chugging along and making three, four, five, six million dollars a year, to add a million dollars in cost is very difficult.

That being said, I do not believe that anywhere in the world there exists more efficient capital markets, and by protecting those capital markets—already I saw on the docket for the coming quarter double the number of companies are going public. I think very soon we will see a much larger number of companies going public than going private again, which has been the historical norm.

Chairman SHELBY. That was one of our concerns early on in the formation of the legislation, you will recall. We did not want to put too big a burden on the small and medium-sized companies who churn our economy.

Mr. GRINSTEIN. By the way, we appreciate it and see where the changes are.

The other thing I think is going to happen is that there is going to become more competition in the independent audit feature. More people are going to become certified consultants in that area, specifically in the internal audit function, and as there becomes more companies in that area, as it was referred to earlier, as these companies grow, there will be more competition and the costs will go down and more efficiency. That is what we need to see.

Chairman SHELBY. Thank you.

Mr. Castellani, regarding corporate risk taking, we certainly do not want to take risk out of the market. We would have no market at all. What have you heard from your members regarding the impact of the Act on corporate innovation and risk taking?

Mr. CASTELLANI. Mr. Chairman, as we have surveyed and we continue to survey our members and talk to our members about the Act, its implementation, and its effect on the business process, the overwhelming concern, or the overwhelming sentiment, is that it has not adversely affected the risk taking process the way the Act has been constructed and the way it is being implemented.

There are costs. The costs are certainly less of a percentage to our members, which are the very largest corporations, than they are to the companies that Mr. Grinstein has been referring to. As I said in my testimony, perhaps the greatest area of cost is going to be within the area of implementing the internal control and internal control reporting requirements.

But there is a concern, and the concern has to be watched and analyzed, and that is that we do not inhibit the business risk-taking process by going beyond what is required for good corporate governance. I do not think we are there yet. You have heard from the earlier panel that there is some concern about being able to recruit and retain good, active, and independent directors. That is a concern and it is getting more difficult.

We have to be careful that we do not criminalize the business decisionmaking process and risk taking, such that we all avoid it. That is our concern.

Chairman SHELBY. That would destroy the market, would it not?

Mr. CASTELLANI. Pardon.

Chairman SHELBY. That would destroy the market?

Mr. CASTELLANI. That would destroy the market.

Chairman SHELBY. Mr. Trumka, some people are not convinced that reform efforts will continue. How do investors ensure that executives and directors push for further reforms within their companies?

Mr. TRUMKA. By having totally independent boards and giving long-term investors the right to have the proxy and nominate those boards. I think there is no substitute for that independent board, and having the long-term investors, people with interest in the company long term, having a say in who gets on that proxy and actually having a real election.

Chairman SHELBY. Mr. Castellani, what is your perspective regarding increasing shareholder participation—stockholders, as we know, obviously own the company—and how can it be done effectively? Sometimes it seems that they are totally ignored.

Mr. CASTELLANI. We think it is important that obviously the boards are responsive to shareholder concerns, as they should be responsible to all of the stakeholders' concerns.

I think there are several things that need to be examined as the SEC moves forward. Certainly we support the SEC's stated objective, which is to get at those few companies, rogue directors, and unresponsive boards, that are ignoring the shareholders.

In the SEC staff report, however, a number of options have been brought forward that may not necessarily get to that stated objective. First, if you use triggers that were described in the staff report, you run the risk, in our own analysis, of getting companies that were never intended. Some of the triggers, as we have looked at last year's proxy season, would encompass more than 100 companies, including many of which are considered having the highest standard of corporate governance.

Second, we think it is going to be very important that the SEC define very carefully what constitutes a shareholder, both from the standpoint of how large that shareholder must be—most all of our members have at least 1 percent shareholders in them—and also, how shareholders could aggregate to bringing a director nominee forward.

Third, we think that it is important that in all this rulemaking we ensure that we achieve good corporate governance, that we are not laying open a process——

Chairman SHELBY. That is the key, is it not?

Mr. CASTELLANI. Absolutely.—that we are not opening a process for organizations and shareholders who have agendas that are different than corporate governance to co-opt a board and cause the disruption that we have seen in boards that have competing agendas, different directors with different agendas, that have adversely affected the ability of the enterprise to prosper and create jobs and create wealth.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

First of all, I want to thank the panel for coming today and for their contributions as we engage in this oversight hearing. Let me continue along the lines of the subject matter the Chairman was asking about.

Mr. Castellani, do you think that the access that investors have, particular institutional investors, to placing representatives on the

board is adequate currently, or do you think it needs to be enhanced?

Mr. CASTELLANI. Senator, our members think that what needs to be enhanced is precisely what we have supported, and is part of the process that the SEC is going forward on. That is that it should be very clear to all shareholders the criteria by which directors are selected and the process by which director nominees are moved forward to the proxy statement.

Second, sir, we believe that boards need to be responsive to shareholders. They need to meet and explain the board's position when shareholders bring forth positions that are inconsistent with what the board has been recommending.

Third, we do support, as I had said, a process that can be implemented to provide more shareholder access to the nomination process, provided it meets the test of providing additional, good corporate governance, making sure that it is focused on shareholders who are, indeed, shareholders, not just share renters, that they are, indeed, long-term shareholders, and that we are ending up with directors who meet the requirements that, in fact, are imposed on us by Sarbanes-Oxley, that they are independent, that they have an expertise that they bring forward, that they contribute to the board's governance, that they contribute to increasing the viability of the enterprise in which they are going to be sitting. So we would support those reforms if you can meet that test.

Senator SARBANES. I take it that, in effect, that means you hold the view that the current system is not adequate and needs to be addressed.

Mr. CASTELLANI. The improvements that have been made in——

Senator SARBANES. There may be questions about how to address it, but you do not assert that that issue should be just left alone?

Mr. CASTELLANI. No, particularly for those boards who are unresponsive, those few companies that are unresponsive, absolutely.

Senator SARBANES. Mr. Trumka, what is your view on this thing? I think you are both in the ballpark that changes need to be made, that we just cannot stay where we are. The question is what changes and how are they conditioned and so forth.

You have heard the various items that Mr. Castellani enumerated. I would be interested in your reaction.

Mr. TRUMKA. First of all, I am glad you asked, Senator Sarbanes, because we do have definitely held positions on it.

First of all, the 1 percent threshold that he advocated we think is far too high. That would eliminate people like TIAA–CREF's and CalPERS, many of our pension funds who hold these shares for the long-term. I mean the real long-term. That type of a threshold would be far, far too high.

Second, the trigger that he recommends would be far too high and would create too much of a lag between the time the trigger comes into effect and the time you can actually nominate somebody. It could be as long as 18 months, and 18 months to some companies could be an eternity. So we would hope what was done is have a trigger that lets us long-term shareholders, like pension funds, like TIAA–CREF, like CalPERS, not speculators, not hedge funds—we agree on that part—but that the trigger not be too high.

A 1 percent threshold would eliminate far too many people and eliminate the people who actually want to participate more.

Senator SARBANES. Mr. Castellani, if the limitations that are being discussed are arrived at, do you think the shareholders then should have direct access to the corporate proxy ballot in order to place their nominees before the shareholders?

Mr. CASTELLANI. Obviously, Senator, the devil is in the details, and that is why we are looking forward to the SEC moving forward on this rulemaking. But again, to reiterate, if it is aimed at those few companies which——

Senator SARBANES. I understand your position.

Mr. CASTELLANI. —and it could work out—Excuse me, sir.

Senator SARBANES. Otherwise, you are not getting very far if they do not have access to the proxy, are you? I mean, that is pretty key, is it not, in giving the shareholders any real ability to impact on the composition of the board?

Mr. CASTELLANI. Absolutely. Let me reiterate. We have been working and providing information and comment to the SEC so that we make sure in those instances, where this type of dramatic action is needed, where this kind of dramatic action is needed, that access is given to the shareholders, to the proxy statement. But with the test that this is significant, represents a significant number of shareholders, is aimed at egregious and unresponsive action, and will result in good corporate governance, not the opportunity for people with other agendas to move those forward and disrupt the company's ability to prosper.

Senator SARBANES. I was struck by this ad that appeared in *The Wall Street Journal* on Thursday, September 25. "In the wake of scandals like Enron and WorldCom, investors deserve a true voice in director elections." It then talks about open access for shareholders as the next critical step of corporate reform.

Now, they say let us make sure the reforms are responsive and responsible. Then they indicate protect against frivolous challenges by requiring significant shareholder involvement, protect against corporate raiders by limiting involvement to long-time shareholders, protect against hostile takeovers by limiting the number of investor-nominated candidates to less than a majority, and protect against unresponsive boards by giving investors timely access to the ballot. I thought that, in effect, was saying there are certain potential abuses that could happen, that we want to guard against. Then they set those out—the corporate raiders, the hostile takeovers, frivolous challenges.

How did all of that sound to you?

Mr. CASTELLANI. I think it misses a point that is important, and I should have mentioned earlier in my answer to your question.

One of the things that is fundamental in the reforms that have been enacted over the last 12 to 18 months is something that has been mentioned I think by every member of this panel and the previous panel, and that is the need for independent boards of directors, particularly majority independent boards of directors.

What the Business Roundtable has supported and what our members are implementing is ensuring that the nominating committees are made up entirely of independent directors so as to avoid the kind of thing that Mr. Trumka just referred to in his tes-

timony; that is, that CEO's pick the members of their board of directors.

The key, in our view, is to have an entirely independent nominating committee. We think, with that, which we are seeing now implemented across corporate America, we will have better, higher quality members of boards of directors, who are more attentive, active, and are representing the view of the shareholders more capably to the views of all of the stakeholders of a corporation.

We would like to see that implemented first. It is a dramatic change, but we think an important and necessary change, and that the remedies that were advocated in that ad, the remedies that are being considered by the SEC, should that system fail, be focused only very narrowly on those companies that fail to implement and fail to be responsive to the reforms that we have talked about in the new listing standards and within the Sarbanes-Oxley Act—that is, the independent members of the nominating committee.

Senator SARBANES. Mr. Trumka, what do you say to that?

Mr. TRUMKA. To the ad?

Senator SARBANES. To his comment about the ad, to the comment we just heard about the ad.

Mr. TRUMKA. First of all, I do not think we disagree that there should be more independence on the nominating committee, and that that should raise the level of directors. However, that does not suffice the overall game because you still need a check and that check is for shareholders to be able to appoint directors when the needs of those shareholders are not being met.

I think the ad, if you take it literally, sounds like—and I will borrow a phrase from corporate America—a poison pill. It sounds like people who do not want to give shareholders, long-term shareholders, institutional shareholders, real access to the proxy, so they will create barriers so high that it cannot be done.

We would say that I do not think a company can get hurt by having shareholders put an independent director on the board, or a couple of independent directors, even if it is those 100 or 200 or 500 of the Standard & Poor 1,000. If they are qualified directors, and the shareholders want them there to speak for the shareholders, I think it only strengthens the company, it strengthens management, and it gives everybody significantly more faith in the capital markets so that they can save and invest with a lot more comfort.

Senator SARBANES. Mr. Castellani, do you feel that if you get one, two, or even three dissident members on the board, who are always raising questions about corporate practices—whether it is environment or labor, issues that you traditionally do not think are within the purview of the corporate board—that is going to, in effect, prevent the corporation from functioning in any normal way?

I preface that by pointing out that we try to run a committee here and we do not regard a dissident voice as impeding the ability of the committee to function. We have to deal with it if it comes up, and sometimes it can be difficult——

Chairman SHELBY. Every day.

[Laughter.]

Senator SARBANES. It can be difficult and awkward, but we manage to do it and everyone feels they have been represented and have been heard.

I am just curious on whether there is a mindset here that says, "oh my god, we are going to have this couple of voices here pounding away and we just cannot handle that."

Mr. CASTELLANI. Senator, first of all, let me make sure the Committee understands that good directors are good directors who question everything, who want to get to the bottom of decisions that are made. There is a difference between a director who is being active and aggressive in seeking out information and a director who has an agenda that may be counter to the stated objective of the corporation.

There has been a fair amount of experience with dissident directors. For example, in the past they have been on corporations where they felt the corporation was accumulating too much cash and, therefore, the cash should have been distributed to all of the shareholders when, in fact, just a couple of years after that it found that that same company was cash short. There have been examples where a dissident director has taken a position about being in a particular market or not being in a particular market, when a company has lost an opportunity to expand its revenues and expand its opportunities for jobs.

More importantly, it removes the cohesiveness that good boards and good companies show in their directors and their governance, where we have seen companies with dissident directors, dissident by the definition of not questioning but having fundamentally different objectives from where the company is going, have had boards were you have had to meet ad hoc separately from that dissident or those dissident directors in order to get their business done.

The last point I would make is that there is a misperception that corporations are democracies. In fact, they are not. Under State laws, and the way they are chartered, they are to represent all stakeholders, and the boards are to implement their fiduciary responsibility, not necessarily in a democratic way, not necessarily by the majority vote of all shareholders. Shareholders always have the opportunity to vote by leaving. It is our members' hope that they do not do that. We want shareholders that stay as investors for the long-term.

In fact, one of the issues which was addressed by the previous panel and the commissioners of the Conference Board was that shareholding has gone from a long-term proposition in a very short period of time to one that is less than a year, including by some of the institutions that have been named here. They have moved to very short holding periods.

So it is not a democracy. I do not think you can equate it to this Committee because it has to move and move very quickly, and move probably more often than a committee of Congress, which has to do with the legislative process. It cannot be as deliberative and it has to satisfy all of its stakeholders and sometimes in a very, very expeditious manner.

Senator SARBANES. Is it your position that if a majority of the shareholders of a corporation want to follow a certain path, that that can be ignored?

Mr. CASTELLANI. If that path is inconsistent with the fiduciary responsibility the directors have, and the directors feel there is a good business reason not to do that, it has, in fact, provided a circumstance that the best path would be to do something else.

Senator SARBANES. To whom do the directors owe their fiduciary duty?

Mr. CASTELLANI. To all shareholders at the same time.

Senator SARBANES. If a majority of those shareholders want to pursue a certain course of action, then what happens?

Mr. CASTELLANI. If it is a majority of the shareholders of the shares that are held, or the shares that are voted at the time, their responsibility is to the shares that are held.

Senator SARBANES. Let's assume that.

Mr. CASTELLANI. If it is a majority of the shares that are held and the shareholders make that known, and it is consistent with the fiduciary responsibility of the board, then the board should employ that.

Senator SARBANES. Is there a fiduciary responsibility different from responding to the majority view of the shareholders?

Mr. CASTELLANI. In some cases, I am told it can be. For example, the elimination of a poison pill requirement. Let us use that as an example. There was a proxy initiative that showed up on a lot of corporations' proxy statements, and has shown up over the last several years. There are some companies that have felt it was better to enhance shareholder value, long term, for all stakeholders by having such provisions to avoid takeover by a financial buyer who intended to either dissipate the company's asserts and the jobs that were incumbent on it, or to resell it to somebody else. So it was inconsistent and they did not adopt it.

Senator SARBANES. I am not going to pursue the subject because it is a very large subject.

Chairman SHELBY. Mr. Trumka wants to comment.

Senator SARBANES. But I am taken aback by this notion that—I mean, I do not know who you put the final ultimate decision on if you deny the majority of the shareholders having that authority.

Mr. CASTELLANI. No, I am not saying——

Senator SARBANES. We are back to the imperial CEO, the imperial board.

Mr. Grinstein.

Mr. GRINSTEIN. Senator Sarbanes, I would jump in here. I disagree gently. I have agreed with much of what you have said today. I actually do think corporations are democracies and what we are doing is actually reinforcing that.

The directors from the State law, you are exactly right. They do have a fiduciary duty to all shareholders or all stakeholders. However, if a majority of shareholders disagree with what those directors are doing, those directors are going to be voted out. That is the ultimate democracy. The President of the United States is responsible to all the citizens, but if a majority does not agree, you are going to be voted out, Senators, Congressmen, whoever.

Senator SARBANES. Yes, we are all very mindful of that.

[Laughter.]

Mr. GRINSTEIN. And sitting on a board, especially in light of Sarbanes-Oxley, we are all very mindful of that, too. So when you are

acting in a fiduciary responsibility, if you feel you have a majority of your shareholders who are opposing something, you are going to be very mindful of that.

I also want to say I agree on the nominating committees, that by diversifying the nominating committees to independent directors only, that will have a tremendous effect. It is going to take time because boards are staggered, so these directors are only coming up every other year, every third year. So the effects of Sarbanes-Oxley and the independent directors on the nominating committees is only going to take place over time. It is going to take 2 or 3 years, or several cycles, until we begin to see the diversity in the boards coming in, or several annual meeting cycles.

Senator SARBANES. Mr. Trumka.

Mr. TRUMKA. I would just like to make a couple of points. First of all, we do agree with Mr. Castellani that we have never found corporations to be democracies.

[Laughter.]

We would like to change that, however.

Second of all, it is not necessarily true that if a majority of shareholders disagree with a director that they will get voted out. If you do not have access to the proxy, management puts those same people forward and you do not get to vote on anybody. That is why having this provision and letting shareholders have access to the proxy is so important.

I want to make this very important point. There is a difference between formal independence and psychological dependence. A board member may be formally independent but psychologically dependent upon management. Only by having shareholders, long-term shareholders with access to the proxy can you guarantee the psychological independence of those board members as well.

Senator SARBANES. Mr. Chairman, I would close with one point.

Chairman SHELBY. Go ahead.

Senator SARBANES. I want to read to you a statement made by Chairman Donaldson before the Committee last week and ask for your reaction to it. This is the Chairman of the SEC.

"The short-term costs of compliance," referring to the legislation, "particularly efforts to improve internal control, should be seen, in my view, as an investment. In the long-term, I believe that the reforms realized from the Act will result in sounder corporate practices and more reliable financial reporting."

"New requirements coming out of the Act, such as personal certification by CEO's and CFO's of a company's financial disclosures, will renew focus on the independence of corporate boards and the focus on internal controls and procedures will strengthen companies in the long-run if they focus on the underlying intent of the Act rather than on mere compliance."

"Companies that view the new laws as opportunities, opportunities to improve internal controls, improve the performance of the board, and improve their public reporting, will be better run, more transparent, and more attractive to investors." That is Chairman Donaldson.

I would be interested in your reaction to that statement of the Chairman.

Mr. CASTELLANI. From our standpoint, from the Business Roundtable member companies, we could not agree more.

Senator SARBANES. Okay.

Ms. GRINSTEIN. I could not agree more.

Senator SARBANES. Mr. Trumka.

Mr. TRUMKA. Yes.

Mr. ANDERSON. We are in absolute agreement.

Senator SARBANES. Thank you all very much.

Chairman SHELBY. I will be brief. We have had two good panels today.

Every SEC Chairman who has come before this Committee—and I have only been here 17 years on the Banking Committee—I have asked the question: Who owns the company; who owns the corporation? Every one of them emphatically said the shareholders. The shareholders, as we all know, own the corporations. The directors, the CEO, and the directors do not. We understand that it be fundamental.

So if the shareholders own the corporation, I believe that where they have a greater voice and they do elect directors—and sometimes that is stacked against them, the participation in the election of directors. I think that is what concerns some people, because I have seen in my tenure here on the Banking Committee, in just looking out at the market, that sometimes CEO's and directors think and act as if they own the company. But if the shareholders fundamentally, as we know and agree, own the company, I think they have a great fiduciary relationship to that.

What is wrong with letting the shareholders, the owners, participate, even if they own just a few shares, if they so desire?

Thank you for appearing here today. I think we have all learned a lot today. The hearing is adjourned.

[Whereupon, at 1 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

I would like to thank Chairman Shelby for holding this important hearing today to discuss the impact of the Sarbanes-Oxley Act on accounting firms, financial reporting, and investor confidence. The passage of this landmark legislation one year ago was the first step in restoring public and investor confidence which had resulted from repeated failures in financial reporting and auditing.

Our capital market system is fueled by accurate financial reporting and disclosure. A relationship of trust must be established between investors and companies in order for continued and increased participation in the markets to occur. After the repeated corporate scandals, the industry has been given the chance to redeem its reputation, through the standards and requirements set forth in Sarbanes-Oxley. What an opportune time for companies to repair what has broken down, and advance the U.S. markets that are revered by the rest of the world.

I have been pleased to hear the progress that both the Securities and Exchange Commission and the Public Company Accounting Oversight Board have made thus far in implementing Sarbanes-Oxley, and I look forward to hearing today about the progress that the industry has made, and any concerns or difficulties that have arisen so far. Thank you to each of our witnesses for agreeing to testify today. I look forward to your testimony.

PREPARED STATEMENT OF CHARLES A. BOWSHER

FORMER CHAIRMAN, PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

OCTOBER 2, 2003

Thank you Mr. Chairman. My name is Charles Bowsher. I am the former Chairman of the Public Company Accounting Oversight Board. I also served as Comptroller General of the United States and head of the General Accounting Office from 1981 to 1996. I was a partner of Arthur Andersen & Co. from 1971 to 1981, and served as Assistant Secretary of the Navy (Financial Management from 1967 to 1971). Prior to that I was associated with and served as a partner at Andersen between 1956 to 1967 in the firm's Chicago office. Presently, I serve as a director of several public companies and have recently been made a member of the Board of Governors of the National Association of Securities Dealers (NASD).

I am pleased to be here today to discuss the recommendations of the Conference Board's Commission on Public Trust and Private Enterprise, and specifically the seven principles with recommendations and specific best practices for each that are contained in Part 3 of The Conference Board Commission's January 2003 report* concerning Audit and Accounting. This report is the second issued by the Commission—the first one was issued on September 17, 2002 and discussed the issue of executive compensation. In addition, I will describe what progress we think has been made in the last year, and what concerns we still have for the future.

By way of background, The Conference Board (the world's leading business network) convened a 12 member Commission in June 2002 to address the causes of declining public and investor trust in companies, their leaders and America's capital markets. The 12 members of the Commission, in addition to myself, included Peter Peterson (Chairman of the Blackstone Group, former Secretary of Commerce and Chairman of the Federal Reserve Bank of New York), John Snow (Chairman and CEO of CSX Corporation and former Chairman of The Business Roundtable), John Biggs (former Chairman, President, and CEO of TIAA–CREF), John Bogle (founder and former Chairman of Vanguard Group, Inc.), Peter Gilbert (Chief Investment Officer of the State Employees' Retirement System of the Commonwealth of Pennsylvania), Andrew Grove (Chairman of Intel Corporation), Ralph Larsen (former Chairman and CEO of Johnson & Johnson and former Chairman of The Business Council), Arthur Levitt, Jr. (former SEC Chairman and former Chairman of the American Business Conference) Lynn Sharp Paine (Professor at the Harvard Business School), Warren Rudman (former Senator and a partner at Paul, Weiss, Rifkind, Wharton & Garrison) and Paul Volcker (former Chairman of the Board of Governors of the Federal Reserve System), who is with me today to discuss two of the seven principles in Part 3 of the Commission's January 2003 report.

To begin, I strongly believe the Sarbanes-Oxley Act of 2002, which was largely the work of this Committee, is an excellent piece of legislation, especially in regard to audit and accounting issues. This legislation was long overdue. As one

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*Held in Senate Banking Committee files.

Business Week headline stated, the reforms of the 1930's were not adequate for the 1990's.

The introduction to Part 3, Audit and Accounting, of the Conference Board report clearly defines the importance of effective audits and the need for continued reform. I would quote two key paragraphs:

> The audit process is integral to the confidence required for the financial markets to operate effectively. Every public company must be audited annually by a firm of independent accountants. In the last several years, crises involving companies such as Enron, WorldCom, Xerox, Cendant, Adelphia, and Tyco have focused attention on the integrity of the audit process and its oversight. The public's trust—including that of investors, insurers, and creditors—that audited financial statements provide an accurate picture of the company's finances is essential for the confidence that the capital markets require. The alleged auditing failures associated with the recent corporate scandals have been a major factor in the erosion of that trust.

The Sarbanes-Oxley Act (the "Act") of 2002, the proposed New York Stock Exchange listing standards, and the Nasdaq corporate governance proposals have each focused on a number of structural reforms to improve the independence of the outside auditors and to strengthen their oversight by the audit committees composed of financially literate independent directors, at least one of whom, under the New York Stock Exchange listing requirements, must have specific financial expertise. The Conference Board Commission on Public Trust and Private Enterprise believes that the following seven principles, particularly with respect to larger public companies, will strengthen the reforms begun by the Act and the NYSE to bolster the public's confidence in audited financial statements.

The first major issue that the Conference Board report addressed is the need for an enhanced role for audit committees. We recommend that corporate boards should make sure and devote sufficient resources and time to implement Sections 301 and 407 of the Sarbanes-Oxley Act, especially in regard to:

- the independence and qualifications of the audit committee members;
- the need for one member of the audit committee to be a financial expert;
- the need for conducting an annual assessment of the performance of the audit committee and its members;
- the right of the audit committee to retain certain outside advisors or educational consultants as they deem appropriate.

Many of the recommendations in our report, and those in Sarbanes-Oxley Act, that relate to an enhanced role of the audit committee were previously discussed and recommended in the 1999 Blue Ribbon Committee Report on Improving the Effectiveness of Corporate Audit Committees, which was created by the New York Stock Exchange (NYSE) and the NASD in response to concerns about the financial reporting process as expressed by the then Chairman of the U.S. Securities and Exchange Commission (SEC).

It is heartening to report that it appears that numerous public company boards in the last year have moved forward to strengthen their audit committees. Audit committee members who were not independent and/or properly qualified have been replaced, and many very qualified financial experts have been named to audit committees. The General Electric (GE) Board is a good example. However, it appears that not all boards have moved forward on this much needed reform and this is an area that the SEC should monitor on an annual basis when the proxy and annual reports on Form 10–K are submitted. I would think the Committee might wish to consider requiring an annual report from the SEC on this issue.

The second major issue the Conference Board report addressed is that of audit committee member education and the need for an orientation program for each member of the committee as well as the need for continuing education programs.

The third major issue that the Conference Board report addressed is that of improving internal controls and internal auditing, which was an important section (404) of the Sarbanes-Oxley Act. Our report states that every public company board, and especially the audit committee, should make enterprise risk assessment and internal controls high priorities in order to facilitate the certification and report processes required by Sections 302 and 404 of the Sarbanes-Oxley Act.

The Public Company Accounting Oversight Board (PCAOB) has not yet issued the standards for Section 404. However, it is my view that many public companies are moving ahead to document and improve their internal controls in order to be ready to include a management report in their 2004 annual report and to be ready for their outside audit firm to review and attest to the company's report on internal controls.

For companies that have adequate and well documented internal controls and an adequate internal audit function, it will not find the reporting on internal controls to be a major or costly effort. However, those companies that have not put an emphasis on internal controls will have a one-time investment to make, but investors will be much better protected once management and outside auditors can attest to proper internal controls. This area is the basic framework for the CEO and CFO certifications regarding the annual financial statements and quarterly reports.

The PCAOB and the SEC must monitor this area very carefully and again, should keep this Committee informed about the progress achieved beginning with the 2004 company reports.

An important consideration to keep in mind is that outside auditors should not be involved in the documentation of clients' accounting and operating controls. This is in keeping with the principle that an external auditor should not audit its own work. The Sarbanes-Oxley Act specifically prohibits an external auditor from performing internal audit services for audit clients.

The fourth area that the Commission report addressed was auditor rotation. We recommend that in order to assure the independence of any audit, the audit committee should seriously consider rotating outside audit firms when some or all of the following circumstances exist:

- the audit firm has been employed by the company for a substantial period of time, for example, over 10 years;
- one or more former partners or managers of the audit firm are employed by the company; and,
- significant nonaudit services are provided to the company—even if approved by the audit committee.

I recognize that the General Accounting Office (GAO) was requested by Section 207 of the Act to study and report on the issue of mandatory rotation of registered public accounting firms. As of now, this report has not been issued by the GAO.

It is interesting to note that the recently released WorldCom report requires rotation of the auditors every 10 years.

My fellow Commission member, Paul Volcker, will discuss the next two major issues that the Conference Board report addressed—professional advisers for the audit committees and services performed by accounting firms.

The last major issue that the Conference Board report addressed directly relates to the Big Four firms which, as a recent GAO report indicated, audit most of the public companies in the United States and the rest of the industrial world. Our concluding paragraph in this section of our report stated that the business model, strategies, and focus of the Big Four should ensure that quality audits are their number one priority. The Big Four must be sure that they each represent a "gold standard" in auditing.

The question here is this: Has the leadership of the Big Four accounting firms each examined their business model to ensure that it is consistent with the idea that quality audits represent their number one priority?

Many observers of the accounting profession would say "no," that the Big Four firms have still not changed, are primarily focused on their litigation risks, and are resistant to major reform. Some, including the Big Four firms, would be more positive. One firm has invested heavily in full page advertisements in *The New York Times* and *Wall Street Journal* to convince the public that the answer is "yes."

I believe the jury is still out. Daily press coverage and other reports of continued problems with Big Four audits and other professional work indicates that much work and rethinking is still to be done.

A very distinguished accounting professor, Art Wyatt of the University of Illinois, just gave a very thoughtful speech entitled "Accounting Professionalism—They Just Don't Get It" to the recent annual meeting of the American Accounting Association, which is the group that represents the accounting professors of all our major universities. I commend this speech to the Committee (Mr. Wyatt's speech is available on the American Accounting Association website, *www.aaahq.org*).

I certainly agree with SEC Chairman Donaldson's recent statement before the House Financial Services Committee when he said that "[w]e should all realize . . . that the PCAOB alone cannot restore investor confidence in the integrity of the accounting profession. If these efforts are to be successful, each accountant, from the CEO of the accounting firm to its most recently hired employee, must demonstrate a willingness to place the interests of investors above all else. Remaining independent and 'telling it like it is' is fundamental."

Mr. Chairman, this concludes my prepared testimony. I would be happy to answer any questions you may have.

PREPARED STATEMENT OF PAUL A. VOLCKER[1]

FORMER CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

OCTOBER 2, 2003

American Leadership and Business Responsibility[2]

Cast your minds back only a few years to the mid-1990's. Powered both by new technology and the ideology of free markets, the integration of markets internationally was in full swing . . .

But then, in the glow of seeming success, something unexpected and disturbing happened. We had a succession of financial and economic crises, first in Mexico and then in Asia, in Russia, and back to Latin America. Those were big setbacks for the emerging world. With few exceptions, individual countries have not yet returned to earlier growth trends . . .

In the wake of the crises, the theme of much of the analysis was that the emerging economies were fragile and vulnerable because of long-standing weaknesses in their business practices: in accounting and auditing, in the prevalence of cronyism and corruption, in badly skewed distributions of incomes, and in a lack of respect for the rule of law. If only, the refrain went, those countries would adopt western, and particularly American business practices, then the opening of financial markets would have proceeded more smoothly, with fewer excesses and surprises.

Well, from the perspective of today, all that seems simplistic, to say the least. We have had to recognize that our own stock market performances and accolades of business performance exaggerated reality. Enron, WorldCom, Tyco, Adelphia, Arthur Andersen—now the New York Stock Exchange itself—have cast a different light on things. We obviously have a lot of work to do here at home if we are to restore confidence in our own securities markets and make good on our implicit claim to be a model for the world economy.

There are those who would dismiss the scandals as the work of a few bad apples. We are warned not to overreact, at the risk of undermining entrepreneurial energy and the spirit of innovation.

Well, I do not want to overreact, but I have been at least as concerned by a sense of denial or complacency.

I know perfectly well that the great mass of American businesses performs with skill and honesty as they respond to the incentives and competitive pressures in the marketplace. But we have seen enough examples of malfeasance, misfeasance, and nonfeasance to know that we are dealing with more than isolated anomalies. The egregious examples are a reflection of a wider willingness to cut accounting corners, to press at the edges of acceptable business practices, to tolerate conflicts of interest, and to find elaborate and questionable ways and means around established accounting principles and tax regulations.

The demand for a response and some basic reforms strikes me as entirely legitimate, just as the financial excesses of the 1890's and 1920's led to constructive change that we now take for granted.

Accounting Reform and Sarbanes-Oxley

The accounting and auditing profession, sadly epitomized by the demise of Arthur Andersen, has borne the brunt of the criticism and the reform effort. There is a certain justification in that.

The auditing profession bears a clear and unique burden of attesting to the validity and integrity of a company's accounts. That responsibility of auditors, incorporated in law, runs to the investing public—to the market for private capital—rather than to the companies that hire and pay them. Honesty in accounting and reporting is, after all, the bedrock of the efficient allocation of capital.

There can no longer be doubt that internal conflicts within accounting firms greatly increased in recent years and became essentially unmanageable. All the big accounting firms took a basic decision to become general business consultants and advisers, sensing that those services would be more lucrative than the core auditing function. In the process, the drive for revenues had the consequence of eroding the auditing discipline that lay at the core of their professional responsibility.

This was an area, in my opinion and that of many others, that demanded a legislative response. If reliable accounting and auditing is essential to an effective capitalist system, I have come to realize what a demanding profession it is. There are

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[1] I have submitted, in lieu of a new statement, excerpts from remarks made on Sept. 24, 2003, which directly pertain to the subject of the hearing.

[2] Excerpts from a September 24, 2003 address by Paul A. Volcker at Washington University, St. Louis.

very large intellectual and practical challenges. It is not a matter of obstructive technicians with green eye-shades, but a most demanding responsibility.

The sad fact is efforts at voluntary reform and professional self-regulation have been weak and ineffective. The need for a legislative response became clear.

The Sarbanes-Oxley Act appropriately deals with three crucial areas.

First, the conflicts associated with the spread of consulting services have been sharply reduced. The sale of many nonaudit services to audit clients is now prohibited or restricted, leading all but one of the remaining "Big Four" accounting firms to sell or spin off their lucrative high-tech consulting practices.

Second, auditing standards and review of actual auditing practices—both revealed by events to have been inadequate—has been delegated to a new regulatory body, the Public Company Auditing Oversight Board.

Third, the new Board, operating alongside the SEC under strong leadership, should be able to maintain the degree of oversight and surveillance that we have long assumed with respect to our securities market generally. In particular, the SEC now has the leadership, the funding, and potentially the staffing to meet its responsibilities in a world of finance ever increasing in complexity.

In focussing on accounting, auditing, and the SEC, I do not want to lose sight of the responsibilities of other so-called "gate keepers" in the financing process. Accounting firms were not alone in designing and encouraging elaborate schemes to circumvent accounting principles, to dodge taxes, and to embellish and smooth earnings. Far from it, there were battalions of investment bankers, lawyers, consultants, and financial engineers prepared to go to the edge or even beyond ethical practice. Too often they have lent their professional authority to practices of their own clients that fraudulently misrepresent operating results. In the process, investors are ill-served and the long-term prospects for the business jeopardized.

I do not think our great schools of business can entirely escape responsibility. I was taken aback a while ago when one of the leaders of Wall Street, sharing with me his sense of distress about the perceived lapse of standards, commented "What do you expect when our best business schools for 20 years have preached the doctrine that the only measure of success is the price of a company's stock, with the implication that any means of enhancing that price short of overtly criminal or unethical behavior is fair game?"

As I overcame my surprise, I had to agree there was at least a grain of truth in what he said.

Corporate Governance

Here, I would suggest, we are entering an area that is really beyond the ability of law and regulation to address. The discharge of professional responsibilities and methods of corporate governance—the arrangements made to run and oversee the operations of our business firms—seems to me to require a rather different approach. The hundreds of thousands of businesses in the United States, from the tiniest to the huge multinational corporations, can hardly be fit into a common pattern.

If government must tread with caution, there has been no shortage of comment and debate. Dozens of conferences and commissions and learned essays have opined on what, if anything, needs to be done. Long checklists of good practice have been developed—the appropriate size of board, the independence of directors, the emphasis on the auditing committee, appropriate remuneration practices, and on and on. Much of that strikes me as helpful.

But it is also clear one size cannot fit all. In the end, what will count is something less tangible, something that cannot be fully reflected in any checklist of good practice.

Boards of directors tend to be collegial bodies. The natural instinct is to support management. After all, they typically have been chosen by the chief executive officer; at the very least, he or she has heavily influenced the choice of directors. Or, if the CEO is relatively new, the appointment is by the Board, and that also implies a readiness and desire to provide strong support.

The CEO, in turn, naturally looks to the Board for counsel and support of strategic plans, of personnel appointments, succession planning, and the like. In effect, the Board acts in support of management, which raises a rather basic question.

It is the job of the CEO to manage. The basic and unique responsibility of the Board is rather different. It is to oversee—to satisfy itself that the CEO and his team are acting with integrity and in the best long-term interest of the stockholders. That implies a certain distance from the CEO, a skeptical eye, and a concern for other "stakeholders" important to the success of the corporation. A priority must be attention to the integrity of management.

In sum, directors need to maintain independence—independence in fact as well as in form.

It seems to me, and increasingly to many others, that this is an area in which we need a change from what has been embedded in American corporate doctrine. The argument has been that combining the function of Chairman and CEO focuses responsibility, assures a clear line of authority, and encourages quick and effective decisionmaking. And so it does.

The difficulty is the "imperial CEO" may not leave much room for the Board to provide really effective oversight. True independence requires effective Board leadership, leadership able and willing to shape the agenda and to encourage full and regular discussion without management present.

My point is that it is difficult at best—and sometimes not possible—for those contrasting responsibilities of management and oversight to be discharged by a single person.

I realize the pattern of a nonexecutive chairman will not fit all companies. It may well not be suitable for new ventures and small corporations, for privately owned companies or in transitional circumstances. But I do think, for large public companies with widely dispersed ownership, a separation of the oversight and management functions should be recognized as preferable, as indeed is common practice abroad. At the least, companies departing from that practice should be required to explain and rationalize that decision, and to provide for a reasonable substitute such as a "presiding" or "lead" director.

Executive Compensation

I suppose no issue has raised more questions about corporate management and Board oversight than the matter of executive remuneration, in my mind justly so. I have seen reference to a truly disturbing statistic. Fifteen years ago, the average compensation of an American corporation reportedly ran to about 40 or 50 times the pay of the average employee; today that ratio approximates 500 times.

What is it that today produces, as a matter of course, tens of millions of dollars of compensation for CEO's in a single year, and occasional pay-offs of well over $100 million? Does it indeed take that kind of pay to motivate top executives? Are the powerful incentives involved really constructive, or have they encouraged excessive risk and even unethical behavior?

Those are serious questions, too often ignored in what clearly became a kind of competitive game, ratcheting pay higher and higher to maintain parity with one's peers.

One aspect has become rather clear. The escalating patterns of compensation over the past decade or so are, directly and indirectly, a by-product of the wide-spread use of stock options . . .

In the 1990's, in the midst of the greatest bull market in all of history, those options paid off in amounts far beyond anything that could have been foreseen by the Boards that granted them. The fact is the dramatic evaluation of the overall stock market lifted almost all individual stocks. The result was companies granting stock options richly rewarded their executives even when business performance fell below average. There have been grotesque examples of leaders of failing companies "cashing in" not long before the default. It is hard to maintain that fixed price options without downside risk truly aligned incentives with an ordinary stockholder.

The fact of the matter is that the enormous jump in total executive compensation was a reflection of the largely unanticipated payoffs on stock options in the 1990's. In effect, a new norm was established for executive pay, aided and abetted by the legions of compensation consultants quick to suggest to their clients the importance of maintaining comparable—or more likely, above average—pay.

Look no further than the stated rationale for the amounts paid the executive head of the New York Stock Exchange, once thought of as rather semi-public responsibility. The sums were justified as comparable to the pay of major financial companies, whose compensation is typically importantly in equity shares and stock options.

There is no doubt that stock options can provide a powerful incentive. For cash poor, risky, and innovative companies they may well have an important role. In any case, the decision will appropriately be made by the dominant owner or owners. That is a very different situation from the large, established public company, with ample financial resources and widely dispersed owners without direct decision-making authority.

Conceptually, the idea that executives and employees should have a stake in the financial performance of their own company surely makes sense. Equity ownership in some amount—taking the risk of losses as well as gains—should help align inter-

ests with owners. But taken to an extreme, particularly with heavy use of one-way options, there are demonstrable dangers.

Again, I do not say this is a matter for legislation; it is rather a matter of encouraging appropriate patterns of corporate behavior. Good accounting practices have a part to play. The strong and effective resistance in the past to the expensing of stock options by American business cannot, I believe, any longer be intellectually defended.

Several leading American corporations have recently decided voluntarily to expense grants of options, an approach, I believe, that will soon become required accounting practice right around the world. Others have now gone further, deciding to end fixed-price stock options entirely or to sharply reduce their use . . .

Conclusion

In sum, we are beginning to see real progress in bringing our practice of auditing, oversight, and corporate governance closer to what we have long preached . . .

Most fundamentally, it seems to me, we as a society need to restore and emphasize the importance in the business world of strong professional values and ethical behavior.

I know that cannot be legislated, certainly not in any detail. But I do not believe either, as some have argued, it is all a matter of what we have learned at Mother's knee, beyond later influence.

Rather, it seems to me, there is the intangible but real matter of societal norms, broadly understood and recognized, not just as a matter of professional and individual pride. What is at stake is the foundation of a truly democratic, competitive market system . . .

If this new world of globalization is to be a prosperous and peaceful world—a world in which a democratic system of capitalism is, indeed, the model—we would better make sure our own markets are performing both effectively and ethically.

PREPARED STATEMENT OF BRIAN P. ANDERSON

CHIEF FINANCIAL OFFICER, BAXTER INTERNATIONAL INC.

OCTOBER 2, 2003

Mr. Chairman, and Members of the Committee: I am Brian P. Anderson, Senior Vice President and the Chief Financial Officer of Baxter International Inc. Baxter International is a global health-care company, listed on the New York Stock Exchange, with approximately $8 billion in sales and 50,000 employees in more than 100 countries worldwide.

I am very pleased to have this opportunity to join you today, along with my colleagues from the business community and others, to look at the Sarbanes-Oxley Act 1 year later. Looking back, 2 years after the Enron story became public, followed by WorldCom, Adelphia, Tyco, and Global Crossing, one easily concludes that these corporate governance and accounting scandals seriously threatened the public confidence that is fundamental to the efficiency of our capital markets, an essential component of our free enterprise system. By passing the Sarbanes-Oxley Act of 2002, Congress took a bold step toward restoring public confidence and rebuilding trust. The question before us now is whether this law, and the tools it provides for reform, have accomplished the intended objective of restoring public trust through meaningful change within corporate America.

The Sarbanes-Oxley Act seeks to effect change through many avenues. For purposes of my comments today, I will address them within the fundamental structure that comprises our modern corporate system: The shareholders/investors, the board of directors, and the senior management of the corporation.

Beginning with the management of the corporation, I believe the most significant aspect of the Sarbanes-Oxley Act in this regard is the visibility and emphasis it places on corporate executives to ensure that financial information is correct. Obviously, the public's confidence in the integrity of financial reporting was seriously eroded as a result of the corporate scandals, and the individual investors who invested their funds based on this information were ultimately the ones who were most harmed by this failure. As you are aware, the Act places responsibility for ensuring enhanced and accurate financial statement disclosure not only upon management of corporations, but also upon public accountants and audit committees of board of directors.

Among the measures designed to improve investor confidence in corporate reporting are (1) significantly enhanced and more timely financial and nonfinancial disclosure requirements, (2) CEO/CFO certification of periodic reports and (3) a rede-

signed approach to regulations of the accounting profession, including auditor independence. In general, my opinion is that these rules have served their intended purpose well. Issuer disclosure in both financial and nonfinancial arenas has improved significantly and, perhaps just as importantly, management's time, energy, and focus on enhanced disclosure has increased, whether through disclosure committees or otherwise. This necessarily serves to protect investors and ensure the reliability of the financial information available to the investing public. One of the most positive outgrowths of this initiative will hopefully be an increase within corporations of a climate of compliance.

For example, at Baxter, we formalized our disclosure committee and documented our disclosure controls and procedures, which we found to be a productive and worthwhile exercise. We found that, for a multinational company operating in over 100 countries, we had a very rigorous reporting and control environment; however, there were improvements that could still be made. We view this as a living and breathing process that, in accordance with the new rules, is reviewed on an ongoing basis and refined as necessary.

On the other hand, I believe that it still remains to be seen whether the time, effort, and expense required by issuers and management to comply with Section 404 of the Act (not to mention the independent auditors) will ultimately result in significantly enhanced internal controls and procedures. Please do not misunderstand my comment: I believe management should acknowledge its responsibility for the adequacy of the company's internal control structure and procedures for financial reporting, and should assess the effectiveness of the company's internal control over financial reporting. At this point, however, it is not obvious to me that corporations today have mastered the most effective method of accomplishing this goal.

While I understand and agree with the intent behind Section 404 of the Act, the time and costs involved are not insignificant or incremental. It will virtually double Baxter's internal and external audit costs. Complying with Section 404 of the Act not only imposes significant and time-consuming obligations on reporting companies, but it also requires an attestation of management's internal control report by independent auditors. My overall concern here is that both reporting companies and external auditors will spend an enormous amount of time, energy, and money to ensure compliance with Section 404 without necessarily achieving the desired outcome of ensuring that companies have systems in place to identify potential weaknesses in their financial reporting.

In general, however, I believe that the increased responsibilities and focus that Sarbanes-Oxley has brought upon independent auditors is a positive development. The importance of the public's trust in accountants, particularly as it relates to audits of public companies, cannot be emphasized enough. In that regard, I believe that Congress has, through Sarbanes-Oxley, successfully implemented important and significant changes designed to ensure auditor independence. By severely limiting the kinds of nonaudit services that can be performed for audit clients, restricting relationships that can result in a lack of independence, establishing "cooling off" periods, and ensuring mandatory audit partner rotation, there should be significantly improved independence of audit firms from their public company clients.

In addition, I support the notion that the previous system of accounting firm self-regulation required substantial revision. Accordingly, I believe that the creation of a Public Company Accounting Oversight Board will serve to enhance investor confidence in the value that independent auditors can bring to our corporate system.

The Act has also, through Section 202, solidified an important link between the independent auditors and the audit committees of boards. At Baxter, we have had several of these initiatives and processes in place for many years, including executive sessions between the audit committee and our independent auditors, and audit partner rotation. We have, since the enactment of the Act, changed our practices in the area of nonaudit work to conform to the new rules. Overall, I believe that the new rules imposed by the Act with regard to public audit firms and their activities should result in significant positive change.

Turning to boards of directors, I believe that the Act has had and will continue to have a significant positive impact on how boards interact with management and each other. The exposure of serious problems around corporate governance and the heightened awareness of this topic have served to put the public spotlight on issues such as board independence, board qualifications, and the roles and responsibilities of board committees. This can only improve accountability and responsibility of our corporate boards, which, in turn, means better representation on behalf of the shareholders.

At Baxter, we are proud of our strong commitment to maintaining the highest standards of corporate governance. In 1995, Baxter became one of the first companies to adopt formal Corporate Governance Guidelines, long before corporate Amer-

ica was required to meet today's new standards. Most of the new rules the Government now mandates are practices we have had in place for years. In fact, as a result of Baxter's many years of attention to corporate governance, the Sarbanes-Oxley Act as well as the proposed New York Stock Exchange rules, has not dramatically impacted Baxter's practices.

The company's corporate governance guidelines, which are annually renewed and revised as appropriate, address issues such as board size, structure, composition, qualifications, diversity, director term limits, retirement ages, strategic planning and succession planning. Working with our chief corporate governance officer, the board continually discusses Baxter's governance practices, changing our policies when necessary and identifying areas where we need to improve our performance.

The board recently adopted categorical independence criteria by which director independence will be assessed. As of September 2003, 10 out of 11 directors were independent under the new criteria, with Harry Kraemer, Baxter's chairman and CEO, being the only nonindependent director.

While our CEO and other members of our executive management team attend board committee meetings to share their thoughts and perspectives, our board and its committees also regularly meet in executive session without any members of Baxter's management team present. These "executive sessions" (where no management is present) are very important to help ensure the objectivity of the board. But we recognize that these practices were not necessarily commonplace prior to enactment of Sarbanes-Oxley, and we commend Congress for raising the bar for all companies.

With respect to shareholders, I believe the Sarbanes-Oxley Act has had, and will continue to have a positive impact. While shareholder confidence was justifiably shaken by corporate scandal and fraudulent behavior, there is a renewed energy and optimism among shareholders these days. The Sarbanes-Oxley Act, as well as the pending changes to be implemented by the New York Stock Exchange and Nasdaq, have provided shareholders with confirmation that their government is attempting to eliminate opportunities for abuse. Debate is increasing regarding the rights of shareholders and the matters over which they should have control, or at least a voice. Shareholders are seeking control over executive compensation, increased access to the proxy statement, increased participation in corporate affairs, and direct access to the board, including board nominations.

Thus, Mr. Chairman, looking back at what has occurred since the enactment of Sarbanes-Oxley, I believe we see on balance a very positive and encouraging picture. It is clear that, in light of the corporate governance and accounting scandals that began to emerge 2 years ago, strong medicine was needed *quickly* to restore investor confidence, create independent oversight, and eliminate the serious conflicts of interest that led to these abuses in the first place.

To those who feel that Sarbanes-Oxley may have gone too far, I would say that the strong medicine appears to be working and that we must not abandon the treatment just because there may be some unwanted or unpleasant side effects. At the same time, to those who might feel that Sarbanes-Oxley may not have gone far enough, I would also urge caution and strongly encourage them to closely monitor the impact of the law to make sure we have not tipped the balance too far in any one direction.

Specifically, looking forward, I believe we must pay close attention to the balance between Federal and State law, the potential erosion of the business judgment rule, increased liability for directors, and the increasing hesitancy of qualified individuals to serve on corporate boards, especially on audit committees.

Federal law historically has regulated the securities markets by requiring specified financial public disclosures from publicly traded companies. State law, on the other hand, has provided guidance on corporate governance, such as corporate structure, shareholder rights, and the fiduciary responsibilities of directors. Although neither the Sarbanes-Oxley Act, nor the pending exchange proposals, technically create a new cause of action for stockholders, some of the provisions within Sarbanes-Oxley, as well as pending stock exchange rules, overlap into areas traditionally covered by State law, such as definitions of director independence and audit committee composition and responsibilities.

In addition, with the balance between Federal and State law in flux, the State courts are sending the signal that they too are expecting more from corporate boards. The Delaware Supreme Court recently has reversed several chancery court decisions that upheld director decisionmaking, and the decision of the Chancery Court in *In re the Walt Disney Company* to deny the defendants' motion to dismiss points to a willingness by the courts to second guess director decisionmaking and question the good faith and duty of care elements of the business judgment rule. The consequences of this trend may be the creation of a new standard of care for

directors that could dissuade some qualified, high caliber individuals from serving as a director of a public company because of the uncertain potential liability.

Finally, I believe all three of the constituencies I have addressed—corporate management, corporate boards, and shareholders—would be better served if the SEC exercised its authority to implement more of the Sarbanes-Oxley provisions through its well established and respected rulemaking process. The SEC has been granted the authority to address unfair and inequitable situations that might arise out of, for example, the Section 402 loan restrictions, or to provide guidance where there are questions of interpretation, but the Commission has stated it will not do so.

Mr. Chairman, we very much appreciate having the opportunity to appear before this Committee today to underscore the importance of what you have accomplished with the enactment of the Sarbanes-Oxley Act, and to express our strong support for the overall goals that this legislation is intended to serve. As I hope I have articulated, I believe that Congress has addressed in a full and fair manner all aspects of our public corporate system through legislation that impacts corporate management, corporate boards and corporate shareholders, and has taken a dramatic step toward restoring public trust and confidence in our capital markets system. I would be happy to respond to any questions you might have.

PREPARED STATEMENT OF JOHN J. CASTELLANI

PRESIDENT, THE BUSINESS ROUNDTABLE

OCTOBER 2, 2003

Good morning. My name is John Castellani, and I am President of The Business Roundtable, an association of CEO's of leading corporations with a combined workforce of more than 10 million employees in the United States and $3.7 trillion in annual revenues. I appreciate this opportunity to share the Roundtable's views on implementation of the Sarbanes-Oxley Act and restoring investor confidence.

I would like to begin by commending this Committee for your efforts to strengthen corporate governance and restore investor confidence over the past 2 years. The Business Roundtable has been a leader in advocating corporate governance reforms for over three decades, beginning in the 1970's with our first statement on corporate governance and continuing through the 1980's and 1990's with numerous publications addressing corporate governance best practices. In May 2002, we published our *Principles of Corporate Governance,* a set of best practices designed to guide corporate governance practices and further U.S. companies' ability to compete, create jobs, and generate economic growth. The Roundtable strongly supported the Sarbanes-Oxley Act, and we have supported the SEC's efforts to implement it.

And a word of thanks to the SEC. Despite a tight rulemaking schedule, it took the time to consider every rule, weigh its consequences, and solicit—and listen to—input from investors, companies, and others.

The Sarbanes-Oxley Act put a necessary spotlight on corporate governance and financial reporting. Our members have viewed the Act as an opportunity to enhance their corporate governance practices and financial reporting procedures. In addition, Roundtable companies have implemented—voluntarily at this point—many of the proposed New York Stock Exchange and Nasdaq corporate governance reforms, with independent boards of directors, entirely independent audit, nominating and compensation committees and written committee charters.

A recent survey of Roundtable companies shows that our members are committed to living up to the spirit, not just the letter, of all of these reforms.

For example, 88 percent of Roundtable companies report increased involvement in board and committee meetings by members of the audit, nominating, and compensation committees, and over 90 percent report increased involvement by the board as a whole. In keeping with the spirit of the reforms, audit committees today have taken "ownership" of the relationship with independent auditors, making it clear that auditors report to the committee, not to management.

Roundtable companies also report a dramatic increase in director evaluations, with 70 percent of companies performing director evaluations this year compared to 44 percent in 2002. As we stated in our *Principles of Corporate Governance,* directors should serve only so long as they add value to the board, and the recent rise in director evaluations reflects companies' renewed commitment to board quality and accountability.

The Business Roundtable supports enhanced communications with shareholders, and, to that end, we supported recent SEC efforts to increase disclosure about nominating committee processes and to require disclosure concerning shareholder com-

munications with the board. In fact, two-thirds of Roundtable companies have discussed with their nominating committees a process to communicate and respond to shareholder proposals and inquiries. An equal number have a process in place to communicate and respond to shareholder nominations of board candidates.

Moreover, the Roundtable has strongly supported the New York Stock Exchange and Nasdaq proposals to require regularly scheduled executive sessions of independent directors. In fact, the independent directors of 55 percent of Roundtable companies expect to meet in executive session five or more times this year. In many cases, directors today are convening in executive session before or after each meeting of the full board.

The New York Stock Exchange also has proposed to require that a director be designated to preside at executive sessions of the independent directors. Our members agree that it is important to provide leadership for a company's independent directors. In our recent survey, 55 percent of Roundtable companies reported that they have named an independent lead director as either an independent chairman, lead director, or presiding outside director. This indicates the diversity of approaches to board leadership that companies take, depending on their unique circumstances.

Finally, 8 in 10 Roundtable companies report that their boards of directors are at least 75 percent independent, and 9 in 10 report that at least two-thirds of their directors are independent, exceeding the proposed New York Stock Exchange and Nasdaq listing standard requirements. As we stated in our *Principles of Corporate Governance,* providing objective, independent judgment is at the core of the board's oversight function—a key to good corporate governance.

Although much progress has been made, implementation of the Sarbanes-Oxley Act is not complete. For example, the SEC provided an extended effective date for its rules relating to internal controls over financial reporting to give companies and their accounting firms time to comply on a better and more cost-effective basis. Nevertheless, these rules may prove to be the most costly of the Sarbanes-Oxley Act reforms.

I mention these costs not to begrudge them. Rather, many of the costs associated with Sarbanes-Oxley are necessary and appropriate. At the same time, we need to remember that business must satisfy the needs of a large set of stakeholders—our shareholders, our employees, our customers, and the communities in which we operate. To do that, we must run our companies in an effective and ethical manner. In this regard, good corporate governance should be equated with high value for all of our shareholders and other stakeholders. We should not so overly focus on regulating the mechanics of corporate governance that we lose sight of creating that value.

We need to be mindful of the potential for over regulation of corporate governance becoming another overhang on the economy. The economy currently faces several overhangs: The war on terrorism and the war in Iraq, the bursting of the bubble of the 1990's and the collapse of stock valuations, and the corporate scandals of the past 18 months. We must be careful that we do not go so far in creating obligations and restrictions in the name of corporate governance that we create another overhang. We do not want directors and managers to become so afraid to take risks that we stifle the entrepreneurial spirit that is an essential characteristic of American business.

All of us—Congress, the SEC, the securities markets, and the corporate community—have worked hard to restore investor confidence over the past 2 years, and we are proud of those efforts. Nevertheless, as I said before, there is still work to be done. The SEC should move expeditiously to approve the proposed New York Stock Exchange and Nadsaq corporate governance listing standards, and companies should continue—as they have been doing—to set standards for transparency, honesty, and fairness that go beyond the law and reflect a culture of integrity.

At the Business Roundtable, our companies will continue our work to improve corporate governance practices. We have a number of initiatives underway. First, we are examining how we can better train both current and future business leaders to enhance the role of ethics in their decisionmaking process. Second, we are working to bring more sense and transparency to executive compensation. Finally, we are continuing to develop and share best practices in corporate governance so that companies and their boards and management can learn what works most effectively.

Congress did its job in enacting the Sarbanes-Oxley Act, and the SEC is doing its job in implementing the Act. We recognize that the rest is up to us.

PREPARED STATEMENT OF KEITH D. GRINSTEIN

CHAIRMAN, COINSTAR INCORPORATED

OCTOBER 2, 2003

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, thank you for the privilege of appearing before you today to discuss the implementation of the Sarbanes-Oxley Act of 2002.

Background

I am currently a member of the boards of directors of three small to mid-sized public companies traded on Nasdaq: Coinstar Inc., F5 Networks, and Nextera Enterprises, Inc. Although a member of the boards of these companies, I appear here today solely on my own personal behalf, and not as a representative of those companies. I am not authorized to comment on our own board deliberations.

Coinstar is a Bellevue, Washington-based company which develops, owns, and operates a network of automated, self-service, coin-counting and processing machines that provide consumers with a convenient means to convert loose coins into cash. Coinstar's market capitalization is roughly $280 million and is listed under the symbol CSTR. I am an independent/nonemployee director and serve as Chairman of the Board of Directors and serve on three board committees: the audit committee, the compensation committee, and the nominations/corporate governance committee. Consistent with proposed NASD rules, Coinstar has a majority of independent board members.

F5 Networks Inc. is a Seattle company that provides integrated products and services to manage, control, and optimize Internet traffic. F5 Networks would be considered a mid-cap company with a market capitalization of roughly $500 million and trades under the symbol FFIV. I am an independent, nonemployee director of F5 Networks and serve on the audit committee and compensation committees of the board. F5 Networks does not have a nominations committee. F5 Networks also has a majority of independent board members.

Nextera, is headquartered in Cambridge, Massachusetts. Nextera's primary asset is Lexecon, an economics consulting firm whose clients include major law firms and the corporations that they represent, government and regulatory agencies, public and private utilities, and national and multinational corporations. Nextera trades under the symbol NXRA, and has a market capitalization of roughly $17 million. I am one of three independent, nonemployee directors of Nextera, and I serve on two board committees, the audit committee and compensation committee of the board. Nextera does not have a nominations committee. As a closely held company, Nextera is exempt from the board independence requirements of NASD rules.

In addition to my affiliation with publicly traded companies, I am an attorney and sit on the boards of three privately held companies and am a founding partner of Second Avenue Partners, a private venture capital firm in Seattle that provides funding and support to Pacific Northwest early-stage companies.

Significant Tangible Benefits of Sarbanes-Oxley

My connection with public companies predates passage of the Act, and thus my perspective on the significance of the changes brought about by the Act comes from the perspective of one who has lived intimately with the preexisting obligations imposed on those responsible for governing publicly-traded companies. Further, my perspective also comes from involvement in companies that have sought scrupulously to comply with their Federal disclosure obligations, have *not* been the subject of investigations by Federal or State authorities, and where I have been privileged to serve with a group of outstanding fellow directors, who have genuinely sshould do the right thing.

As an initial matter, it is important to recall that prior to the date of the Act, while the Nasdaq had certain requirements for listed companies such as requiring audit committees, corporations are creatures of State law and State law does not dictate how a company is to be governed. State law does however spell out the duties of directors such as the duty of care and loyalty. Nonetheless there was a growing understanding among public companies that certain corporate governance practices were better than others. Except as a matter of disclosure, there was no Federal law concerning corporate governance and the Federal law simply required disclosure of the company's practices, most notably in connection with its proxy statements and its annual and periodic reports.

Further, prior to passage of the Act the existing Federal and State proscriptions against fraud and the Federal disclosure obligations were taken seriously and the existing criminal sanctions were a significant deterrent to wrongdoing. There was, however, a mood of complacency that had crept into the board rooms, especially in

the heady days of the bull market. This complacency led to excessive latitude being given to management in the conduct of corporate affairs and less attention given to the independent oversight function of board members.

This manifested itself in several ways: Boards gave undue deference to management in matters such as (1) compensation packages, (2) recommendations of management about corporate decisions, (3) accounting policy and disclosure matters, and (4) nominations for future directors. This also meant that directors would frequently not voice issues that could be viewed as questioning the judgment of management.

Directors serve for many reasons but often for the money and prestige associated with board membership. Because management often controls the director selection process, board members could be held hostage to that management. Although I have not directly experienced this in my tenure, it seems that there are few directors that may place undue importance on the money and prestige of board membership. This may have caused some board members to acquiesce in management demands for larger and larger compensation packages and to condone the reporting of the financial consequences of poor management decisions through issuing management-friendly audit reports.

The notorious and well-known corporate scandals that prompted passage of the Act have brought about a marked change in attitude in the board room. There has been less deference being given to management initiatives. Questions that went unasked before are being asked now. Board meetings are more frequent and board members are better prepared at meetings. Management has provided us with more information, we see more attorneys at board meetings, board committee charters are being written or reviewed by outside counsel, and more attention is being paid to corporate governance and structure. Boards are adopting written compensation policies, and tend to be more "hands on" with respect to pay-package decisions. Issues that before would not have even been discussed, are being presented to the board for discussion and advice.

It is difficult to isolate specifically those provisions of the Act that have had this effect. I will point to just a few of the most important changes.

Audit Committees

I sit on three audit committees. The requirement for independent audit committees and the specification of their powers have been markedly strengthened by the Act. Even on the boards where I sit that had adopted the best practices guidance for performance of their duties even before the passage of the Act, the audit committee members have undertaken to take their duties even more seriously and their powers have been strengthened. The auditors also appreciate more clearly than before that they work for the audit committees, not management. We see two important changes: Auditors are more responsive to our requests, and auditors are giving more attention to their audits.

Consulting Services by Auditors

The audit committees on which I sit do not authorize our auditors to engage in consulting services. Auditors do not invite the potential for conflict. This has been a marked change wrought by both the SEC's 2001 independence rules and the changes adopted by the Act.

Internal Control Audits

Companies are now required to have quarterly internal control audits. Where before these internal audits may have been performed by our auditors as part of nonaudit services, the auditor independence reforms have required us to look elsewhere for those services. There is increased competition for these services, increased information to audit committees, and a renewed focus on responsibility—we are getting a good work product.

CEO/CFO Certifications

The certification process has been a disciplining process for executives and financial officers, and that disciplining process has filtered down to others within the company who report to them. From the board's perspective, it has provided us with additional comfort as to our ability to rely on management's representations concerning internal controls and the financial condition of the company.

Costs of Implementation

There can be no question that the Act has increased the cost to companies of compliance. For small and mid-cap companies these increased costs are a significant drain on the bottom line. Such companies have fewer assets and less revenue over which to amortize implementation and continuing compliance liabilities and expenses. In my personal view, the benefit in investor confidence and the improved

corporate governance that is taking place, is worth the cost. It is hard to put a short-term price tag on the lack of investor confidence that was mushrooming out of control at the time of passage of the Act.

In general, I estimate that compliance with the Act imposes a direct cost on a small cap company of about $250,000 per year, and a larger mid-cap company of closer to $1 million. Some of these costs are likely to be recurring costs, and some of these costs are likely to be one time costs and could level off as we gain more experience in administering the changes brought by the Act.

Let me summarize the components of those costs:

More Board of Director Time

Directors are compensated by a per-meeting fee and by the amount of time spent on matters. Since enactment of the Act, we have had more frequent board meetings and more frequent meetings of board committees. This is especially true in the case on the audit committees. This translates into a direct increase in board fees.

Increased Auditor Fees

As I have noted, auditors are spending more time on engagements, and the direct interaction between audit committees and the auditor has increased. Further, another direct increased cost is caused by the new requirement that annual and quarterly reports be issued more quickly. There is an increased demand on auditors to conduct their review more rapidly before the quarterly and annual reports are filed. This translates into a direct total increase in auditor fees.

Increased Insurance Costs

Companies have seen the cost of Director & Officer insurance increase by between 15 percent and 30 percent. In my experience this is an increase of about $100,000 in premiums for each $10 million in insurance coverage. As I understand it, insurance companies have not yet begun to see a substantial increase in actual outlays, but the premiums have increased because of a perceived increase in risk; premiums may level off in time as we have more experience under the Act.

Legal Fees

We see more attorneys at every phase of our work on boards. This includes work on drafting or redrafting board or committee charters, attendance at board, and committee meetings and on consultations with management.

Looking Forward

The Act was landmark legislation that was needed at the time and has had a profound impact on corporate America and the accounting and brokerage industry. There has not been sufficient time to assess the impact of the changes brought about by the Act, including the indirect benefit of increased investor confidence, and the intangible benefit of better corporate governance. The direct Federal oversight over the accounting profession was long overdue and I have already seen a marked improvement in accountant responsiveness. I am optimistic that the Act strikes the appropriate balance between federalization of certain aspects of corporate governance and increased Federal disclosure obligations.

There are some areas on which the Committee should pay particular attention. The cost of initial compliance for small and mid-cap companies is significant for those companies. If those costs increase and do not level off or decrease over time, then these companies are faced with a long-term compliance cost drain. In particular, we have little experience with increased costs of litigation spawned by the new duties imposed by the Act. If we see a significant increase in litigation costs, then the Committee may want to consider enacting some safe-harbors to curb abusive and unwarranted litigation in the future.

As a venture capitalist, I am well aware that there are alternative sources of capital than the public markets and that at some point companies could be driven to those alternative sources if the costs of being public financing keep escalating. However, I have seen no evidence that the Act has had that effect, for example that the Act has driven companies that otherwise would have become public to those alternative capital sources.

Conclusion

Enactment of the Act was the right thing to do at the right time—a time of a severe crisis in investor confidence in publicly traded companies. From my vantage point, I have seen a subtle shift in the balance of power away from corporate management and toward independent members of boards of directors and ultimately shareholders. There are a number of procedural and substantive rules adopted by the SEC in implementing the Act and some of those rules have only recently been

implemented and there has not been sufficient time yet to assess their merit or to evaluate their true costs. And I remain optimistic that as we gain more experience administering the Act, the initial costs of implementation may be reduced substantially. But the increased costs of implementation and compliance of the provisions of the Act are in my judgment a necessary price of restoring investor confidence in publicly traded companies.

Thank you. I look forward to your questions.

PREPARED STATEMENT OF RICHARD L. TRUMKA

SECRETARY-TREASURER, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

OCTOBER 2, 2003

Good morning, Chairman Shelby and Senator Sarbanes. My name is Richard Trumka and I am the Secretary-Treasurer of the American Federation of Labor and Congress of Industrial Organizations. The AFL–CIO's member unions sponsor benefit plans with over $400 billion in assets, and collectively bargained benefit plans that union members participate in hold over $5 trillion in assets. For America's working families' retirement security is in large part dependent on the integrity of our capital markets.

The labor movement strongly supported the passage of the Sarbanes-Oxley Act of 2002. America's working families owe a great debt of gratitude to Senator Sarbanes for authoring the Act, and to this Committee, for passing what would become Sarbanes-Oxley in a bipartisan vote before the WorldCom scandal broke. Your leadership came at a time when many predicted Congress would do nothing in response to the growing wave of scandal engulfing our Nation's public companies.

I would like to review the key features of the Act that have markedly improved investor protections.

- the Act put an end to most consulting by public company audit firms;
- the Act created the Public Company Accounting Oversight Board (PCAOB), which after a controversial start has proven to be a strong, yet flexible independent regulator;
- the Act requires independence and expertise on company audit committees, and makes clear the importance of strong and independent boards generally;
- the Act bans loans to insiders at public companies, putting an end to a key executive compensation abuse; and provides for disgorgement of executive stock profits in certain circumstances; and
- the Act reinforces the fundamental principle of our securities law—that companies must disclose to investors what a reasonable investor would want to know before making an investment decision, and that the obligation to do so truthfully rests on senior management.

In the last year, these provisions have been impressively augmented by the work of the SEC and the PCAOB. The SEC and its staff have stepped up and addressed through rulemaking several vital issues, for example by ensuring that attorneys for public companies act in the interests of the company, and not just in the interests of the companies' executives. The Commission has also followed the logic of Sarbanes-Oxley in properly demanding increased disclosure from powerful market actors like hedge funds that have been allowed to operate in secret.

The PCAOB is currently addressing the vital issue of financial controls at public companies. I can tell you as the Chief Financial Officer of the AFL–CIO that proper financial controls are critical to the responsible management of any large organization. The events of the last few years have shown the need to strengthen these controls at public companies, and to give company management who are trying to do the right thing some guidance as to what are appropriate safeguards. We have confidence that the PCAOB will do just that.

More than a year later, we believe Sarbanes-Oxley is a success, not just because of the specific provisions of the Act, but because of the tone the Act set and the message it sent. In the first proxy season after the Act passed, investors acted themselves to push companies to have really independent boards, to reign in executive pay, and to manage their audit process more effectively. The AFL–CIO is very proud of the role that unions and worker pension funds have played in these efforts by sponsoring 360 such proposals, 48 of which received majority votes at company annual meetings. These proposals led to real changes in executive compensation at companies like GE, Coca-Cola, Tyco, Hewlett-Packard, and Alcoa.

We have also seen in recent events at the New York Stock Exchange, a powerful message that runaway executive pay is simply no longer acceptable, even in the case of individuals who have performed well.

Sarbanes-Oxley also serves as a guide to appropriate corporate governance in institutions that actually are not subject to the Act. Since May 8 of this year, I have served as the Chair of the Corporate Governance Committee of the Board of ULLICO Inc., a private company owned by unions and union pension funds where there was serious wrongdoing by prior management. Among the first acts taken by the new board the shareholders elected last spring was to move the company toward voluntary compliance with the relevant provisions of Sarbanes-Oxley, including CEO certification of the company's financial statements and the Act's audit committee provisions.

However, the job begun by this Committee last year is not complete. Key elements of the investor protection agenda remain to be enacted, here in Congress, at the Securities and Exchange Commission, and at FASB, and the Public Accounting Oversight Board. While we are generally pleased with the work done at those agencies, we believe there is still an unfinished corporate reform agenda that they and Congress should turn to.

In the remainder of my testimony, I would like to lay out some key elements of what remains to be done.

First, our legal system continues to suffer from real deficiencies in the extent to which both individuals and institutions can defraud the investing public and get away with it. Despite your best efforts, Mr. Chairman, in many circumstances lawyers, accountants and investment banks can still aid and abet companies that commit securities fraud and enjoy immunity from investor lawsuits. This is wrong, and really only Congress can fix it.

There are also areas where the Private Securities Litigation Reform Act has made it easier to defraud the investing public and get away with it. Sarbanes-Oxley addressed one such area by lengthening the statute of limitations, but there are others such as the PSLRA's repeal of joint and several liability for securities fraud and the blanket immunity it grants for "forward looking statements" that remain. Again, these problems with the PSLRA can only be addressed by Congress.

However, as important as litigation can be to both deterring corporate wrongdoing and dealing with its consequences, it can not substitute for real working corporate governance and accountability on the part of company management. And as long as CEO's dominate the selection process for company directors, we simply will not see at problem companies the kind of vigorous independent boards that we need and that Sarbanes-Oxley called for.

That is why the labor movement believes the most important effort now underway to address the continuing governance problems at our public companies is the SEC's rulemaking initiative to give long-term investors with a substantial stake in public companies the right to have their board nominees included on management's proxy.

Today, it is practically impossible for even the largest long-term investors, the TIAA-CREF's and CalPERS, to nominate and run their own candidates for the boards of public companies. So we have elections in name only. At one company we know of, Lockheed Martin, a former Enron director continues to be nominated by management despite unprecedented shareholder opposition, and the only thing shareholders can do is withhold their vote—they have no alternative candidate to vote for.

And of course, CEO's know that investors have limited options. They know they can ignore shareholder votes on runaway executive compensation or company audit policies, and there is little that shareholders can do. So we strongly support the SEC and Chairman Donaldson's efforts in this area, and fervently hope that what will emerge from rulemaking is real access to the proxy for long-term investors.

Finally, I would like to note that despite everything that has happened, we still have inadequate disclosure to investors of the facts of executive pay and what financial impact that pay has on the companies that award it. Despite FASB Chairman Bob Herz's hard work in this area, stock options still are not required to be expensed, a state of affairs that amounts to a subsidy to an inappropriate form of executive compensation. And as we have seen over and over again in the last year, investors simply are not given enough information about CEO's deferred compensation plans. While these are matters properly in the hands of the SEC and FASB, they are key elements of the post-Sarbanes-Oxley agenda.

While much has been accomplished since Sarbanes-Oxley was passed, the work of reform is not complete. There is no better evidence of that than the recent comments of one of the most influential people in corporate America, Ken Langone, CEO of Invemed Associates, former chair of the New York Stock Exchange's Compensation Committee, member of the Compensation Committee at General Electric

and three other public companies, and Lead Director at Home Depot. Mr. Langone, who is actually responsible for the pay package the Stock Exchange offered Richard Grasso and was involved in the pay and benefits offered to Jack Welch, remains unapologetic. He has told the press that given the chance to vote for Grasso's pay package, he would do so again. As long as this is the attitude among key decision makers in corporate America, there is work to be done.

Fortunately, the independent agencies that are active in the area of corporate governance are by and large stepping up to the plate. The SEC, the PCAOB, and FASB have all responded admirably to both the specific mandates of Sarbanes-Oxley and the tone set by the passage of that legislation. The labor movement urges this Committee and Congress as a whole to recognize that work, to fund it, and to protect the independence of those agencies as they go about their vital tasks.

Let me conclude by expressing my deepest appreciation to the Committee on behalf of the working families of the AFL–CIO for inviting the AFL–CIO to appear today, and our hope that we will continue to be able to work together on these vital issues for all Americans. Thank you.