TESTIMONY OF
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CONCERNING THE IMPACT OF THE SARBANES-OXLEY ACT
BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES
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Chairman Oxley, Ranking Member Frank, and Members of the Committee:

Thank you for inviting me to testify on behalf of the Securities and Exchange Commission concerning the impact of the Sarbanes-Oxley Act of 2002. I appreciate the opportunity to discuss this important matter with you.

I. Introduction

A little over two years ago, when I became Chairman of the Commission, the headlines were still dominated by reports of financial fraud, lapses in audit and corporate governance responsibilities, and intentional manipulation of accounting rules. Congress had acted swiftly in the face of this breakdown by enacting the Sarbanes-Oxley Act, which called for the most significant reforms affecting our capital markets since the Securities Exchange Act of 1934. Since its enactment in the summer of 2002, the Act has effected dramatic change across corporate America and beyond, and is helping to re-establish investor confidence in the integrity of corporate disclosures and financial reporting. Your strong support of the Act and our efforts to implement its sweeping reforms, along with the support of your counterparts in the Senate, demonstrate Congress's dedication to ensuring the integrity and vitality of our markets.

Before turning to the particular provisions of the Sarbanes-Oxley Act, I want to start by saying that I am pleased to be testifying today alongside William McDonough, the Chairman of the Public Company Accounting Oversight Board. While he will testify more fully on Board activities, I can assure you that the PCAOB has developed as a respected and effective organization under Chairman McDonough's leadership.

The goals of the Sarbanes-Oxley Act are far-reaching, and aim to restore investor confidence in and assure the integrity of our markets. Consequently, the reforms in the Act address nearly every aspect and actor in our nation's capital markets. The Act affects every reporting company, both domestic and foreign, as well as their officers and directors and other key participants in our capital markets. The principal objectives addressed in the Act can be grouped into the following themes:

- To strengthen enforcement of the federal securities laws;
- To strengthen and restore confidence in the auditing profession;
- To improve executive responsibility and the "tone at the top" at companies;
- To improve disclosure and financial reporting; and
- To improve the performance of gatekeepers, such as accounting firms, research analysts and attorneys.

The Act called on the Commission to undertake nearly 20 rulemakings and studies. The Act also set ambitious deadlines for the Commission, and in most cases required us to implement the final rules speedily. The Commission completed the bulk of the rulemaking within six months and completed all required rulemaking in less than a year after the Act's enactment, having considered the thousands of letters of public comment that we received. 2004 marked the first year that the nation's largest companies, comprising more than 95% of U.S. market capitalization, were fully subject to all of the new regulatory requirements of the Sarbanes-Oxley Act.

Just as the Sarbanes-Oxley Act was a landmark piece of legislation for Congress, the successful implementation of that legislation will be seen as a watershed in the history of the Commission. Given the scope and the scale of the task Congress placed before us, I am pleased to report that with the dedication and hard work of its staff, the Commission's overall discharge of its rulemaking responsibilities has been exceptionally "on the mark" in fulfilling the Act's objectives while avoiding unnecessary problems. Among the many benefits have been CEO and CFO certifications, accelerated electronic insider transaction filings, independent audit committees with increased responsibilities, and strengthened internal controls. Collectively, these accomplishments should have an enormous positive impact on the management and governance of U.S. public companies in the decades ahead, and should help to safeguard the fundamental imperative that our markets be characterized by levels of investor confidence and participation that are second to none.

Although most of the Act's benefits have been accomplished without substantial expense for market participants, we should not minimize the cost to public companies and their investors of achieving the full measure of the Act's objectives. In particular, the internal control reporting and auditing requirements, which companies are dealing with for the first time, have required significant outlays of time and expense. We expect that the short-term costs to improve internal control over financial reporting will over the long-term result in structurally sounder corporate practices and more reliable financial reporting. With these critical goals now firmly in view, calls to roll back or weaken Sarbanes-Oxley generally as a result of concern over the costs of internal control reporting are, in my judgment, unjustified.

At the same time, the Commission and the PCAOB must be sensitive to the need to recalibrate and adjust our rules and guidance to avoid unnecessary costs or unintended consequences. To this end, the Commission and the PCAOB will remain committed to the implementation of the Act in the most efficient and effective way.

I would like to review a few specific accomplishments.

II. Restoring Confidence in the Accounting Profession

A central focus of the Sarbanes-Oxley Act was to enhance the integrity of the audit process and the reliability of audit reports on issuers' financial statements. The Commission has taken the actions directed by the Act in this area and, when appropriate, pursued additional measures with the goal of restoring public confidence in the independence and performance of auditors of public company financial statements. The Commission's actions in this area in response to the Act include:

- Adoption of new rules related to auditor independence;
- Adoption of new rules related to improper influence on auditors;
- Adoption of new rules related to retention of records relevant to audits and review of financial statements;
- A study on principles-based accounting standards;
- Recognition of the Financial Accounting Standards Board as an accounting standard-setting body under the Act; and
- Oversight of the PCAOB.

Based on the information we have received, we believe the new rules have begun to have a beneficial effect in strengthening the integrity of the independent audit. We also have seen that audit committees are taking their responsibilities seriously and that they are much more sensitive to auditor independence issues.

Because Chairman McDonough is here today, I will not review with you the important work of the PCAOB, but I do want to emphasize that the Commission and the Board have forged a close working relationship. In addition to coordinating with us on major projects related to auditing matters, the PCAOB has agreed to prepare a long-range strategic plan for its operations and budget as well as a self-assessment of the internal controls for its operations and budget. In addition, the Commission is preparing to conduct its initial examination of the PCAOB, as contemplated by Section 107(a) of the Act. We anticipate receiving the strategic plan and self-assessment and commencing our initial examination of the PCAOB prior to our review of the PCAOB's 2006 budget, in accordance with our statutory responsibility to oversee the PCAOB.

III. Strengthening the Enforcement of the Federal Securities Laws

The Act also has helped the Commission to restore investor confidence in the capital markets by strengthening enforcement of the federal securities laws. The Act added a number of new weapons to the Commission's enforcement arsenal to better deter would-be securities wrongdoers and compensate injured investors.

Overall, the Act has strengthened the Commission's ability to obtain meaningful remedies as well as powerful but fair sanctions against wrongdoers, aided in the greater return of investor funds, created new causes of action, provided the Commission with more flexibility in choice of forum, and enhanced the Commission's ability to continue to conduct thorough, effective, and fair investigations.

One of the toughest challenges facing the Commission has been finding, recovering, preserving and, when appropriate, returning funds to injured investors. Two of the most powerful tools that the Act gave the Commission to help meet this challenge are the "Fair Funds" provision under Section 308(a) of the Act and the authority to seek a temporary freeze of extraordinary payments by an issuer under Section 1103 of the Act.

The Fair Funds provision authorizes the Commission to take civil penalties collected in enforcement cases and add them to disgorgement funds for the benefit of victims of securities law violations. Before the Act, by law, all civil penalties were paid into the U.S. Treasury. Now, the Commission has authority, in certain circumstances, to use civil penalties to help compensate injured investors. The Commission has authorized Fair Funds in over 100 cases, with a total value of over $5.2 billion for anticipated distribution to harmed investors.

There is still room for improvement, however. First, Fair Funds authority is limited to cases in which disgorgement is ordered against the same individual against whom we are imposing a penalty. There are cases, however, in which there is no ill-gotten gain – or disgorgement – to be obtained from a particular individual but against whom it is appropriate to impose a penalty. In these cases, under the existing Fair Funds provision, we do not have authority to use the civil penalty to compensate injured investors. In reports pursuant to Sections 308(c) and 704 of the Act, we recommended several amendments to the current law that we believe will assist our collection program, strengthen our enforcement efforts generally, and provide more compensation for injured investors. These recommendations were incorporated in the Securities Fraud Deterrence and Investor Restitution Act, H.R. 2179. We appreciate your extraordinary efforts and support and are hopeful that these proposals will eventually become law.

As we continue to use the Fair Funds provision, we have faced some challenges in administering the program – and doing it fairly, expeditiously, efficiently, and with the greatest possible return to injured investors. It is a learning process for us as well, and over the past year, we have taken a number of steps to increase the amounts returned to harmed investors including:

- in administrative orders, requiring settling respondents to pay the costs of distribution for complex distributions;
- where appropriate, consolidating individual verdicts and funds in related cases; and
- whenever possible, seeking to ensure that Fair Funds monies awaiting distribution are earning interest.

The other provision I would like to highlight is Section 1103, which allows the Commission to seek a temporary order to escrow extraordinary payments by an issuer to its directors, officers, partners, controlling persons, agents, or employees. Section 1103 allows us to prevent the payment of "extraordinary" rewards to executives and others while the company is subject to a Commission investigation. Whereas, previously, top executives potentially had the ability to remove and dissipate company assets while an investigation was ongoing, the Act, under appropriate circumstances, allows us to preserve the status quo while our enforcement staff concludes its investigation and gathers evidence to determine whether such payments are warranted.

"Congress designed Section 1103 to add necessary teeth to the Commission's ability to perform its mission. It ensures that recovery by way of disgorgement, etc., is effective rather than empty." That is what the Court of Appeals for the Ninth Circuit recently stated in its opinion affirming the freeze of extraordinary payments to the CEO and CFO that we sought in the Gemstar-TV Guide International case. Needless to say, Section 1103 will continue to be a valuable and powerful tool.

IV. Improving Executive Responsibility and the "Tone at the Top"

Another critical objective of the Act was to improve executive responsibility and the "tone at the top" of public companies — a key theme that dates back to President Bush's ten-point plan of March 2002. The tone set by top management of a company contributes greatly to the integrity of a company's financial reporting process. The provisions of the Act that the Commission has implemented addressing this theme include:

- Certification by CEOs and CFOs of company reports;
- Required disclosure regarding codes of ethics for CEOs and senior financial officers;
- Electronic filing within two days after securities transactions by insiders; and
- Prohibition on trading by insiders during pension fund blackouts.

Among these, the certification provisions have perhaps had the greatest immediate impact. The Act affirms senior executive responsibility for the financial reporting process of public companies by requiring CEOs and CFOs to certify the financial and other information in their reports filed with the Commission. In addition, as discussed below, 2004 marked the first year that many companies have had to comply with the requirements of Section 404 of the Act, and the certification provisions reflect that requirement. While CEOs and CFOs already had responsibility for company disclosures in the filings in question, the certification requirements have focused their attention on the completeness and accuracy of disclosure in important ways.

In implementing Section 302 of the Act, the Commission complemented the certification provisions with a requirement that companies maintain adequate disclosure controls and procedures. These are controls and other procedures designed to ensure that information required to be disclosed is recorded, processed and accurately reported within the required time frame. This requirement is intended to ensure that information is captured, evaluated as to materiality, and disclosed, if required, in a timely manner, and we believe it also has had a key role in making the certification requirements more effective.

V. Improving Disclosure and Financial Reporting

In addition to increasing focus on executive responsibility, the Act takes several important steps toward improving disclosure and the financial reporting process. Accurate and reliable financial reporting is the bedrock of our disclosure-based system of securities regulation. Investor confidence in the reliability of information in a company's filings with the SEC is fundamental to the vibrancy of our markets. The rules the Commission adopted in this area to implement the Act include those requiring:

- Enhanced disclosure of off-balance sheet transactions;
- Disclosure regarding the use of non-GAAP financial measures;
- Increased disclosure of material current events affecting companies; and

- Public reporting on companies' internal control over financial reporting by both management and auditors.

Although each of these reforms is very important in its own right, the reform that has drawn the most attention recently is Section 404's requirement that management assess the effectiveness of a company's internal control over financial reporting and that external auditors attest to, and report on, that assessment. This requirement went into effect for large public companies in the 2004 audit cycle. Companies representing over 95% of total U.S. market capitalization are now obligated to comply with Section 404's reporting requirements.

An effective system of internal control over financial reporting is very important in producing reliable financial statements and other financial information used by investors. The establishment and maintenance of internal control over financial reporting has been required of public companies since the enactment of the Foreign Corrupt Practices Act of 1977. The Sarbanes-Oxley Act has brought a new focus to internal controls and encouraged companies to devote adequate resources and attention to the maintenance of those controls. The requirements of Section 404 may have the greatest long-term potential to improve financial reporting by public companies by helping to identify potential weaknesses and deficiencies in internal controls. In addition, although no system of internal controls can detect every instance of fraud, good internal controls may help companies deter fraudulent financial or accounting practices or detect them earlier and perhaps minimize their adverse effects.

Much of the discussion about the Section 404 requirements recently has focused on the costs of implementation and the number of companies that have announced that they or their auditors have been unable to complete their assessments or audits of internal controls, or that they have discovered material weaknesses in their internal controls as a result of their first assessments. While important, neither of these issues should distract from the underlying benefit of the new requirements.

With regard to the implementation costs, there is no doubt costs have been higher than we and public companies anticipated, though I believe it important to note that a substantial portion of the cost may reflect initial start-up expenses as many companies, for the first time, conducted a systematic review and documentation of their internal controls. In this regard, a number of commentators have suggested that costs in the second and subsequent years will decrease substantially.

On the other hand, we also heard that some costs may have been unnecessary. For example, it appears that some participants in the initial implementation phase may have taken an approach that resulted in excessive or duplicative effort. The Commission and the PCAOB are working to provide appropriate guidance in order to clarify these issues for the 2005 audit cycle.

In any event, implementing Section 404 has not been easy for public companies and has required significant outlays of time and expense. Even companies that started with a sound system of controls have faced the task of documenting and comparing them against an objective benchmark. This is a complex undertaking for a small company, and exponentially more so for a firm with multiple lines of business, thousands of employees and global operations.

While we can and will do more on the subject of Section 404, there is undoubtedly enormous cost to investors of corner-cutting in internal controls. The

Section 404 effort should improve not only the quality of information to shareholders, but also the quality of information management relies on to make decisions. So while investors benefit, they also may find that the companies they are invested in are better managed.

As for material weaknesses and other deficiencies that have been reported during this first year of implementation, it is important to note that investors will benefit from receiving full disclosure regarding any material weaknesses that are found — disclosure about the nature of any material weakness, their impact on financial reporting and the control environment, and management's plans for remediating them. Section 404 was intended to bring such information into public view. This increased level of transparency should also ensure that the disclosure of a material weakness is the starting point and not the ending point of investors' analysis.

There can be many different types of material weaknesses and many different factors may be important to the assessment of any particular material weakness. A material weakness in internal controls should not alone necessarily be motivation for immediate or severe market reaction. When armed with sufficient information about weaknesses and remediation plans, investors appear to be making reasoned judgments about whether those disclosures affect the mix of information they use to make investment decisions. The goal should be continual improvement in controls over financial reporting and increased investor information and confidence.

Of course, the Commission has been and will continue to evaluate the implementation of our rules and the auditing standard issued by the PCAOB to ensure that these benefits are achieved in the most sensible way. Section 404 reporting is too important not to get right. We have issued several measured extensions over this past year to accommodate the first wave of reporting under the Section 404 provisions. In each case, our motivation was to be sure that companies and their auditors have the time and resources necessary to implement the new requirements correctly. Our staff also issued several rounds of guidance in the form of answers to frequently asked questions about application of the new provisions.

In addition, we have actively sought feedback about first year experiences in implementing the Section 404 requirements, in order to determine if the Commission rules and PCAOB standards are operating as intended. Just last week, we held a public roundtable to review the first year's experience with implementation of the internal control requirements, and we are continuing to assess feedback from the public regarding companies' and auditing firms' implementation of these new reporting requirements.

At the roundtable, we heard from a distinguished and diverse group of panelists, including company management, audit committee members, auditors, investors and analysts, about their experiences with the implementation of the internal control requirements. The roundtable discussion revealed that many companies have experienced benefits and improvements to their internal controls as a result of implementing these requirements, and these requirements also have led to an improved focus on internal controls by all. However, as I mentioned earlier, we also heard there are some areas related to implementation of the new requirements that need further attention or clarification.

We currently are evaluating whether there are ways we can make the process more efficient and effective while preserving the benefits. Throughout our evaluation we are closely coordinating with the PCAOB, and I have instructed our staff to consider, as quickly as possible, whether and how we can improve the guidance available to management and auditors in order to improve the effectiveness of the process. Chairman McDonough also announced at the roundtable that the PCAOB envisions issuing its first set of guidance as early as May 16th. In addition to any guidance or potential rulemaking the Commission or the PCAOB may consider, there also has been an expressed desire for the sharing of best practices so that companies and auditors can benefit from the substantial learning that has taken place from the first year of implementation. We wish to encourage and facilitate these efforts. I also am supportive of the PCAOB's announced efforts to review and evaluate the results of the first year of auditor internal control reports.

The responsiveness we are demonstrating with Section 404 represents a critical aspect of the Commission's approach to implementation of the Act—that we can and must address unnecessary costs and unintended consequences while rigorously ensuring that we maintain the investor safeguards of good disclosure and transparency. We are actively engaged in other activities to evaluate and assess the effects of the internal control reporting rules, and other disclosure provisions of the Act, especially on smaller companies. For example, we established the Securities and Exchange Commission Advisory Committee on Smaller Public Companies, which held its first meeting last week. The committee will conduct its work with a view to protecting investors, considering whether the costs imposed by the current regulatory system for smaller public companies are proportionate to the benefits, and identifying methods of minimizing costs and maximizing benefits. In addition, at our request a task force of the

Committee of Sponsoring Organizations (COSO) of the Treadway Commission has been established. The task force anticipates publishing additional guidance this summer in applying COSO's framework for internal control over financial reporting to smaller companies. I also am supportive of the PCAOB's efforts to be sensitive to the special challenges smaller companies face in the implementation of Section 404.

We also are cognizant of the regulatory challenges our foreign registrants face. In addition to accommodations we made for foreign companies in our rules, we recently extended the compliance date for internal control reporting for an additional year for foreign public companies, as well as smaller companies. We are seeking input from foreign registrants regarding their experiences to date, including at last week's roundtable. In addition, review of the first year experiences of larger U.S. registrants should help identify issues and best practices for foreign registrants.

VI. Improving the Performance of "Gatekeepers"

In addition to addressing auditors and the accounting profession, as discussed above, the Sarbanes-Oxley Act and our new rules have required better focus by other gatekeepers in our capital markets on their proper roles, and I believe we are seeing a positive effect as a result. The effective operation of gatekeepers in the marketplace is fundamental to preserving the integrity of our markets. Unfortunately, revelations from the recent corporate and accounting scandals revealed that these parties did not always fulfill their role. The actions the Commission took in response to the Act in this area included:

- Rules governing research analyst conflicts of interest;
- Standards of conduct for attorneys practicing before the Commission;

- A study on rating agencies and proposed Commission rulemaking in this area; and
- Rules requiring that companies disclose whether they have a financial expert on their audit committees.

Recognizing that financial statements, financial reporting and the audit itself form the bedrock upon which full and accurate disclosure is built, the Act further recognized the importance of the audit committee in these processes. In addition to the disclosure requirements regarding audit committee financial experts, Section 301 of the Act called for, and the Commission adopted, rules directing the nation's exchanges to prohibit the listing of any security of a company that is not in compliance with the audit committee requirements established by Section 301. Under the new rules, listed companies must meet the following requirements:

- All audit committee members must be independent;
- The audit committee must be directly responsible for the appointment, compensation, retention and oversight of a company's outside auditors, and the outside auditors must report directly to the audit committee;
- The audit committee must establish procedures for the receipt, retention and treatment of complaints regarding accounting and auditing matters, including procedures for the confidential, anonymous submission of concerns by employees; and

The company must establish funding for the audit committee, including the means to retain and compensate independent counsel and other advisors, as the audit committee determines necessary to carry out its duties.

The new rules apply to both domestic and foreign companies that have securities listed in the United States. Based on significant input from and dialogue with foreign regulators and foreign issuers, however, several accommodations for foreign issuers were included in the final rules to address potential conflicts with foreign legal requirements, where consistent with fulfilling the investor protection mandate of the Act.

Following-up on Commission requests that pre-dated Sarbanes-Oxley, the New York Stock Exchange and the Nasdaq both amended their listing standards to fulfill the principles underlying this provision of the Act. In late 2003 the Commission approved listing standards that increased board independence and effectiveness by, among other things, mandating that boards be composed of a majority of independent directors, requiring executive sessions outside the presence of management and requiring strong audit, compensation and nominating/governance committees composed of independent directors. In addition, separate from Sarbanes-Oxley, we approved changes to listing rules to require shareholder approval of equity compensation plans.

These are significant changes that should have a lasting impact on improving responsibility and accountability in our markets. In terms of impact to date, we know that many companies have restructured at least part of their boards to satisfy the new stricter independence standards for directors, the majority independent director requirement and the requirement that only independent directors be involved in processes relating to auditing, director nominations, governance and compensation. These requirements have continued the movement to refocus attention on the importance of independent directors. We expect that the markets will be evaluating the performance of companies under these new requirements.

VII. Conclusion

Before concluding, I would offer my own observation that the real key to achieving the great potential of the Sarbanes-Oxley Act lies not with the Commission or the PCAOB, but with the dedicated and serious efforts of American businesses and their managers, who probably have the most to gain from preserving the reputation of our markets as the best place in the world for investment capital. A wise man once remarked that "capital will always go where it is welcome, and stay where it is well treated." I believe that a company that recognizes the true benefits of the Act in strengthening our capital markets will have no trouble seeing that effective compliance with Sarbanes-Oxley – doing the right thing – is not only in the best interests of its investors, but the long-term interests of the company itself.

Let me again thank you for your leadership and vital support in re-establishing and strengthening investor confidence in the integrity of our nation's capital markets. Throughout the massive rule-making projects directed by the Sarbanes-Oxley Act, the goals of the Commission and its staff have been to protect investors and restore confidence in our securities markets. The Commission has been and will continue to monitor carefully the implementation and effects of the new rules and requirements, and we will continue to take actions as appropriate to ensure that the objectives of the Act are achieved, while unnecessary burdens on companies, auditors, advisers and other market participants, as well as the economy, are avoided.

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