How to Protect Investors Against Another Enron

James K. Glassman

Resident Fellow, American Enterprise Institute

And

Host, www.TechCentralStation.com

Testimony before a hearing on H.R. 3763, "The Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002"

Committee on Financial Services
U.S. House of Representatives
The Honorable Michael G. Oxley, chairman

March 13, 2002

American Enterprise Institute
1150 17th Street, N.W.
Washington, D.C. 20036
202/862-7198
jglassman@aei.org

Good morning, Mr. Chairman and members of the Committee. Thank you for inviting me to testify today.

My name is James K. Glassman. I am a resident fellow at the American Enterprise Institute for Public Policy Research in Washington, where I concentrate on economics and financial markets. I am also host of the website TechCentralStation.com, which focuses on matters at the intersection of technology, finance and public policy.

Since 1993, I have written regularly on investing for a broad audience. I am currently a weekly syndicated financial columnist for the Washington Post, and my column appears as well in The New York Daily News, the International Herald Tribune and newspapers around the country. My second book "The Secret Code of the Superior Investor," a guide mainly aimed at novices, was published in January and was called the best new investing book of the year by Business Week.

I believe my usefulness to this committee lies in my understanding of the needs, desires and fears of small investors and of the consequences of public-policy measures on the economy and financial markets.

Protection Against Deception:

Investors Apply the Best Discipline

The Enron scandal is primarily a story of executives and auditors deceiving investors about the true state of a business. The question that the legislation before you addresses is how to protect investors against such deception.

“The Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002” (H.R. 3763) makes several changes in current law: mainly, to increase oversight over auditors, to ensure the independence of auditors by barring activities that pose conflicts of interest, and to increase transparency of transactions. In the current overheated atmosphere, the bill is admirably level-headed and restrained, especially in comparison with the “Comprehensive Investor Protection Act” (CIPA). Still, some of H.R. 3763’s provisions are troubling. Rather than protecting investors, these provisions may harm them.

In fact, investors do a remarkable job protecting themselves, mainly through a simple system of rewards and punishments. Investors reward good corporate citizens with higher stock prices, and they punish miscreants with lower. Investors have their own unwritten set of rules, and when companies violate them, the retribution is swift and often extreme. Those rules center on trust – essential for the operations of all capital markets. Investors do not tolerate lying in any form. In Enron’s case, as soon as it became clear that the firm had deceived them, investors entered a verdict of guilty and applied capital punishment. They didn’t wait for a trial; they didn’t wait for an SEC investigation. If you lie to us, investors said, then you’re dead. They dumped Enron’s stock, and a company with a market capitalization of $60 billion in early 2001 and $30 billion as recently as the fall of 2001 became practically worthless by the end of the year.

This is precisely the response we should want from investors: brutality. Similarly, clients of Arthur Andersen, Enron’s accounting firm, did not wait for an indictment or a government report. Delta Air Lines, Merck & Co. and Freddie Mac, among others, fired Andersen as their auditor. On March 11, the Wall Street Journal reported that employees

were leaving a sinking ship and that another firm was trying to buy Andersen. While Andersen has had problems in the past, it is safe to say that the Enron episode alone stands a good chance of destroying the 88-year-old firm entirely. That's discipline.

Enron and Andersen executives face possible criminal penalties as well. But even if they did everything by the letter of the law – and GAAP accounting – investors and clients would have exacted severe punishment.

In the face of such a ferocious reaction, one wonders why Congress is considering, in 10 committees and at least 32 bills, new laws. Congress has played an important role in exposing the details of the scandal to the public and in calling the participants to account publicly. This committee deserves particular praise. Voltaire once said, "In this country it is a good thing to kill an admiral from time to time to encourage the others." That is, to encourage the others to behave. The Enron case has definitely encouraged better behavior. Many companies have reacted quickly with more disclosure than the law now requires, the most recent example being General Electric. Firms foolish enough to believe that they could deceive investors and get away with it are now on notice. Firms with questionable balance sheets and income statements have suffered sharp price declines since the Enron scandal broke. If investors and analysts had been dozing before, they are wide awake now.

The market incentives for responsible corporate governance and accurate accounting are powerful. With more than 8,000 publicly traded companies from which to choose, why should investors buy shares in those that aren't forthcoming? A recent study by Paul Gompers, Joy Ishii and Andrew Merrick, published by the National Bureau of

Economic Research,[1] found that “a portfolio strategy based on purchasing shares in companies with the strongest investor protections and selling short those firms with the greatest management power earned an abnormal return of [that is, beat the broad market by] 8.5 percent a year.”

In addition, short sellers have an enormous incentive to expose corporate wrongdoing. If they are right, they can make millions of dollars. Bethany McLean of Fortune broke the story of Enron’s deception after she was tipped off by James Chanos, who heads Kynikos, an investment firm that specializes in selling stocks short – that is, betting that they will fall.

After the Enron scandal entered full public consciousness in December, the media carried stories claiming that, as a result, investors were losing faith in the stock market in general. Instead, while investors have become more vigilant, they have not responded by dumping shares across the board. In fact, in January 2002, according to the Investment Company Institute, investors added $19.6 billion more than they took out – the largest such net gain in many months.

Investors have done the right thing. They have continued to buy stocks, but they have exacted terrible retribution against Enron and against other firms suspected of deceiving them. Now, Congress wants to enter the picture with additional remedies….

[1] “Corporate Governance and Equity Prices” (NBER Working Paper No. 8449). Summary at National Bureau of Economic Research website: http://www.nber.org/digest/dec01/w8449.html

What Should Not Be Done

Auditor Independence. H.R. 3763 would bar accounting firms from providing the same publicly traded corporate client with both external audit services and either financial-information system design or implementation services or internal audit services. The CIPA, introduced by the ranking member of this committee also forbids a long list of activities, including appraisal or valuation, "expert services" and just about anything else.

But the enthusiasm for these "independence" rules is misguided.

The Securities and Exchange Commission failed to achieve enactment of such regulations in 2000 "primarily because of a lack of evidence demonstrating that providing non-audit services does, in fact, compromise auditor independence," write Zoe-Vonna Palmrose, professor of auditing at the University of Southern California, and Ralph S. Saul, a former director of the SEC's division of trading and markets, president of the American Stock Exchange and chairman of CIGNA Corp, in an extensive article in Regulation.[2] The SEC began examining this issue in the late 1950s, and, since then, "the question of whether non-audit services compromise audit firm independence or cloud the appearance of independence has been studied and investigated by numerous government and self-regulatory commissions and committees. None of the studies recommended the separation of auditing from consulting."[3] The SEC, in its latest attempt, "produced no empirical evidence of abuse."[4] Indeed, one study found that in 25 percent of cases, the

---

[2] "The Push for Auditor Independence," Regulation, Winter 2001, pp. 18-23.
[3] Ibid, p. 19.
[4] Ibid, p. 20.

provision of both audit and non-audit services “had a positive impact on the effectiveness of the audits.”[5]

But the Commission was apparently not so worried about empirical evidence. The SEC’s response in a June 2000 statement was that “studies cannot always confirm what common sense makes clear.”[6]

Nor has clear evidence established yet of a link between auditor independence question and the deception practiced at Enron. On the contrary. The theory put forth by advocates of “independence” rules is that companies use the high fees involved in contracts for non-audit services in order to bribe accounting firms to produce deceptive audits that favor the company. The average company among the 30 Dow Jones Industrials paid its auditor three times as much for non-audit as for audit work. Enron, however, paid Andersen $25 million for audit work and $27 million for non-audit. The audit payments were exceeded by only one Dow company (Citigroup) while the non-audit payments were exceeded by thirteen. The ratio of non-audit to audit work for Enron was lower than that of all but three of the 30 Dow companies.[7]

It is true that investors should be concerned about the audit-bias problem. After all, the company that pays the auditors wants to put the best face on its financial results, while the auditing firm is supposed to be presenting the material fairly. That’s a real-life conflict, and reducing it is the reason audit committees were invented and the reason that investors take financial statements so seriously. But why should forbidding non-audit work solve the problem? After all, it is just as easy to bribe accountants directly: just

---

[5] Ibid., p. 21.
[6] Ibid.
[7] “Blue-Chip Companies, Blue-Chip Fees,” sidebar, Wall Street Journal, March 7, 2002, p. C1

pump up the fees for audit work. Instead of $10 million for a typical large-company audit, why not slip the accountants an extra $5 million?

While evildoers lurk in the corporate world as well outside it, the main reason that such respected companies as McDonald's, General Motors, DuPont and ExxonMobil use the same firms for both audit and non-audit work is not that this combination provides some kind of nefarious leverage but because a technology revolution has occurred in the infrastructure of American businesses – one that has greatly benefited the economy, as Federal Reserve Chairman Alan Greenspan noted in his testimony before this committee on Feb. 27.[8] A thorough audit requires a thorough knowledge of the information-technology systems of a complex global corporation, and often the auditing firm is in the best position to provide such non-auditing services. Clearly, having one firm do both jobs lowers overall costs, and forcing companies to divide the job is economically inefficient. It will add expenses, lower profits and, inevitably, lower stock prices. That hurts investors; it doesn't help them.

But will auditor independence increase investor confidence, lowering risk aversion and boosting stock values in the long run? That's a dubious proposition. If the conflict is so threatening to investors, then why, at least before Enron, did companies that separate the functions not advertise to shareholders and potential shareholders that they were free of conflicts?

The Congress and the SEC should not substitute their judgment of who should provide accounting services for the judgment of the companies that actually buy those services. Similarly, as Palmrose and Saul note, "There is not just one model for

[8] See http://www.federalreserve.gov/boarddocs/hh/2002/February/Testimony.htm

organizing accounting firms, and…each firm, not the SEC, should be able to define the particular model for that firm."[9]

Auditor Oversight. The legislation proposes a public regulatory organization (PRO) to oversee the accounting profession. As I stated earlier, the discipline provided by investors, clients and suppliers, as well as current criminal and civil laws and SEC regulations, offer adequate protections currently. The constitution of a particular board is not the problem. Why should the accounting profession be subject to a PRO when the professions of the law, journalism and politics are not? Misbehavior by professionals in these arenas can be at least as destructive as misbehavior by accountants.

But if an oversight board is created, the guidelines offered in H.R. 3763 are far superior to those in CIPA, which says, in effect, that the SEC and the General Accounting Office (which, I don't have to remind you, is a congressional agency) should run the accounting industry.

Increasing the Complexity of Accounting Rules. Government officials need to understand that the complex nature of American corporations means that every loophole cannot be plugged, every possible deception and distortion cannot be remedied with a new rule. In this regard, the Europeans, believe it or not, have a better approach than do the Americans. In a recent interview in the Financial Times, Frits Bolkestein, the European Commision's commissioner for internal markets, stated, "Having rules is a good thing, but having rigid rules is perhaps not the best thing. You must give an

---

[9] Regulation, p. 19.

accountant a certain latitude to use his judgment. It's not merely a question of ticking boxes."[10]

The Economist recently put it well: "There are two main approaches to rule-setting. One is to define precisely how to deal with each and any situation. The other is to spell out rough principles and let auditors decide how to apply them. America has typically gone for precise rules rather than broad principles…. If the rule says that above 10 percent an item should be shown, then those with something to hide go for 9.9 percent."[11]

Harvey Pitt, the SEC commissioner, has said that "the current system of disclosure is designed to avoid liability, not to inform anybody."[12] I read 10-K and 10-Q statements all the time. I understand this stuff, but I yearn for a plain-English explanation of what is going on within a company. The answer is not more numbers and legalese but more leeway for auditors and corporate executives to explain the true health of a company. That requires two things: 1) a loosening of current rules, and 2) strict accountability by companies and auditors. I strongly agree with President Bush's call to make CEOs personally responsible for the financial statements of their companies. Another point in the President's plan "to improve corporate responsibility and protect America's shareholders" was, "The authors of accounting standards must be responsive to the needs of investors."[13] Absolutely. But this means giving them more flexibility, not less. Andersen should been able to tell shareholders, "The books of Enron are consistent

---

[10] "Bolkestein: a breath of fresh air or maverick who shoots from the hip?" Financial Times, Feb. 21, 2002, p. 4.
[11] "When the numbers don't add up," The Economist, Feb. 9, 2002, p. 58.
[12] Ibid, p. 60.
[13] See http://www.whitehouse.gov/news/releases/2002/03/20020307.html.

with GAAP, but shareholders should be aware of the hundreds of off-balance-sheet entities that carry heavy liabilities."

What Should Be Done

Real-Time Disclosure. I strongly agree with Section 4 of H.R. 3763, which requires that officers and directors disclose sales of company stock to the SEC before the end of the business day after the transaction and made available to the public by the SEC on the day after that. I would go further, requiring contemporaneous information (that is, within an hour) to be released directly to the public on both sales and purchases. News of such sales and purchases is important information that could signal the true state of corporate health. Investors need to know it in minutes, not in 40 days.

Improper Influence on Conduct of Audits. Section 3 of H.R. 3763 correctly states that it should be unlawful for corporate officers to "improperly influence" accountants into "rendering…financial statements materially misleading.

Blackout Periods and Restrictions on Selling Company Stock. Section 5 states that, if participants in a 401(k) are prohibited during a transition period from selling their company stock, then officers and directors who own company stock outside the plan should be prohibited from selling as well. This is a fair, confidence-building measure. In addition, I favor a ban on any restriction on the transfer of company stock by employees

within a 401(k) plan. Enron employees, for example, could not transfer company stock (given to them by Enron) until age 50. A simple rule should be that every asset in a 401(k) plan must be a marketable security or mutual fund. No lettered or restricted stock, period.

End Double-Taxation of Dividends. Cash dividends are the clearest, most transparent evidence of corporate profits. An investor who sees dividends increasing every year can, properly, have confidence in a company. But dividends are taxed twice – both at the corporate and the personal level – and, mainly as a result, fewer public companies now pay dividends than ever in history and dividends represent a smaller and smaller proportion of total earnings. Ending double taxation of dividends would increase payouts and vastly increase investor confidence. I realize that this matter goes beyond the committee's jurisdiction, but it is probably the single most important legislative step that can be taken to protect shareholders.

Treat Options as Expenses. Currently, accounting rules do not treat as immediate expenses most options granted to employees. Therefore, companies have an incentive to pay executives with options, even if such compensation does not make economic sense. Options often provide the wrong incentives for executive behavior, pushing them to boost profits in the short run, by whatever means. But, more important, options are a real expense – they are things of value given as compensation by the shareholders – and they should be treated that way.

Peripheral Issues

Analyst Conflicts of Interest. H.R. 3763 calls for a study of "matters involving equity research analyst conflicts of interest." The CIPA goes much farther, requiring, for example, that "analyst compensation not be based on investment banking revenue" and that criteria be established to ensure that "analyst compensation be principally based on the quality of the equity analyst's research."

In my testimony last year before this committee's subcommittee on capital market, insurance and government-sponsored enterprises, I stated, "There is little doubt that conflicts of interest pervade the securities industry." In fact, they pervade life – even journalism. For example, a study by the Roper Center of 139 Washington bureau chiefs in 1992 found that 89 percent said that they voted for Bill Clinton and just 7 percent for George Bush. Yet I doubt that a single one of these journalists would admit to bias in reporting – and most would probably be correct. Analysts are torn by conflicts, just as politicians and journalists and mothers and fathers are, but ultimately their judgments about companies are out there for the public to assess. An analyst who recommends bad stocks in an effort to sell investment banking services will be an analyst who will ultimately lose his job.

A study of 360,000 recommendations by 4,340 analysts over a 10-year period by Brad Barber of the University of California at Davis and other economists, published in the April 2001 issue of The Journal of Finance, found that analysts' top stock selections

beat the market benchmark by a remarkable 4.1 percentage points annually and their lowest-ranked selections trailed the market by 4.9 percentage points.[14]

A further public airing and more studies of this issue would not be fruitless, but blaming the stock-market decline or the collapse of Enron on stock analysts is inaccurate and misleading. It wasn't just analysts who were wrong on Enron. Large institutions, with skilled research staffs, including Fidelity and Janus, the giant mutual fund houses, had invested heavily in Enron stock as well.

Repealing Litigation Reform. On Dec. 22, 1995, the Senate joined the House in overriding President Clinton's veto of the Private Securities Litigation Reform Act of 1995. The vote in the House was 319-100; in the Senate, 68-30. The bill scaled back the excesses involved in often-frivolous securities fraud cases brought by a small group of politically generous plaintiffs lawyers. "California's high-tech industries, in particular, have suffered from lawsuits aimed more at squeezing out settlements than righting wrongs," said the Fresno Bee in an editorial at the time.[15] The law took such steps as barring "professional plaintiffs" from being named in more than five class-action lawsuits in a three-year period and requiring plaintiffs to cite the concrete facts of each allegation of fraudulent behavior. Lawsuits to recover damages for securities fraud have continued since 1996, but the law redressed a severe imbalance and it undoubtedly helped high technology prosper and the U.S. economy expand.

Now, some in Congress have decided that these moderate reforms were responsible for the Enron excesses. If only plaintiffs' attorneys could have sued Enron, it

---

[14] The Barber study and quotations are from my testimony, "The Analyst Paradox: If They're So Plagued With Conflicts, Why Do They Do Such a Good Job?" June 14, 2001. See www.aei.org.
[15] Fresno Bee, "Curbing stock swindles," editorial, Dec. 13, 1995, p. B6.

would have brought the company back to the straight and narrow. In fact, of course, attorneys could have sued Enron earlier, and they are certainly suing Enron and its auditor, Arthur Andersen today. Repealing this reform would not protect shareholders; it would hurt them by forcing their companies to make payments of tribute and distracting executives who should be focusing on managing their firms.

Conclusion

In times of scandal, emotions run high, and the urge to rush in with legislative remedies is understandable. But it should be resisted. Parts of H.R. 3763 are admirable, but the bill goes too far in trying to substitute the economic judgment of regulators for that of investors, clients and managers. Ultimately, legislation of this sort diminishes earnings and depletes corporate value – a loss not just to executives but, in a nation in which half of all households own stock, to small investors as well.

Market discipline and current criminal and civil laws provide powerful remedies and protections against another Enron already.

As a financial columnist, what bothers me most about this legislation – and, far more, what bothers me about CIPA -- is that it sends the wrong signal to investors. When stocks decline, the underlying logic of this legislation goes, someone must be doing something illegal or immoral. Analysts and accountants are the current targets. This is absolutely the wrong message to send investors. They need to understand that the stock market is a risky place and that they themselves are responsible, in the end, for their own

investments. Yes, the market provides the threat of punishment, but bad things still happen to the best of investors, and he only protection is diversification.[16]

For that reason, my focus as a remedy would not be to change accounting rules but to educate investors. We don't want to scare them out of the market – and so far they have not been scared. We want instead to get more of them into the market. The best way to do that is to inform them of the true risks and rewards of investing.

Thank you.

[16] See my op-ed piece, "Diversify, Diversify, Diversify," Wall Street Journal, Jan. 18, 2002.

James K. Glassman
Biography
202-862-7198

James K. Glassman is a resident fellow at the American Enterprise Institute, a Washington public policy think tank, where he specializes in issues involving economics, technology and financial markets. He writes a weekly syndicated financial column for The Washington Post that appears as well in the International Herald Tribune, the New York Daily News and other newspapers.

His new book, *The Secret Code of the Superior Investor* (Crown), published in January, was recently called the best investing book of the year by Business Week. He is also the co-author of *Dow 36,000*, a best-selling book on stock valuation that was published in 1999.

In addition, he is host of TechCentralStation.com, a website that concentrates on matters of technology and public policy.

From 1987 to 1993, he was editor and part-owner of Roll Call, the twice-weekly newspaper that covers Congress. Prior to that, he had a long career in magazine publishing -- as president of the Atlantic Monthly, executive vice president of U.S.News & World Report and publisher of the New Republic.

He has also had extensive television experience – as host of Capital Gang Sunday on CNN and TechnoPolitics on PBS. He has been a guest on ABC's Nightline, CNN's Crossfire, PBS's Charlie Rose Show, CNN's Larry King Show, and others. His articles on public policy and economics regularly appear in The Wall Street Journal and have also been published in Forbes, the New York Times, the Los Angeles Times, and others.

Mr. Glassman has given frequent congressional testimony, recently on subjects as varied as the Asian financial crisis, Social Security reform, the Enron scandal, personal investing, and telecommunications policy.

He is the recipient of, among other honors, the Norman B. Ture Award of the Tax Foundation for contribution toward sound tax policy and the Warren Brookes Award of the American Legislative Exchange Council for distinguished journalism.

He is a graduate of Harvard University, B.A., cum laude, where he was managing editor of the university daily, The Crimson.

He has two daughters and lives in Falls Village, Conn., and New York City.