RICHARD C. BREEDEN & CO.

TESTIMONY OF

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BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

CONCERNING

ACCOUNTING AND DISCLOSURE
REFORM AND OVERSIGHT

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Chairman Oxley, Congressman LaFalce, Members of the Committee. It is a great pleasure to appear before you today. I was privileged to serve as Chairman of the Securities and Exchange Commission from 1989-1993. In total I served for nearly ten years in government posts spanning the administrations of Presidents Reagan, Bush (41) and Clinton. Through my own firm I now provide restructuring and workout management services for companies that are experiencing financial distress or crisis, as well as strategic consulting on internal controls, corporate governance and other capital markets issues.

I was honored to work with you, Mr. Chairman, Mr. LaFalce and other members of this Committee to pass the savings and loan reform legislation in 1989, the Market Reform Act of 1990, and the Securities Enforcement Remedies Act of 1990, among other bills. During those years we worked closely together on a wide range of subjects including government securities regulation, market stability and reform, litigation reform, derivatives oversight and accounting and disclosure issues.

During my time at the SEC we completed the most far reaching overhaul of proxy rules in more than a decade, putting in place new rules for disclosing the details of executive compensation and options grants, and allowing greatly expanded shareholder participation in corporate governance. We handled more than 1,200 enforcement actions, including major enforcement actions against Salomon Brothers concerning corruption in the government bond market, and against Michael Milken for wrongdoing in the market for high yield bonds.

We won vital pay increases for SEC staff, expanded the agency's budget, and improved enforcement and examination resources dramatically in both quantity and quality. We implemented the EDGAR electronic filing system that made disclosure readily accessible to every investor and created the Rule 144A market for raising capital. Rules for small businesses were simplified to help them tap the capital markets more economically.

In these and many other activities I enjoyed great cooperation and support from Republicans and Democrats in Congress, without partisanship. I was proud of my partnership with Congress in trying to enhance the extraordinary traditions of the SEC in enforcing the rule of law in the most important capital markets in the world. Our record then of working together to enact legislation that could command widespread support makes me believe that <u>this</u> Congress and <u>this</u> SEC, under the capable leadership of Chairman Harvey Pitt, can achieve sound and sensible legislation in responding to today's problems and challenges.

Faith in the markets and our system of corporate governance has taken a real pounding from the Enron/Andersen scandals. Because we were successful in encouraging tens of millions of Americans to put a portion of their family savings into the securities markets, more Americans have been harmed financially by the violations of law and craven dishonesty in the whole Enron saga than in any previous single case. Responding to these terrible events requires a measured, careful and thoughtful response. We should not try to do too much, or allow ourselves to do too little. Certainly the starting point should be to enforce existing law, and then to make further improvements carefully.

While it is easy to condemn the abuses that occurred at Enron/Andersen, the difficult task is to design measures to improve transparency of market information, produce better accuracy in audited financial statements and encourage better governance of both accounting firms and corporations. Also, we need to make any improvements without creating unintended new problems by damaging existing disclosure systems or creating unnecessary costs or overbroad regulation.

The Critical Role of Auditors

The events at Andersen and the issues raised by its indictment are as important for investors and the overall market as the events at Enron. Accountants play a unique role as the scorekeepers of the market economy. While companies in the U.S. don't have to employ a law firm, an underwriter, or other types of professionals, federal law requires a publicly traded company to hire an independent accounting firm to perform an annual audit. In addition to this shared federal monopoly, more than a hundred million investors in the U.S. depend on audited financial statements to make investment decisions. This imbues accounting firms with a high level of public trust, and also explains why there is a vital federal interest in how well the accounting system functions.

Auditors are there to get the numbers right, not to help CEOs or CFOs hide debt, artificially inflate income, and conceal risk. The ultimate objective of the system is for investors, creditors and other participants in the market to have a full and fair picture of the financial condition of the company and its results. Market participants need to be able to understand a company's risk posture and trends in its results. To do that, they have to be able to see the entire picture of a company's financials, not carefully selected pieces.

Our tools in getting the numbers right include accounting principles that accurately reflect economic substance ("GAAP", or generally accepted accounting principles), auditing standards that detect false numbers ("GAAS", or generally accepted auditing standards), and trained and capable accountants proficient in the application of GAAP and GAAS, backed by firms with sophisticated software, and multiple layers of internal review. The system also relies on the auditor's independence and integrity to apply GAAP and GAAS competently, and irrespective of pressure from the issuer. Enron has exposed weaknesses in every one of these areas.

Part of the problem in Enron was the abysmally poor quality of FASB pronouncements concerning off balance sheet liabilities, and the latitude that exists to "accrue" profits out of mathematical models without adequate safeguards to test the validity of the results. The poor quality of these standards gives wide scope for mischief in their interpretation. Another part of the problem, however, was that those with responsibility for insisting on full and fair disclosure by the company appear to have ignored their duties to the investing public.

Even as accounting firms have steadily consolidated into some of the largest businesses in the world, earnings restatements and blown audits appear to be happening with more frequency, and getting bigger. This suggests that there is something in the internal dynamics of the auditing firms themselves that has gotten in the way of audit accuracy and integrity. Clearly we can do a better job, and everyone should work together toward that objective.

Questions of the Committee

1. Please compare and contrast H.R. 3818 with H.R. 3763 with respect to creating a new accounting regulator. What powers does the new regulatory body need to be effective? Should the regulator be able to establish standards for audit quality, independence, and ethics, rather than rely on the standards set by industry?

At the outset of any discussion of possible change in the regulation of accounting firms, it is important to note what should not change. This concerns the role and responsibilities of the SEC and the Department of Justice ("DOJ") in the oversight system. Historically the SEC has been the only federal agency with oversight responsibilities for the accounting profession and its performance in carrying out audits of publicly traded companies in accordance with both GAAP and GAAS. The SEC's role is generally grounded in its power to define accounting, auditing and disclosure requirements for issuers of publicly traded securities, which it does through Regulation S-X and other rules. The SEC has also had statutory authority to bar accountants from participating in audits of public traded issuers. The SEC also has ultimate authority to approve accounting standards promulgated by the Financial Accounting Standards Board ("FASB"), though it does not have direct oversight over the FASB and its work. The SEC and DOJ have responsibility for investigating violations of law – including the SEC's rules – by accountants or their firms, and for taking appropriate enforcement action. No other federal agency plays a role in this area. Under no circumstances should a third governmental body be created or brought into this system, though any of these basic powers are in doubt, this historic mandate should be renewed and reaffirmed.

There is only one thing about the existing governmental structure described above that in my judgment should be changed. That is that the accounting oversight resources at the SEC and DOJ should be increased substantially. If the total budget of the SEC was doubled – which I believe should be done – the agency could run for more than 75 years before it would cost as much as investors lost in Enron and Global Crossing alone. That of course doesn't count recoveries by the SEC, which pay more than 100% of its cost anyway. Most of the increased resources should probably go into accounting and examination personnel, though enforcement could use some reinforcements too, though any allocation of resources should best be left for Chairman Pitt to recommend.

The document shredding at Andersen exposes a serious threat to the rule of law in this area that warrants an increase in DOJ's criminal resources as well. The actions of Andersen's management and legal staff were so flagrantly in disregard of Andersen's legal obligations that the SEC brought charges of securities fraud against the entire Andersen firm in the Waste Management case last year, where Andersen consented to a permanent injunction. Similarly, the deliberate acts of Andersen's own personnel appear to have resulted in criminal charges for obstruction of justice in the Enron case. Andersen's legal view appears to have been that it was powerful enough to do what it wished, irrespective of how many people might be hurt.

The impact on Andersen's innocent employees of its collapse, if that occurs, is certainly regrettable, and everything reasonably possible should be done to avoid it. However, we should not learn the wrong lesson here. Firms cannot allow themselves to behave in a manner that ignores their responsibilities to tell the truth, to carry out their audits in conformity with professional standards, and to respect and comply with obligations to protect records of potential wrongdoing where, as in Enron, the rights of large numbers of people may be affected. The leaders of the major accounting firms should play a strong role in placing honesty and integrity above the short term monetary interests of the firm, and in respecting the limits of the law at all times. As a former CEO myself, I do not believe there is any higher personal responsibility than to ensure your organization is firmly and unequivocally dedicated to integrity and truthfulness.

In the wake of the savings and loan debacle, then President Bush sought and obtained authorization for a special force of 200 dedicated new FBI agents and a similar sized force of prosecutors to pursue white collar fraud cases involving looting of S&L's. I don't know the right number of personnel, but before we pass new laws we should add enough prosecutors to enforce current law effectively. Plainly many people at Enron and Andersen violated the law, and our first obligation is to enforce those laws and put wrongdoers in jail.

<u>A New Oversight Board</u>.

The basic structure and powers of a new oversight body for accounting can of course be debated, and there is not necessarily any "right" or "wrong" answer. Various structures can be made to work, and the most essential element is for a high level of consensus to be developed on the role that such a body should play, and the powers and resources it needs to carry out its missions. It is much better to reach agreement on what should unquestionably be done as first principles than to fail to act because of disagreement on how far to go. HR 3818 and HR 3763 contain many common principles that can form the basis for consensus that should significantly benefit U.S. investors.

My own view is that there is one and only one governmental "regulator" for the accounting industry, and that regulator is now and should remain the SEC. The SEC has the history, the culture and the institutional strength to be able to stand up to any wrongdoer. However, private sector groups working under the SEC's aegis can extend the reach of supervision in a healthy fashion. Therefore, the best model for a new accounting oversight group would be one that parallels the structure of the NYSE and the NASD. Those organizations have considerable resources and enforcement power, but they exercise private authority delegated by government that is subject to the oversight and review of the SEC itself. The SROs in the securities world play a highly important role, though it is the SEC itself that is the ultimate arbiter of policy, and that brings the toughest cases where its big guns are most necessary.

I would be strongly opposed to see a new accounting oversight body that created even the potential for divided jurisdiction or competing approaches to civil enforcement actions or overall policy. We should not repeat the mistake that was made when the CFTC was created as a separate agency with powers parallel to the SEC, as institutions over a period of decades will develop their own views and seek to expand their resources and mission, and this could lead to unnecessary confusion or interference with the SEC's ability to carry out its proper role of protecting investors and holding audit firms and their personnel accountable for complying with GAAP, GAAS and other requirements of the securities laws. The provisions of HR 3818 dealing with the proposed "Public Auditing Regulatory Board ("PARB") should be clarified to make explicitly clear that the PARB is not a public regulatory body, and that it is explicitly subject to SEC authority in its rules, interpretations or actions. These essential characteristics are set forth more clearly in HR 3763.

Like the NASD, the PARB should be a private sector body, not a government agency. It should not be subject to any government pay or personnel standards, it should not be part of the federal budget process, and it should not in any other manner be treated as part of the government. I believe this will lead to a much stronger organization, and avoid confusion as to role or function. It will be important for any new oversight group to be able to hire top notch people and to seek to retain those personnel for a long tenure. Experience in this field is vital. Therefore, salaries for the leadership of this body should be comparable to those at the NYSE or the NASD. Over a period of years I would expect the new oversight group would need to build a staff with significant accounting, examination and enforcement expertise, together with the resources devoted to developing both new accounting principles and auditing standards.

Funding for the new body needs to be assured, and various mechanisms have been suggested for doing so. Whatever method is chosen, the organization must have assured funding so that it does not risk loss of resources if it tackles the major firms head on in areas that they do not like. If such a group is to be created, the purse strings must not be held by the accounting industry. I would personally not use the stock exchanges as the mechanism for collecting fees, as this would be administratively complex and could introduce distortions in decisions on where trading would take place. Rather, I would prefer a surcharge on audit fees, with a statutory cap of 5 - 10% of audit fees. The audit firms would collect and remit these fees to the organization, but would not otherwise have any role in the group's budget or spending levels. The SEC should have authority to review the budget and spending of the new group, but not to set these levels.

Many people have suggested that the new body should follow the tradition of the SEC and the former Public Oversight Board ("POB") in having multiple commissioners. The provisions of HR 3818 require seven full time commissioners, who must sever all other business ties, and who would serve four year terms. Personally I believe this structure would be unworkable and undesirable. First, seven commissioners is too many. Even the SEC has only five commissioners, and as the number of commissioners increases, the amount of internal coordination time rises exponentially. A group of seven commissioners would not work nearly as effectively as a smaller group. Second, it would be highly unattractive for board members to sever all other business relationships and board memberships to accept a four year term with this body. This requirement will make it impossible to attract top caliber board members.

The SEC during its history has had many extremely talented commissioners, who advanced the scholarship and work of the agency considerably, such as the late Al Sommer. However, in recent years it has been more difficult to keep the Commission's five seats filled, and many potential candidates have declined to be considered due to the limited executive role, low salaries, the interruption of their career and other reasons.

Individual commissioners can in fact do considerable damage to the ability of an agency to function cohesively, and the more commissioners there are, the greater the risk that some of those commissioners will seek to undermine the work of the group rather than assisting it. Therefore, the model of the NASD and the NYSE is better. They have a CEO and a strong, full time professional executive staff, with a board of directors who serve part time and have careers elsewhere. Ideally the independent directors of any new oversight group would be paid a substantial director's fee in view of the fact that they should be prepared to meet one or more days each month, and to devote considerably more time to the position than would be true with a corporate board. However, it would be a serious mistake to create full time commissioners for this role.

<u>Subpoena Power</u>.

The new accounting body should <u>not</u> have the power to subpoena either documents or witness testimony, as this is a power of government that should continue to repose solely in the SEC and the DOJ. However, the SEC should have statutory authority to issue subpoenas at the request of this body, and to provide materials responsive to the subpoena or other compulsory process to the new group.

In order for any person or firm to audit a publicly traded company, they should have to be a member in good standing of the new oversight organization. Thus, failure to provide documents or testimony to the new body could be handled by expelling individuals or firms from the oversight organization, which would end their ability to audit public companies promptly. The new body should have the ability to suspend or expel any individual or firm from its membership, which action would have the effect of an industry suspension. Unlike cases under the SEC's rules, the new body should have the ability to suspend individuals or firms with immediate effect, and the standards for judicial review should be set quite high so that absent manifest abuse such suspensions cannot be overturned. It is a practical reality that in the past the major accounting firms have chosen to expend the resources to litigate suspensions for unlimited periods, including one case that lasted for 17 years in seeking a two year suspension for two accountants. In order for the new body to have a chance of playing a meaningful oversight role, it has to be armed with disciplinary powers that will prevent the Big Four from simply litigating it to a standstill.

Since in my formulation this will be a private sector entity rather than a governmental one, a political appointment process would not be appropriate. The members of the initial board of directors and the selection of the CEO should be worked out between the SEC and the Congressional leadership. The GAO should not play any role in this process as is proposed in HR 3818 for many reasons, not the least of which is that the chances of success for the new board would not be enhanced by embedding in it a Constitutional issue concerning the legitimacy of the appointment of its leadership. This alone could be grounds for litigating any rules or suspensions to the Supreme Court, and then possibly having to start all over again. The CEO of this body should have a strong background in the investigation and enforcement of securities laws, as well as a strong financial background and a good knowledge of the accounting system. It should not be anyone who formerly ran any of the major accounting firms, as it is terribly important that the public be able to trust that this group will listen to the accounting industry for its point of view, but not be beholden to it.

Setting Accounting Principles.

As the Committee knows, FASB controls the process of developing accounting standards. While FASB has worked hard to develop the best possible standards, the overall process is less than satisfactory for several reasons. The FASB is not accountable to the SEC for which standards are most needed to deal with issues in the marketplace, and to limit undue risks to investors. It sets its own agenda, and it may or may not respond to the SEC's concerns.

Second, the FASB is not accountable to the SEC for the timing of its work. As a practical matter the SEC's choice is to accept or reject standards in whole, but without the ability to modify provisions of the standard even where the SEC believes that a standard will be open to substantial abuse or confusion that could result in unnecessary risks for investors. While the SEC could do the job of developing accounting principles directly, a private sector body similar to the FASB is a better approach for many reasons. However, the SEC should be able to assign the homework and to specify when it must be turned in, as well as having the ability to modify the language of standards however it believes most appropriate. The SEC should also have the power to adopt standards written by any other group, so that it could adopt a specific international accounting standard in place of a proposed FASB standard, or standards drafted by academic or other professional groups if it believes those standards are superior to ones drafted by the FASB.

This function of developing new accounting standards should ideally be folded into any new private sector oversight body, subject to direct oversight by the SEC. This would maintain a healthy distance from direct government standard-setting, but would at the same time allow the SEC greater input into the establishment of the agenda, setting deadlines for action, and reviewing or modifying final standards. The overall process needs to be able to work faster, and to be much more responsive to producing standards that provide transparency, consistency of application, and resist distortion and manipulation.

Placing the current functions of the FASB into any new body would create advantages in having the professionals who develop accounting principles be part of the same group that oversees cases in which audit professionals are alleged to have misinterpreted such standards. Merging the FASB into the new oversight group would also eliminate the funding issues that have troubled the FASB, as the new body will presumably have a broad-based revenue source that could eliminate the pressure that now exists in FASB funding.

Today auditing standards and practices are codified by the AICPA, rather than the FASB. There is not any particular logic to having one body determining a standard for inventory accounting, for example, and a different body trying to determine how to test compliance with that standard through the audit process. The function of setting and modifying both GAAP and GAAS should take place in the same body, preferably the new oversight group overseen directly by the SEC. As with accounting principles, there would certainly be advantages in having the body that must judge whether accountants have complied with GAAS also have the institutional knowledge derived from setting those standards.

Independence standards in my view should most appropriately be set by the SEC, as has traditionally been the case. Independence is a core element in the integrity of the financial reporting process, and the rules of the road should be set by the SEC. Certainly day-to-day oversight for independence requirements can be performed by the new body, as well as perhaps interpretations subject to review by the SEC. Here the new body should have the ability to go beyond what is required by the SEC, but not to do less, just as the NASD may establish ethical standards and specific guidelines of behavior that go beyond what SEC rules may require. At the same time, restrictions that are tenuously related to independence could perhaps be revisited as well, making the standards more reasonable in their application where there is no direct connection to an audit team or senior firm management.[1]

2. What limitations on the provision of non-audit services by auditors to their audit clients are appropriate to ensure that the judgment and independence of auditors are not impaired?

The volume of consulting services being provided by auditors to audit clients seems to have risen to the point where there are now many companies whose annual consulting fees to their auditor are a multiple of the annual audit fee. This represents a substantial change since I was at the SEC, and I believe that Chairman Levitt was right to point out the corrosive effect that the volume of such fees is having on auditor independence. As the consulting practices of the major audit firms

[1] For example, if the spouse of an audit firm partner has options or stock in his or her employer, this should not be deemed to violate the independence of the audit firm, so long as this stock was demonstrably acquired as a result of the spouse's employment, rather than through open market purchases, and the family member is not actually on the audit team. Indeed, greater flexibility could in general be shown for situations involving audit firm personnel who are not remotely involved in the audit team or supervision of the audit team, particularly where investments are managed by others such as mutual funds.

have grown, management time has been shifted into selling consulting work rather than finding ways to enhance audit quality. At some point the consulting revenue derived from an audit client may become the principal focus of the relationship, with the audit an afterthought. While the major firms have all announced plans to divest at least a portion of this business, this does not eliminate the issue.

On the other hand, it is important not to overstate the impact that consulting practices may have on independence. Certainly in the case of Enron, had Arthur Andersen not been performing any consulting work, its pure audit fee of $25 million per year would have been more than large enough to create powerful incentives for the managers at Andersen to give the client the accounting treatment it wanted for its SPEs. Unlike consulting fees, which are one time assignments, the audit is generally viewed as a long term engagement. On average, audit engagements at Coopers & Lybrand when I was there lasted nearly twenty years. Thus, the $25 million annual audit fee would have a present value much greater than $25 million in one time consulting business. Therefore, even if firms performed no consulting work whatever, there would still be issues of the willingness of the auditors to antagonize a big client determined to use accounting games to overstate income.

There are at least two separate types of concerns in the debate over restrictions on consulting services by audit firms. First, there are certain types of services that are unhealthy, and should be restricted due to their nature. These include performing internal audit services, along with investment banking, legal services, valuation services relating to assets or earnings that are part of the financials to be audited, product structuring services and perhaps insolvency management services. Each of these types of services creates inherent risks of conflict in subsequent audit decisions that the firm must make, and a real risk that the firm may alter its judgments concerning appropriate accounting treatment because of positions it may have taken in selling the client the consulting engagement, or in the advice provided by consultants that the audit team will be reluctant to undercut. Financial information system design and implementation, and large software projects, may fall into this category since it is part of the auditor's job to evaluate the integrity of these systems. If staff of the audit firm built the system, the firm's own auditors are unlikely to evaluate it independently. Thus, on this issue I believe HR 3763 may not go far enough.

A second type of concern, separate from issues of inherent conflict, is the issue of the sheer magnitude of consulting services. Here I believe that good practice is to limit the total volume of non-audit fees in any year to a percentage, such as 15-25%, of the audit fee. The audit should be the primary relationship with the client. Thus, the audit firm could sell permissible types of consulting services to an audit client, but only up to a maximum annual dollar limit.

While there is merit in the concern that too much consulting for audit clients can undercut independence, we should not carry accountants too far into the cloister. Investors have an interest in marking sure that in performing the audit, the audit team had available to it a full range of professional competence to enable it to evaluate liabilities accurately and to be certain that the financial statements present a full and fair picture of the corporation's financial results and condition. Thus, I believe that tax services in particular are part of the core competence of any audit firm. An auditor cannot possibly give a full and fair report on a company's results and condition if it is oblivious to the company's tax exposure. Firms typically have a set of GAAP books, and a separate set of tax books, and it is essential to understand specific differences between the tax books and the financial reporting books. Also, there is enormous convenience to clients to be able to have the firm that determined its GAAP income help prepare its tax returns.

Similarly, internal controls consulting contributes to the integrity of reported financial information, and it is also a vital issue of core competence for the audit team. Human resource or benefit plan consulting does not seem to present the same level of inherent dangers of pressure on auditors not to take an independent view of financial reporting issues, though one could argue that issue either way.

Philosophically, I do not believe in restricting businesses from performing lawful services except where there is a compelling reason to do so. A ban on combining auditing and consulting has parallels to the Glass-Steagall Act or the product restrictions that used to limit bank holding companies solely to "banking or services closely related thereto" as designated by the Federal Reserve. In recent years both of these types of structural barriers against "one stop shopping" in financial services have been repealed or liberalized by Congress, yet it is precisely "one stop shopping" that the auditors offer through their consulting divisions.

Though any restrictions will be offensive to some, there is a benefit from having a clearly understood set of limits so that public confidence in the integrity of audit decisions can be restored, and so that we remove undue pressures undermining auditor independence. Absent legislation there is a risk that competitive pressures will push each individual firm to look for ways to enter or reenter specific consulting services ahead of its competitors to try to establish a dominant market position. Backsliding from voluntary action is also a risk, so that there is a benefit to having a set of services that are prohibited by legislation, with the SEC authorized to interpret those restrictions (or perhaps the new oversight group subject to SEC review). At the same time, we should err on the side of allowing competition, and trusting the SEC to bring particular abuses back to Congress for future action.

> 3. What are the essential reforms relating to corporate governance? Do you support the notion that audit committees should hire and fire the auditor? Should directors be restricted from serving as consultants?

As the Committee knows, corporate governance is generally a matter of state law, rather than federal. Indeed, during my time at the SEC the D.C. Court of Appeals overturned the SEC's "one share, one vote" rule on grounds that this was beyond the powers of the agency as a matter of corporate governance even though it was contained in rules of SROs under the express oversight of the SEC. Therefore, I am cautious concerning changes in corporate governance that would be appropriate as a matter of federal legislation. Happily, the SEC under Chairman Pitt has already moved forcefully and thoughtfully to enhance disclosure requirements to address major risks demonstrated in the Enron situation.

Perhaps my greatest governance concern is the idea that a CFO could be allowed by any board to hold any financial interests whatsoever that are adverse to the company he or she serves as CFO. The outside audit team, the audit committee and the board itself depend on financial data provided by the CFO and his or her department. Any conflict of interest on the part of the CFO is inherently extremely dangerous, as this is a person who has the institutional capability to circumvent review by the board and the outside auditor.

One remedy for this problem would be to require immediate and prominent disclosure of all separate financial interests contrary to the company held by a CFO or other senior corporate managers, and to require such disclosure to be featured prominently in the company's public filings and to be described in detail in the proxy statement. This disclosure could be enhanced by requiring the audit committee to make an affirmative finding that any such separate interests were in the interest of the company, and to publish this analysis in the proxy statement.

Another area where good corporate governance could be reinforced by enhanced disclosure would be a requirement to disclose immediately any actions by the board of directors of a publicly traded company to suspend the company's code of conduct or conflicts, as took place at Enron, and to include an annual statement regarding conflicts among senior officers and the board's policies on conflicts in the proxy. Of course these steps are undoubtedly among the issues the SEC is now considering, and I am confident that the agency will find the best ways to use disclosure to alert investors to such inherently dangerous situations. Presumably boards of directors will in the future be very reluctant to follow the example of the Enron board. When it comes to allowing conflicts of interest by the officers of a company, "just say no" is certainly the right policy.

<u>Engagement of the Auditor</u>.

As a theoretical matter, the engagement of the outside auditor must be approved by the board of directors, and the audit committee is the board's representative in reviewing any such decision. In practice, however, the engagement of the auditors is frequently a matter that is initially handled by the company itself, and particularly by the CFO, with the board ratifying the company's decision. In my view, the audit committee should in fact control retention and termination of the auditors. The audit committee should also review carefully the proposed audit plan, the number of hours to be spent and the areas of focus, and interview potential engagement partners proposed by the audit firm. The Chairman of the audit committee should review the bills submitted by the auditors, and the Committee should meet regularly with the engagement team so that there are both formal and informal opportunities for the auditors to communicate issues of concern.

The outside audit team needs to understand that while the audit committee will listen carefully to the views of the CFO and give them substantial weight, the final decision on retention or rotation will be made by the audit committee. At the same time, the company needs to understand that the audit committee will look to purchase the best audit, not the cheapest audit.

There are several corollaries of this view concerning the importance of audit committee control of the audit. One is that the committee must be prepared to devote adequate time to its work, particularly for a large and complex company. Not only must the members of the Committee have the necessary finance and accounting knowledge, they must be willing to use it. Unfortunately, today audit committees are not compensated to spend serious amounts of time in most companies.

<u>Directors as Consultants</u>.

Under the current rules of the NYSE, a director who receives more than $60,000 in consulting fees from the company is not considered to be "independent" in the following year. This restriction seems appropriate to prevent an individual director from having a significant financial reward that is controlled by management while still participating as an independent director on the audit committee. Though the same standard should be applied to contributions to a charity that employs the director, I do not believe there is any need for additional federal legislation on this point. An absolute bar would seem more restrictive than necessary since a director may have valuable background that would make limited consulting engagements mutually beneficial.

4. What measures can Congress or SROs take to ensure that an analyst is truly independent?

The SROs have recently promulgated new standards in this area that are a definite step in the right direction. Once we have experience under the new standards, it will be possible for the SEC and the SROs to provide better recommendations as to whether more needs to be done. Certainly investors would like to know that analyst recommendations are made on the basis of investment analysis, and that they are not bought and paid for by issuers through their investment banking fees.

5. Do you support mandatory rotation of auditors?

At present, I do not believe that mandatory rotation would be appropriate. For the issuer, there are serious costs involved in changing auditors. More importantly, a change in audit firms also increases the chances of financial risks going unnoticed by a new audit team in the first year or two of an engagement. Institutional knowledge by the audit firm of its client can definitely lead to a better audit plan, and a better audit product. Therefore, I don't believe federal legislation mandating rotation is desirable.

Rather than mandatory rotation, auditor retentions by an audit committee should be made for a longer term, such as three or four years. Today the annual selection of the auditor happens so often that it is treated as a matter of routine. Thus, a very important decision is to a degree trivialized by the frequency it is made.

A better system would be for the audit committee to appoint the auditors to a three or four year contract that could only be terminated by the committee. At the end of this longer engagement, the audit committee should solicit proposals from multiple firms as to the next award of the audit mandate. This would ensure that every four years at least the audit committee would devote serious time to the issue of whether a rotation of auditors would serve the best interests of the shareholders. In considering whether to renew the incumbent auditor, the audit committee should strongly consider a new firm if the company had restated its earnings or been the subject of proceedings relating to inaccuracy of publicly reported financial results, or if the auditors failed to notify the audit committee of the existence of significant audit or accounting issues. These are judgments best left to the board and audit committee, however.

> 6. How can we best ensure that independent corporate directors are truly independent and that corporate audit committees will effectively take charge of the audit and the relationship with the auditor?

This relates in part to the time commitments that can be expected of audit committees and audit committee chairs. In the typical audit committee, the committee has three or four members, and no staff. The committee is dependent on the company and the auditor for information, and in smaller companies there may not be any internal audit staff or financial analysts to help the committee with analysis. Committees sometimes meet only four times per year to approve the quarterly financials, and some committees do not devote enough time to do the job well. Other committees have highly experienced members and perform a thorough review of financial reporting issues.

One possibility is for the chair of the audit committee to assume a more active role with the finance department, meeting with inside staff and outside auditors much more frequently. Audit committee chairs could in effect play a role of "lead director" in accounting and disclosure matters. However, most outside directors would probably be unwilling to shoulder the risk or time commitments that would be involved in such an expanded role. Alternatively, the audit committee could hire independent financial advisors more as a matter of routine to help analyze the company's financial statements and all related issues of the selection and application of accounting principles.

<u>"Truly Independent" outside directors</u>.

Certainly there should be a stronger market discipline for companies that do not have a strong board of mostly independent directors with knowledge and experience relevant to the company and its activities. The head of the local cancer hospital may be a great director for a pharmaceutical company engaged in significant anti-cancer drug research, but it is difficult to see what such a background would bring to the oversight of an energy trading company, for example. This does not mean that an individual of basic intelligence and with a good sense of ethics cannot serve effectively as a director, simply that a higher standard of relevant experience might be useful as a market expectation. However, it is difficult to legislate the selection of good directors, and all CEOs have a legitimate interest in wanting to select as directors persons whose judgment they respect. Market participants should carefully consider board quality, and pay less for stocks of companies with directors who do not offer strong and independent capabilities.

7. Do you support a mandate by Congress to the SEC to more systematically review and comment on the disclosure of issuers.

No. I believe the SEC's record here is exemplary, particularly given the systematic underfunding of the SEC that has existed for decades. When I was Chairman I wanted to review more current disclosures of issuers, but we did not have the trained and experienced staff necessary to review new offerings, '34 Act disclosures, proxy statements and tender offer disclosure documents simultaneously. Adding legislative straight jackets while resources are limited simply forces an allocation of staff that may not be most appropriate given risks to investors at any given time. Markets and their risks change constantly, and the SEC has the expertise to adjust its focus to try to give the maximum protection to investors. Greater oversight of 1934 Act filings would in my view be desirable, but the SEC needs an increase in the number of accountants and disclosure staff so that issuers with the largest market capitalization or most widely held securities can be subjected to regular and thorough reviews. The SEC needs to retain flexibility in how to target its resources.

The provisions of HR 3818 concerning a current disclosure system are in my view too detailed and would create serious issues. However, both bills and recent SEC proposals provide that more rapid disclosure should be fostered by the SEC, and I agree.

Both bills contain similar provisions on improved transparency and disclosure. Enron's disclosures of its SPEs were miserable, and a mandate to the SEC to improve SPE disclosure (which is a complex problem) is certainly warranted in light of Enron. However, I favor the approach of giving the SEC time to review what should be done and how to do it. I believe Chairman Pitt will prove exceptionably capable in leading the SEC in this area.

8. Litigation Reforms. HR 3818 contains provisions that would overturn many limits in abusive shareholder litigation, including restoring joint and several liability, aiding and abetting liability and other measures. I do not believe any such steps would be desirable. Litigation reform was long overdue, and it should not be rolled back. I do support provisions of HR 3818 concerning

document retention by audit firms. I would make any document destruction by an accounting firm unlawful except in accordance with SEC rules.

9. Will the market fix the problems shown by Enron?

The market has certainly already responded to the overall Enron situation. Audit committees are undoubtedly more wary of consulting engagements for the incumbent auditors, and boards will undoubtedly be more wary of proposals to approve conflict of interest waivers for the CFO. Audit firms will hopefully understand that they are not free to destroy documents relevant to criminal or civil investigations, and that audit committees must be notified when the auditor has concerns as to the appropriateness of accounting judgments. Markets have shown they are prepared to penalize companies perceived to have poor transparency or inadequate disclosure. All of these are very healthy signs of market corrections to the abuses at Enron, and these trends will be reinforced if in fact corporate officers or audit firm personnel are convicted of criminal violations and serve time in jail. This is in my judgment the most important part of insuring that investor losses in Enron are not simply ignored in the future.

The market response may or may not prove to be short lived. Sometimes memories of such events can be short, and lessons may not be truly learned. Only time will tell if lasting changes in behavior will result from the Enron events. However I am optimistic that this situation has been so disgusting to so many people, and so intensely covered in the press, that there will be a lasting beneficial effect on market behavior.

At the same time, there are many issues, particularly involving Andersen and its activities, that the market cannot solve alone. For example, the SEC does not have sufficient tools to oversee the accounting industry or to provide strong accountability for audit failures. It doesn't have enough people, and the law allows essentially endless litigation over cases of auditor malpractice. The DOJ also has a very important role to play, and I believe that it needs more dedicated criminal resources to enable it to pursue cases of individuals or firms that have engaged in criminal wrongdoing. The POB was never an effective body, and has now been disbanded. Thus, absent legislative change, I believe that there is a gap in the practical ability of the overall system to provide meaningful enforcement and accountability for accounting problems.

While there were corporate governance and other issues at Enron, had the accounting system done its job the problems would have come out much sooner, and devastating losses could have been prevented. Without ignoring the importance of putting all the corporate lawbreakers in jail, it is important to remember that the heart of this problem was failure of the auditors to do their job, coupled with woefully inadequate disclosure by Enron itself.

There are other areas in which modest legislation would improve the overall system, some of which are contained in each of HR 3763, HR 3818, and the President's proposals. For example, we should consider areas in which disgorgement of profits from executive stock sales should occur. Using the model of section 16(b) of the 1934 Act, which recaptures short swing profits on sales by officers, directors or 10% holders, Congress may wish to consider legislation that would recapture for the estate of a bankrupt corporation all profits from sales of stock by such persons within a defined period such as six months prior to a bankruptcy filing. This would eliminate the incentive of officers to conceal bad news while they frantically try to unload their own stock. Congress could decide to limit such disgorgement to cases where the SEC finds evidence of sales that occurred when there was not adequate disclosure of the Company's problems.

Finally, it is always the case that an argument can be made that market response has cured the need for legislation. However, most often the companies that don't need the reforms adopt better practices, while companies that may pose the greatest risk to investors will not change their policies. Our laws in the accounting and disclosure area have to be updated in light of our experience in order to keep them relevant to current issues, and to maintain their vitality over time. If we ignored the catastrophe that Enron represents for investors across the country, we would be sending a message of insensitivity that could harm confidence in the broader market and damage the ability of companies to raise capital in the future. This case demands a reasoned and measured response, but a response nonetheless.