TESTIMONY OF
MARC E. LACKRITZ
PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS
U.S. HOUSE OF REPRESENTATIVES

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I. Introduction

Mr. Chairman and members of the Subcommittee, I am Marc E. Lackritz, President of the Securities Industry Association.[1] SIA and our more than 600 member firms share your interest in improving the clarity and relevance of financial information, and we applaud you for holding this timely hearing. As financial intermediaries,[2] our livelihood depends on the quality, consistency, and reliability of financial information. Indeed, the U.S. capital markets are the envy of the world precisely *because* the quality of information has continued to evolve and improve. We are eager to work with your subcommittee, other members of Congress, regulators, and all interested parties to further improve the quality of financial information.

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[1] The Securities Industry Association brings together the shared interests of approximately 600 securities firms to accomplish common goals. Our primary mission is to build and maintain public trust and confidence in the securities markets. Our members (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. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated $236.7 billion in domestic revenue and an estimated $340 billion in global revenues. (More information about SIA is available at: www.sia.com.)

[2] Although we are financial intermediaries, our members are also issuers and publicly held companies. Our testimony, however, focuses on investors and their perspective on financial information.

II. Overview

Our liquid, transparent, and dynamic capital markets function to allocate a scarce resource – capital – to its most efficient use. These vibrant markets provide issuers the opportunities to raise capital – to establish or expand their businesses or help finance public projects – and give investors the opportunities to put their capital to work. Our markets have thrived largely because of investors' ability to obtain, digest, and appropriately price securities derived from information about companies and the economy. Without that information, the entire price discovery function of the markets would collapse. And without the markets to act as signaling mechanisms for capital allocation, our entire economy would become as moribund and flat as those of state-run economies.

Three factors allow information to flow fully, efficiently, and fairly. First, companies have powerful motives to disclose information. Certainty, clarity, and comparability in the disclosure of financial information lowers the cost of capital. Second, the federal securities laws have long buttressed the efficient flow of information to the markets, especially by punishing the dissemination of deliberately false information. Third, our markets have excelled at embracing advances in technology, from the telegraph to the Internet. This has enormously enhanced the capabilities of market participants to receive and absorb information in their trading decisions.

None of this would be possible however, without the public's trust and confidence that all market participants adhere to stringent rules, vigorously and fairly applied. Because of that trust, billions of shares trade hands every day, and manufacturers, school districts, and hospitals have access to financing in our capital markets. But public trust and confidence also depends on access to reliable and timely information, both by the public directly and by the investment advisers, mutual fund, pension, and 401(k) plan managers who manage trillions of dollars of

savings. At a time when nearly 57 million Americans – or half of all U.S. households – own stock, the securities industry is committed to ensuring that individual investors can achieve their financial goals, such as planning for a child's education or for a comfortable retirement. With 76 million Baby Boomers hurtling toward retirement, we recognize that the quality of information must be paramount.

Securities firms have expended tremendous resources over the last several years to ensure that our greatest asset – the public's trust – is never compromised. Corporate governance, accounting, research, SRO governance, and mutual fund scandals have produced a tsunami of regulation. Our industry's compliance costs nearly doubled over the past three years to an estimated $25.5 billion, mainly because of increased staffing and frequent inquiries from regulators.[3]

Similarly, some of these regulatory requirements have made it more expensive and daunting to list in the U.S. markets, driving foreign issuers away, and causing many others to consider going private.4 New York Stock Exchange CEO John Thain recently testified that in 2000, nine out of every ten dollars raised by foreign companies through new stock offerings were done in the U.S. But last year, none of the top ten initial public offerings (IPOs) measured by global market capitalization was registered in the U.S. markets. In fact, 23 out of the 25 largest IPOs in the world chose to register outside the United States, often in London or the Deutsche

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[3] *The Cost of Compliance in the U.S. Securities Industry, Survey Report*, February 2006, Securities Industry Association, available at http://www.sia.com/surveys/pdf/CostofComplianceSurveyReport.pdf. Broker-dealers have added 8,800 new compliance officers, accountants, auditors, lawyers, paralegals, legal assistants, and accounting and auditing clerks since the passage of Sarbanes-Oxley. Those positions now represent 6.1 percent of all industry jobs, up from 4.6 percent before Sarbanes-Oxley. During this same period, the industry shed 63,000 net positions.

[4] A 2005 Foley & Lardner, LLC study found that the average cost of being public in 2004 increased 33 percent over 2003 for a company with annual revenue under $1 billion, with audit fees accounting for the largest out-of-pocket cost increases (Foley & Lardner, LLC, *The Cost of Being Public in the Era of Sarbanes-Oxley* (June 16, 2005), at http://www.foley.com/files/tbl_s31Publications/FileUpload137/2777/2005%20Cost%20of%20Being%20Public%20Final.pdf).

Bourse. Going forward, we must carefully consider how proposed regulation and legislation will affect the competitiveness of our markets, as well as how we can maintain our global leadership across the world.

III. Role of Financial Information in the Marketplace

Today's investors have virtually instantaneous access to volumes of information about issuers, investment choices, and the securities markets due in large part to technological advances and the ubiquity of the Internet. In many ways, technology has democratized the securities markets by making the same information available to all investors – not just high net-worth individuals or institutions – at the same time. Investors can review and analyze issuers' filings on a more current basis, quickly compare that information to other issuers' reports, follow market trends, and read analyst reports concerning the company. Investment decisions, however, are only as valuable as the quality of the information they have available to them.

The increasing number of financial restatements by U.S.-listed issuers over the last several years has raised concern about the accuracy of financial statements. In 2005, a study by Glass Lewis found that one in every 12 U.S.-listed public companies restated their financials, up from one in every 23 in 2004.[5] Partially, that increase may be due to the complex nature of ensuring compliance with some accounting standards. In the post-Enron era, executives may be paying closer attention to their company's financial reporting mechanisms and internal controls and are therefore doing a better job of ensuring that errors or interpretive issues are being resolved. As a result, investors are now getting more accurate information than ever before because of increasingly rigorous standards being imposed either internally or externally on issuers.

[5] Glass, Lewis & Co., LLC, *Getting it Wrong the First Time* (March 2, 2006), available at <http://www.glasslewis.com/downloads/Restatements2005Summary.pdf>.

SIA believes the SEC's current financial disclosure regime works exceptionally well to provide the highest quality information to investors. We do not believe it is necessary to mandate any additional disclosure of financial information, but we urge policymakers to support continued improvements in global accounting standards. Because of varying country-to-country standards, investors cannot easily analyze and compare investment choices, and may not able to make fully informed decisions. SIA therefore supports more consistent, comparable, "principles-based" accounting standards. Such standards will facilitate the seamless flow of capital across national borders as well as reduce the costs of providing relevant information to investors.

IV. Financial Reporting Requirements

A. Regulated Quarterly Disclosures

Current information in the marketplace comes from three basic sources: regulated disclosures, voluntary issuer guidance, and research analyst reports. Regulated disclosures include filing quarterly reports on SEC Form 10-Q,[6] annual reports on Form 10-K, and extraordinary transactions on a current basis on Form 8-K.[7] In total, these reports comprise a comprehensive and effective disclosure regime.

In 1996, the SEC unveiled its EDGAR online filing and disclosure system, thus allowing the public to access and compare corporate reports in a reliable centralized location. The SEC is also assessing the benefits of XML-tagged data, and is offering companies incentives to disclose financial information using the XML-based Extensible Business Reporting Language (XBRL). The goal of using XML-tagged financial reporting data is to provide "greater context for data

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[6] Form 10-Q includes quarterly financial results, management discussion and analysis, and a description of significant events that have occurred within the company during the quarter.

[7] Extraordinary transactions include bankruptcy, death of an officer or director, change in public accountant, etc. Karel Lannoo and Arman Khachaturyan, *The Emerging Framework for Disclosure Regulation in the EU,* Report of a Centre for European Policy Studies (CEPS) Taskforce (2003).

through standard definitions, enabling investors and other marketplace participants to analyze data from different sources and to support automatic exchange of financial information across various software platforms, including web services."[8] XML, if adopted for EDGAR and generalized reporting, will make financial analysis quick, cheaper and better, making it more accessible to the average investor and reducing significantly the cost of doing securities research. These initiatives – in combination with the pertinent information many issuers already provide on their corporate websites – would give investors real-time access to an unprecedented volume of company information.

Some critics of quarterly reports claim that they lead to a short-term, "make your earnings" mentality. They have suggested that quarterly reports should be eliminated so that issuers can focus on the longer-term horizon. Others have called for more real-time accounting reporting. SIA believes that the information contained in quarterly reports has improved the quality of the markets and helped investors. Regulated quarterly reporting is an important mechanism for corporate management to communicate with shareholders regarding issues that affect the company's financial status. We therefore oppose efforts to eliminate the quarterly reporting.

The punishing effects that a late filing can inflict on an issuer further underscore the importance of quarterly reporting. Late filings often indicate conflicts between auditors and management and may signal serious financial trouble for the company.[9]

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[8] SEC Press Release, *SEC Announces Initiative to Assess Benefits of Tagged Data in Commission Filings,* July 22, 2004, available at: http://xml.coverpages.org/SEC-XBRL.html.

[9] For example, in October 2004, Investors Financial Services Corp. decided to delay filing its 10-Q to correct its accounting methods for mortgage-backed securities purchases. The company's share priced plunged 16 percent and the stock price did not recover until three weeks later, after the company had restated three years of financial results. David Henry, *Where's the Quarterly Report*, BusinessWeek Online (Dec. 13, 2004).

B. Accounting Standards

High quality accounting standards are absolutely crucial to ensuring that financial reporting results in clear, timely, and relevant disclosure to users of financial statements. We believe accounting standards can be improved in three ways: by using fair value to measure all financial instruments; by simplifying standards; and, by converging differing national standards.

Fair Value

Though it has some very resolute opponents, accounting standard setters and regulators have generally concluded that all financial instruments should be measured at fair value. The securities industry – which has long-utilized fair value (or mark-to-market) in its daily activities[10] – has worked with the Financial Accounting Standards Board (FASB), the International Accounting Standards Board (IASB), and the SEC on developing fair value standards that meet rigorous criteria. Indeed, the forthcoming FASB statement on Fair Value Measurement[11] and the proposed statement on a Fair Value Option[12] are both very significant contributions to improving accounting standards.

As regulators have noted in the context of Basel II,[13] disclosures that provide insight into an entity's risk positions and exposures can enhance regulatory and market discipline.[14] Using

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10 Fair value is used in structuring and pricing instruments, risk evaluation and monitoring, margining, and in the compensation of our employees.

11 *FASB Working Draft of Statement of Financial Accounting Standards No. 15X, Fair Value Measurements and the Proposed FASB Staff Position* (Oct. 21, 2005).

12 *The Fair Value Option for Financial Assets and Financial Liabilities — Including an amendment of FASB Statement No. 115 (Proposed Statement of Financial Accounting Standards)* (Jan. 25, 2006).

13 After a number of banking failures earlier in the decade, in 1988 the Bank for International Settlements' ("BIS") Basel Committee on Bank Supervision produced an international model agreement on a set of minimal capital requirements for banks that became known as the Capital Accord. As the markets evolved and financial instruments became more complex, it was recognized that the Accord (now known as Basel I) was inadequate, and work began on a replacement ("Basel II") that would be reflective of the increasing interdependence of financial markets, and that would ensure that the capital requirements for financial institutions were in line with the best current thinking on prudent risk management.

fair value forces firms to confront adverse market movements at an early stage, and investors receive an earlier warning of developing problems. Similarly, fair value forces companies to state what an asset is worth today, rather than what they hope it will be later, which is what we believe users of financial statements prefer. As our economy and capital markets have become more dynamic, the historical cost of an asset may no longer be an adequate basis to make investment decisions.

Simplification

The complexity and sheer volume of current accounting literature has become overwhelming even to the most sophisticated professional. To some degree, that is the necessary consequence of an ever more complex and dynamic economy. However, complexity does create some dangers, including the possibility of "gaming" the system.[15] Both SEC Chairman Christopher Cox and FASB Chairman Robert Herz have recognized the problem and have committed their organizations to tackle the issue.[16] Standard setters, regulators, and the private

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[14] Jaime Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, Madrid, Risk Management Trends and the Supervisory Structure, (May 27, 2004).

[15] Fair value also has an important role here. Last June, the SEC released its report and recommendations on off-balance sheet transactions in the wake of the Enron disaster. In discussing transactions entered into for no economic purpose but instead to obtain a desirable accounting treatment, the report noted that "the motivation for the transaction or the structuring could be essentially eliminated if all financial instruments were recorded at fair value." In the securities industry's view, that's a key lesson of that debacle. *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers*, p. 110 (June 15, 2005).

[16] FASB Chairman Robert H. Herz Remarks before the 2005 AICPA National Conference on Current SEC and PCAOB Reporting Developments (Dec. 5, 2005); SEC Chairman Christopher Cox Remarks before the 2005 AICPA Conference on Current SEC and PCAOB Reporting Developments (Dec. 5, 2005). Since December, FASB has adopted a series of Statements designed to reduce complexity. *See, FASB Issues Final Standard to Account for Certain Hybrid Financial Instruments – New Standard Provides a Means to Simplify Accounting* (Feb. 16, 2006).

sector have all recognized the benefits that would result from a more "principles-based" approach to accounting.[17]

Achieving that goal, however, will not be easy. As Chairman Cox and Chairman Herz have both observed, issuers and their auditors are justifiably afraid of being second-guessed by juries, regulators, and the media. As a consequence, preparers and their accountants clearly want to reduce their exercise of professional judgment and adopt a "check-the-box" approach to accounting and auditing in the hope that it will minimize their liability. Correcting that tendency will to some degree involve addressing tort reform. Although it is a difficult and complex subject, it must be addressed so that professionals do not have to fear doing their job. We believe this Committee and others in Congress should examine this very important issue.

Convergence

The ever-increasing volume of cross-border transactions attests to the evolution of the capital markets and the erasure of national boundaries. However, historically the various countries of the world have independently evolved their own accounting practices over time. While those differing accounting conventions generally share the same goal of providing investors, analysts, and other users of financial statements with insight into the operations of issuers, "homogenizing" the standards can be difficult. FASB and the IASB, and the SEC and the Council of European Securities Regulators ("CESR") have recognized the importance of accounting convergence.[18] We hope that in the near future a sufficient degree of convergence or comparability will be achieved so as to permit issuers listed in the United States or the European

[17] For a discussion of how moving to "principles-based" rather than "rules-based" standards can contribute to financial stability, see *Toward Greater Financial Stability: A Private Sector Perspective*; The Report Of The Counterparty Risk Management Policy Group II; pp. 151-153; pp. C-1-C-2 (July 2005).

[18] FASB Press Release, *FASB and IASB Reaffirm Commitment to Enhance Consistency, Comparability and Efficiency in Global Capital Markets* (Feb. 27, 2006).

Union to obtain listings in the other jurisdiction with minimal difficulty. Greater comparability across borders will again help to facilitate the flow of capital by more efficiently allocating scare resources on a global basis.

C. Volunteer efforts by issuers to improve quality of disclosure

In addition to the SEC-mandated quarterly reporting, many corporate issuers voluntarily provide periodic earnings guidance. The *Private Securities Litigation Reform Act of 1995* – which protected issuers from liability for forward-looking statements about projected performance – prompted many companies to issue earnings guidance more widely. Earnings guidance is often the subject of extensive media coverage, speculation, and comparison.

Guidance is not mandated by statute or regulation, but most companies choose to provide this information in response to market demands. A recent survey of executives and directors of companies that issue earnings guidance found that most executives believe that earnings guidance has provided valuable information to the marketplace and has kept performance expectations in check.[19]

Although corporate executives believe that earnings guidance has many benefits – including higher valuations, lower volatility, and improved liquidity[20] – a recent McKinsey study

[19] *McKinsey Quarterly: Weighing the Pros and Cons of Earnings Guidance: A McKinsey Study* (March 2006). Another McKinsey study notes that in February 2006, Google's share price fell seven percent after failing to meet the lofty expectations for the fourth quarter of 2005, although Google had not issued any earnings guidance. The survey authors noted that some commentators speculated that if Google had released earnings guidance, expectations could have been kept more squarely in check. Peggy Hsieh, et. al., *McKinsey Quarterly: The Misguided Practice of Earnings Guidance* (March 2006) http://www.mckinseyquarterly.com/article_abstract.aspx?ar=1759&L2=5&L3=5.

[20] *McKinsey Quarterly: Weighing the Pros and Cons of Earnings Guidance: A McKinsey Study* (March 2006).

seems to disprove these perceptions. Results showed that frequent earnings guidance does not increase valuations, or have any effect on share price volatility or liquidity.[21]

Several large U.S. issuers have discontinued the practice of issuing earnings guidance in favor of issuing more detailed performance information.[22] Issuers want to focus on long-term goals instead of short-term earnings, and reduce the costs associated with issuing earnings guidance (both the hard costs of management time spent on preparing the guidance as well as the negative effect on the share price when earnings guidance targets are subsequently not met). In fact, when Coca-Cola discontinued releasing earnings guidance in 2002 citing an increased focus on long-term goals, its share price held steady.[23]

SIA agrees that the decision to issue earnings guidance should rest with the issuer. As a policy matter, we should all work to encourage more and better financial information in the marketplace, but the release of earnings guidance should not be mandated by law or regulation.

VI. Conclusion

The current system of financial disclosure has served investors, issuers, and the securities industry extraordinarily well. In addition to mandated disclosures, issuers often voluntarily provide information beyond what is required by the SEC, thus giving investors access to more detailed information about the company. We believe the that greater use of fair value accounting, and the simplification and convergence of accounting standards would further assist issuers in providing better quality information to investors.

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[21] The issuance of corporate earnings guidance does appear to increase trading volumes in the short-term, but this does not have any lasting effect on liquidity. Peggy Hsieh, et. al., *McKinsey Quarterly: The Misguided Practice of Earnings Guidance* (March 2006). The McKinsey study surveyed 4,000 companies with revenues greater than $500 million. The results may differ for smaller companies.

[22] These companies include Citigroup, Coca-Cola, Intel, Motorola, Berkshire Hathaway, Ford, and General Motors. Dan Roberts, *Guidance Falling Out of Favour on Wall St*, Financial Times (Mar. 12, 2006).

[23] Peggy Hsieh, et. al., *McKinsey Quarterly: The Misguided Practice of Earnings Guidance* (March 2006).

Because of the diverse roles we play in the capital markets, we are sympathetic to the concerns of issuers and financial officers that the current system hinders their good-faith efforts and imposes unnecessary costs. We hope we can work together with investors, issuers, accountants, and regulators to improve the quality, consistency, and clarity of information so that we can maintain the global preeminence of the U.S. capital markets.