WRITTEN STATEMENT
OF
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ON

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

BEFORE THE COMMITTEE ON FINANCIAL SERVICES U.S. HOUSE OF REPRESENTATIVES

March 13, 2002

Chairman Oxley, Ranking Member LaFalce and Members of the Committee:

I am Marc E. Lackritz, President of the Securities Industry Association ("SIA"),[1] and I am pleased to testify before you today on legislation to improve the accuracy of information in the capital markets. We commend you, Mr. Chairman, and members of the Committee for your ongoing efforts to ensure that investors will continue to be well served and well protected.

[1] The Securities Industry Association brings together the shared interests of nearly 700 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of nearly 80-million investors directly and indirectly through corporate, thrift, and pension plans. In the year 2001, the industry generated $198 billion in U.S. revenue and $358 billion in global revenues. Securities firms employ approximately 750,000 individuals in the United States.

The securities industry shares your commitment to ensuring the highest level of public trust and confidence in the nation's financial markets. Indeed, we have worked closely with Congress over the last few years to achieve several major accomplishments that benefit investors. We made a seamless transition to the year 2000 and, under the watchful eye of this Committee and others, an equally smooth transition to decimal prices. Most recently, the determined and successful efforts of the exchanges, the industry, and government officials to reopen the financial markets quickly after September 11 is a vivid illustration of our mutual resolve to maintain the public's confidence. These examples illustrate the leadership and commitment of Chairman Oxley, members of this Committee, as well as your colleagues in the Senate, and underscore the cooperation and trust we have built in working with each other to ensure that investors' interests come first.

I. PUBLIC TRUST & CONFIDENCE

SIA is deeply concerned about the implosion of Enron and the corrosive effect that this event is having on the public's trust and confidence in our country's corporations and financial markets. Public trust and confidence is the bedrock of our financial system, the core asset underlying why our financial markets are the envy of the world. The securities industry relies on the public's resolute trust and confidence that the markets operate fairly with complete integrity to best perform their capital-raising function. When that trust and confidence is undermined, investors become more reluctant to provide the capital that companies need to grow and prosper, employ more workers, and provide financial returns that boost our nation's prosperity.

Although Enron's collapse appears to be a massive failure in the accuracy of information that flowed into the marketplace, the securities industry's regulatory structure remains

fundamentally strong. When Congress wrote the federal securities laws in the 1930s, it established a regulatory system that has helped to foster the most liquid, transparent, and honest capital markets in the world. We are still learning the entirety of what went wrong with Enron, and the efforts already underway by this Committee, the Securities and Exchange Commission ("SEC"), the Department of Justice, and other authorities, show that we have the means to address problems that episodes such as Enron uncover. No system is perfect, however, and we strongly support reasonable reforms to improve the quality of information in the marketplace. We look forward to working with Congress, regulators, and others to develop thoughtful, workable solutions to the issues that Enron has raised.

II. OPPORTUNITIES FOR REFORM

SIA's agenda for reform is aimed at achieving one goal: to ensure that financial information, the lifeblood of our markets, is honest, accurate, and easily accessible to investors so that they can determine how best to meet their investment goals. SIA supports several initiatives – including various pension reforms, full funding of SEC pay-parity provisions, and many of the provisions contained in H.R. 3763 – that we believe will go a long way towards achieving that goal. We note that the Administration and the SEC have advanced many of the proposals we support. Before commenting specifically on H.R. 3763, we will briefly discuss some of the other reforms we believe will improve our current system.

A. Pension Reform/Retirement

SIA welcomes the series of reforms in pension laws announced by the Administration in February. Specifically, we support prohibiting insiders from selling their securities during a blackout period, requiring prior notice to plan participants of blackout periods, and the concept

of permitting participants to sell company stock in their 401(k) plan after a reasonable period, such as three years.

We also commend the House for passage of the *"Retirement Security Advice Act"* (H.R. 2269) and we encourage the Senate to follow the House's lead in passing the bill for the President to sign. The legislation would enable retirement plan administrators to provide individual financial advice to employee participants. By allowing employers to bring in specified, regulated entities to provide investment advice to plan participants and individuals with IRAs, investors would have greater access to the information they need to make informed decisions about their retirement accounts. Importantly, the legislation includes stringent disclosure and reporting requirements to protect investors and ensure the integrity of advice provided.

B. Full Funding of SEC Pay Parity Provisions

SIA has always supported a fully funded SEC, with the staff and the tools necessary to bring wrongdoers to justice. An experienced, sophisticated staff is vital to the effective regulation of our complex industry. SIA has been profoundly troubled by the huge turnover in experienced staff that the SEC suffered in prior years. For that reason we strongly supported H.R. 1088, the "*Investor and Capital Markets Fee Relief Act*," legislation that originated in this Committee, and was then passed by Congress and signed into law by President Bush. This new law reduces SEC fees and establishes for the agency's professionals pay parity with other financial regulators. We have consistently stated that we need a "tough and effective" cop on the beat, and we believe the SEC should have the resources it needs to maintain a high standard of regulation. Congress should fund pay parity and increase the agency's funding.

C. Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002 (H.R. 3763)

SIA believes that CAARTA includes a number of important improvements to the current regulatory system. President Bush included many of these reforms in the recently unveiled 10-point plan to enhance corporate disclosure. We support many of the bill's provisions, as outlined in our comments below:

Auditor Oversight (Section 2)

H.R. 3763's provisions on auditor oversight represent a sensible and appropriate reaction to the shadow that the Enron debacle has cast on the current performance of outside auditors. Investors and all other market participants depend on high-quality, accurate information. SEC Chairman Harvey L. Pitt has correctly identified the need for "the government . . . to ensure that appropriate standards of ethics and competency are in fact established, and then rigorously implemented and enforced."[2] We agree entirely, and we also concur with Chairman Oxley and Chairman Pitt that a private-sector regulatory body, predominantly comprised of persons unaffiliated with the accounting profession, is the appropriate means of ensuring these high standards.

The bill sets up a strong statutory framework for public oversight of the independent audit function. The general structure and power of the oversight body seems to be generally modeled on the provisions of Sections 15A and 19 of the *Securities Exchange Act of 1934* under which the National Association of Securities Dealers ("NASD") was formed. This approach –

[2] Remarks at the SEC Speaks Conference by Chairman Harvey L. Pitt, U.S. Securities and Exchange Commission, February 22, 2002.

which appears to adopt established provisions of the federal securities laws – is well conceived, and we support it.

Improper Influence on Conduct of Audits (Section 3)

Section 3 of the legislation would give the SEC authority to prescribe rules making it unlawful for an officer, director or affiliated person of an issuer of a public company to willfully "influence, coerce, manipulate or mislead" an independent auditor for the purpose of making the issuer's financial statements materially misleading. Although the SEC already has strong authority to prosecute such offenders,[3] the Committee should consider granting the SEC the statutory authority to require senior executives to disgorge bonuses and other incentive-based forms of compensation in cases of accounting restatements resulting from misconduct. We note that President Bush included such a recommendation in his 10-point plan.

Real-Time Disclosure of Financial Information (Section 4)

SIA believes H.R. 3763's provisions for more timely and better disclosure of corporate information will help investors and those who advise them. The SEC has announced its intention to act in that area by proposing rules that will: (1) provide accelerated reporting by companies of transactions by company insiders including transactions with the company; (2) accelerate filing by companies of their quarterly and annual reports; (3) expand the list of significant events requiring current disclosure on Form 8-K; (4) require companies to post filings on their website

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[3] See, *e.g.*, *Exchange Act* sections: 20(a) (liability for those who "directly or indirectly control a violator unless they acted in good faith); 20(b) (liability for doing through another person directly or indirectly an act that would be otherwise unlawful for such person to do himself); 20(c) (liability for officers or directors or shareholders of public companies "without just cause to hinder, delay or obstruct the making or filing of any . . . document, report, or information" required to be filed with the SEC); 20(e) (liability to SEC for aiding and abetting violations or imminent violations of the *Exchange Act*); 21B (money penalties in administrative proceedings brought by the SEC to address, among other things, acts that willfully make or cause to be made false and misleading a report required to be filed with the Commission); and, 21C (cease-and-desist proceedings to sanction, among others, anyone who "is, was or would be a cause of the violation" of an *Exchange Act* requirement).

at the same time they are filed with the SEC; and, (5) require disclosure of critical accounting policies in Management's Discussion and Analysis ("MD&A"). SIA generally supports these thoughtful reforms, and we will be making more specific comments when the SEC publishes the proposals.

It is important to avoid certain pitfalls, however, in seeking to accelerate and expand corporate disclosure. For example, expanding the list of significant events for disclosure creates a risk of market overreaction and volatility while the information is being digested. Inadvertently promoting shortsightedness among investors and market watchers would only serve to increase market instability and potentially frighten new investors. Moreover, increasing the frequency of disclosure could increase the risk that good-faith mistakes will be made by issuers seeking to provide accurate information within the accelerated time frame. This, too, could impede markets properly functioning.

The best way to ensure that investors and advisers receive good information without producing abnormal market effects is to provide the SEC with the flexibility to make the necessary judgments about the timing and content of required disclosures. The SEC could then adapt rules when necessary to respond to changed conditions or unanticipated harm to the financial markets and investors.

Insider Trades During Pension Fund Blackout Periods (Section 5)

SIA supports the purpose of Section 5, which is to prevent corporate insiders and large shareholders from selling shares while employees are barred from selling their shares. We suggest that Subsection (5)(c) provide that the Commission's authority to adopt rules may also

include the authority to prevent hardship or other unintended consequences, and that Section 5(c) is in addition to the Commission's general exemptive authority under Section 36 of the *Exchange Act*.

Improved Transparency of Corporate Disclosures (Section 6)

SIA strongly supports the goal of providing investors with improved transparency in financial statements. It is essential that users of financial statements have an accurate insight into the value of the issuer's franchise. We suggest, however, that the Committee consider certain changes to Section 6. At the outset, the SEC should not be mandated to revise its regulations in the area, but should be given the flexibility to examine and revise them only if necessary.

In addition, the disclosures that the bill would require generally overlap with an SEC statement to issuers regarding certain disclosures they may have to include in their MD&A.[4] As those disclosures have only recently been mandated, we believe it is premature to legislate in this area until investors, analysts, and regulators have had an opportunity to evaluate the quality of disclosure produced pursuant to the statement. Additionally, Special Purpose Entities ("SPEs") play a key role in a number of important financial markets, especially in the case of securitization programs. Regulatory or legislative actions that might cast a shadow over SPEs should be carefully considered in light of the significant adverse impact upon financial markets that would flow from inappropriate restrictions.

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[4] SEC Release No. 33-8056 (January 22, 2002) discusses disclosures that issuers may have to include in their MD&A with respect to off-balance sheet arrangements, certain OTC contracts accounted for at fair value, and transactions with related and certain other parties, in order to ensure that they are meeting their disclosure obligations.

Moreover, since SPEs are generally bankruptcy remote, incorporating detailed financial information concerning them into the financials of an issuer could be quite misleading, either by suggesting that in the event of an insolvency of the issuer the assets of the SPE would be available to its creditors, or conversely that the liabilities of the SPE are obligations of the issuer.

We also fear that requiring disclosure rules to be adopted within 180 days after enactment of the legislation would be an insufficient time for the sort of careful and detailed analysis of the disclosure regime that we believe is necessary. The importance of getting the disclosure issues right the first time is too great to risk subjecting the SEC to an artificial deadline of such brevity.

SIA supports an analysis designed to improve the transparency and usefulness of financial statements. In that vein, we strongly urge that the Shipley Report's principles and recommendations for enhanced disclosure be reviewed by the SEC with a view to incorporating elements into the SEC's disclosure regime.[5] The Report recognized the importance of having investors exercise market discipline upon issuers, and concluded that this can be best achieved when investors have an accurate insight into the key risk-management methods and practices employed by issuers. The globally active financial firms that formed the group are currently in the process of reporting pursuant to its principles and recommendations. We believe these principles and recommendations represent the industry's "Best Disclosure Practices" and are an invaluable reference point for improving disclosure practices.[6]

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[5] *Working Group on Public Disclosure*, January 11, 2001; Walter V. Shipley, Chairman, Letter to the Honorable Laurence H. Meyer.

[6] Importantly, the Shipley report rejected a uniform approach to making these disclosures, as firms will not all be in the same lines of business, have a uniform approach to risk management, nor share a single view of how best to monitor and manage their risks. As risk management practices continue to evolve, it is important to guard against premature codification of standards that may well become less than "state of the art" over time.

Further, we doubt that filing 10Qs and Ks somewhat sooner will greatly advance the cause of better disclosure of financial information. We believe that as part of the effort to improve disclosure, it would be beneficial to look at the earnings estimates that firms release, usually prior to the date on which their filings with the Commission are made. Those releases typically generate more interest by analysts, investors, and the media than the statements that are subsequently filed. We recommend that a private sector "Best Practices" group be formed for the purpose of developing a set of minimum standards for earnings releases. Such requirements might include a calculation of profit/loss per share; an estimate of revenues; a requirement that if a *pro forma* estimate is included that it also include a reconciliation to GAAP; etc. SIA would be pleased to work with such a group.

Reducing redundant disclosures would be an additional improvement to the disclosure system. For example, a number of virtually identical disclosures are currently required in the financials and the MD&A. An attempt to rationalize these disclosures and place them in a single location would assist readers of financial statements, and help to make them more concise and clear.

SIA believes that it would be very burdensome for issuers to explain how different accounting principles and the judgments made in applying those principles could have resulted in materially different financial statements. GAAP requires an issuer to make any number of choices with respect to accounting principles and how to apply them, many or all of which may have a "material" impact on its financials. Such a provision would seemingly require issuers to prepare their financial statements under a variety of accounting formats in order to determine

whether any one of the choices that has been made might have resulted in materially different results.[7] We think that requiring issuers to identify clearly their key accounting principles should suffice.[8]

Study of Rules Relating to Analyst Conflicts of Interest (Section 7)

Section 7 of the legislation directs the SEC to conduct a study of any final rules of the self-regulatory organizations ("SROs") regarding conflicts of interest by equity research analysts. SIA commends Chairman Oxley, as well as Representative Baker, Chairman of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Entities, for your outstanding leadership in seeking improvements in this area. SIA developed a set of best practices a year ago in a good-faith effort to address concerns that equity analysts' objectivity could be impaired by conflicts of interest posed by their firms' investment banking business, among other factors. We believe that our Best Practices for Research have been useful, but we recognize that, as a voluntary trade association, we have no ability to compel enforcement of them. We understand the concerns of those who believe that stronger enforcement measures are needed.

The NASD and NYSE have recently proposed regulations that would require new disclosures, as well as new restrictions on the internal operations of broker-dealers' investment

[7] As a simple example, firms are given a choice with respect to reporting the cost of sales, either FIFO ("first in, first out") or LIFO ("last in, first out"). Choosing one rather than the other will impact the profits reported, and all things being equal, FIFO will tend to result in lower costs and higher profits. (N.B.; The IRS doesn't permit a company to go from using one system to the other.) Thus, Acme Widget might conceivably report profits of $1.25 per share under FIFO, but profits of $1.10 if it had used LIFO. Such a difference in numbers would certainly qualify as material, but a firm couldn't know what the difference would be unless it ran its numbers under both approaches.

[8] Finally, for the sake of clarity and focusing on the central concern, we propose revising the phrase "any issuer engaged in trading non-exchange traded contracts" to "trading instruments where no dealer or exchange quotes exist" in section 6(c)(2)(C).

banking and research units. We have serious issues with some aspects of these proposals, which we will address soon in a comment letter to the SEC. However, we support the overall goal of the proposals, and we expect that the regulations will likely satisfy the legitimate concerns that have been raised by Congress, the news media, and the investing public. Most importantly, the SROs will be able to examine for compliance with the new regulations, and the regulations will be fully enforceable.

If experience shows the need to adjust the regulations, the SROs and the SEC will be able to make the necessary changes to make them more effective. For this reason, we do not believe that enacting these regulations into statutory law would serve any purpose, and could well be counterproductive. We think that the approach of Section 7, however, is very appropriate. Congress can and should be kept abreast of how well the new regulations are working.

Oversight of Financial Disclosures (Section 8)

The provision requiring the SEC to set minimum periodic review requirements for a certain segment of issuers will unnecessarily interfere with the SEC's ability to establish priorities and allocate its resources in the manner that is deems most appropriate to fulfill its investor protection mandate. No matter how large the agency's budget may grow, the Commission will still need the flexibility to respond to changed conditions and issues that may require special attention in the future. Prioritizing the allocation of the SEC's resources should not be written into stone, but should be left to the discretion of the agency and its oversight Committees.

Moreover, the unstated goal of this provision – that SEC review will somehow validate information submitted by issuers – is unrealistic. Ensuring quality filings is a burden that should fall squarely on an issuer and its auditors. Regulation can set the standard for the quality of those disclosures, and enforcement action can prevent and deter violations of those rules. But setting the SEC up to be some sort of guarantor of the accuracy of information is a false promise that will prove deceptive to the public and impossible for the agency to fulfill. A fairer and more realistic approach would be to require the SEC to report annually on the amount and type of reviews that it has conducted.

III. LITIGATION REFORM

Long-time opponents of the *Private Securities Litigation Reform Act* ("PSLRA") have argued that the act is somehow responsible for the Enron debacle. They also claim that the PSLRA has made it impossible for those victimized by Enron insiders to obtain relief. Both of these claims are simply false.

The PSLRA was enacted to address serious and well-documented abuses of the litigation system by lawyers who had no real clients. Extensive hearings over two Congresses demonstrated that a small coterie of lawyers sued companies whenever the stock price fell for *any* reason, filing boilerplate complaints alleging securities fraud, and seeking to extort settlements consisting of token payments for shareholders and enormous fees for the lawyers.

The PSLRA – enacted by a substantial bi-partisan majority of Congress over a presidential veto – contained a balanced package of reforms to address these concerns. For example, the act raises the standard for filing a complaint that alleges securities fraud; gives

judges the authority to select the plaintiff who will best represent the interests of all class members (rather than rewarding whoever races into court the fastest); restricts the ability of lawyers to engage in "fishing expedition" discovery tactics where they do not have facts to support their claims; and, requires auditors who uncover illegal acts to notify the SEC if the company does not take corrective action.

The modest nature of the PSLRA reforms is empirically borne out by the impact that the act has had on the cases brought and settled since its adoption. In each of the last four years, the number of shareholder suits filed has been equivalent to or greater than the number of cases typically brought each year prior to PSLRA's enactment. The average cost of settling has gone up rather than down post-PSLRA, and this year's cases alone include some of the largest settlements ever. This suggests that the courthouse door is very much open to securities class-action litigation.

There is also no merit to the argument that the PSLRA is having any tangible negative effect on claims being brought in the Enron case. In fact, class action litigation is proceeding apace as we speak (dozens of class actions have already been filed), and Arthur Andersen has already placed on the table a settlement offer which, if accepted, would by itself constitute one of the largest securities class-action settlements ever, even before settlements or judgments have been reached with any of the other defendants.

Clearly, Enron is proof that securities class-action litigation is still vibrant and profitable for securities trial lawyers. Why else would groups of prominent plaintiffs' lawyers have recently squared off in a very conspicuous fight to be named lead plaintiff in the litigation?

Further enriching the trial bar is not a valid basis for changing public policy. The premises of the PSLRA are still valid – the courts should continue to hear meritorious cases, while groundless cases should not be permitted to drain capital from companies and shareholders into lawyers' pockets.

IV. CONCLUSION

SIA believes our system of securities regulation and corporate disclosure is second to none. What we know about Enron's collapse so far – and we still don't have all the facts – is that our regulatory system remains fundamentally strong. It is important to resist the temptation to hastily adopt legislation or regulation that may seriously harm our capital markets. Indeed, our financial markets are envied worldwide for their efficiency and integrity, and we have the opportunity now to develop responsible reforms that will improve the markets for everyone who participates in them. Certainly, Enron has brought us a new set of challenges to address. We look forward to working with Congress, the SEC, and the Administration to developing a reasonable, measured response to those challenges.