S. HRG. 107–1142

PERSPECTIVES ON IMPROVING CORPORATE RESPONSIBILITY AND CONSUMER PROTECTIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON CONSUMER AFFAIRS, FOREIGN COMMERCE AND TOURISM

OF THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

JULY 18, 2002

Printed for the use of the Committee on Commerce, Science, and Transportation

U.S. GOVERNMENT PRINTING OFFICE

87–971 PDF WASHINGTON : 2005

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

SENATE COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

ERNEST F. HOLLINGS, SOUTH CAROLINA *Chairman*

DANIEL K. INOUYE, Hawaii	JOHN McCAIN, Arizona
JOHN D. ROCKEFELLER IV, West Virginia	TED STEVENS, Alaska
JOHN F. KERRY, Massachusetts	CONRAD BURNS, Montana
JOHN B. BREAUX, Louisiana	TRENT LOTT, Mississippi
BYRON L. DORGAN, North Dakota	KAY BAILEY HUTCHISON, Texas
RON WYDEN, Oregon	OLYMPIA J. SNOWE, Maine
MAX CLELAND, Georgia	SAM BROWNBACK, Kansas
BARBARA BOXER, California	GORDON SMITH, Oregon
JOHN EDWARDS, North Carolina	PETER G. FITZGERALD, Illinois
JEAN CARNAHAN, Missouri	JOHN ENSIGN, Nevada
BILL NELSON, Florida	GEORGE ALLEN, Virginia

KEVIN D. KAYES, *Democratic Staff Director*
MOSES BOYD, *Democratic Chief Counsel*
JEANNE BUMPUS, *Republican Staff Director and General Counsel*

SUBCOMMITTEE ON CONSUMER AFFAIRS, FOREIGN COMMERCE AND TOURISM

BYRON L. DORGAN, North Dakota, *Chairman*

JOHN D. ROCKEFELLER IV, West Virginia	PETER G. FITZGERALD, Illinois
RON WYDEN, Oregon	CONRAD BURNS, Montana
BARBARA BOXER, California	SAM BROWNBACK, Kansas
JOHN EDWARDS, North Carolina	GORDON SMITH, Oregon
JEAN CARNAHAN, Missouri	JOHN ENSIGN, Nevada
BILL NELSON, Florida	GEORGE ALLEN, Virginia

CONTENTS

WITNESSES

APPENDIX

PERSPECTIVES ON IMPROVING CORPORATE RESPONSIBILITY AND CONSUMER PROTECTIONS

THURSDAY, JULY 18, 2002

U.S. SENATE,
SUBCOMMITTEE ON CONSUMER AFFAIRS, FOREIGN COMMERCE, AND TOURISM,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The Subcommittee met, pursuant to notice, at 9:35 a.m. in room SR–253, Russell Senate Office Building, Hon. Byron L. Dorgan, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF HON. BYRON L. DORGAN, U.S. SENATOR FROM NORTH DAKOTA

Senator DORGAN. We call the Subcommittee hearing to order. This morning's hearing will be conducted in 2 parts. Beginning at 9:30 a.m., we will have the first portion of the hearing dealing with the perspectives offered to us by a number of organizations and individuals on corporate responsibility, consumer protections, and related issues; all of us know that we have had a crisis of confidence in this country—in many instances, for very good reasons—in the economy and corporations.

Virtually every day, we hear additional news about some of America's best-known corporations restating earnings. We have news about corporations filing for bankruptcy. We have news of companies—such as Xerox, Global Crossing, Qwest, WorldCom, Merck, Enron, Tyco—restating earnings going back a quarter, a year, 2 years, 3 years, 4 years. It seems to me each and every day brings a new revelation about behavior and about practices inside the companies, about the actions of accountants and law firms that make you just shake your head and say, "What on earth were people thinking about?"

This is about public trust. The mechanism by which we accumulate capital in this country is such that people must be able to trust those who are running our companies, those who are preparing financial statements, those who are running accounting firms, those who are running the law firms. The faith in those institutions and those organizations has been sorely shaken in recent months.

We recently passed a piece of legislation in the Senate dealing with corporate responsibility. Much more is yet to be done, however. That needs to go to conference. There are things that are left out of that bill. We will need to have a second round on that issue.

We thought it was important to continue the work that we have done in this Subcommittee, much of it focusing on Enron following the announcements with respect to the Enron Corporation's scandals, I guess I would call it. The more we looked into Enron, I said it was a culture of corporate corruption, and I am more convinced of that now than ever. But it is not just the Enron Corporation. It goes well beyond that.

We're going to have a hearing later this morning in which we hear about mark-to-market accounting in the State of California. Mechanisms by which I believe price fixing occurred in the State of California to the tune of billions of dollars. Billions of dollars taken out of the pockets of California consumers by manipulation of wholesale electricity prices and, therefore, the manipulation of retail electricity prices, as well. This isn't petty theft. This is wholesale fraud, in my judgment. We'll have some discussion about that later this morning.

To give us a perspective from several different points on the compass about corporate responsibility, consumer protection and related issues—as a prelude to other activities this Subcommittee will have dealing with WorldCom, Global Crossing, Tyco, Xerox, and other companies, as well—we want to hear from four witnesses.

I would ask the four witnesses to step forward and come to the table as I call their name—they are the Honorable Richard Moore, the State Treasurer for the State of North Carolina, the Honorable Howard Metzenbaum, a former colleague of ours; who is now Chairman of the Consumer Federation of America. Senator Metzenbaum, of course, served many years as a distinguished Senator from Ohio here in the U.S. Senate. Ms. Joan Claybrook, President of Public Citizen, and Ms. Nell Minow, Editor of The Corporate Library. And let me thank all of you for being here to testify this morning. My colleagues will be along in a bit.

We are holding this hearing in two parts this morning. After receiving your testimony and asking some questions, we will reconvene the hearing at 11 o'clock, to hear from Army Secretary White on subjects that relate to the Enron Corporation, his former employer.

Again, let me thank all of you for being here. As a matter of courtesy, I'll call on Senator Metzenbaum first. Senator Metzenbaum, we miss you here in the U.S. Senate, but we know that you are doing great work as Chairman of the Consumer Federation of America. Your voice has long been missed since your departure. We welcome you this morning and appreciate your willingness to offer testimony on behalf of the consumers of America.

Senator Metzenbaum, please proceed.

STATEMENT OF HON. HOWARD M. METZENBAUM (RETIRED SENATOR), CHAIRMAN, CONSUMER FEDERATION OF AMERICA

Senator METZENBAUM. Thank you, Mr. Chairman, and I miss being in the U.S. Senate, miss the opportunity to work with you, and I appreciate your invitation to offer my comments on this very important issue.

I am particularly pleased to appear before you, Senator Dorgan, because you personally have done so much to highlight corporate abuses and to propose real reform.

I spent my career in the U.S. Senate working to prevent corporations from running roughshod over the rights of consumers and workers. I have to tell you that I have never seen a more appalling example of the heartless, unfettered corporate greed than that revealed by the present widespread accounting scandals. Companies like Enron and WorldCom lied to their investors, lied to their employees, hid crucial information about their finances, and, in some cases, actually tried to influence, improperly, government officials. The executives behind what appears to have been a massive fraud—massive frauds on a grand scale should be brought to justice quickly.

This country finds itself in the midst of a corporate crime wave. It's astounding. It's incredible. It's unbelievable. And while the average citizens ponder their diminishing retirement accounts and wonder whether they will be next to lose their jobs, a debate rages in Washington over whether this is the product of a few bad apples or evidence of a systemic breakdown. The outcome will determine whether Congress and the Administration adopt an effective policy response.

Back in the early 1940s, the number of corporate restatements used to run at a pretty predictable 45 or so a year. But around the middle of the last decade, it just took off. From 1997 through 2001, there were 1,089 restatements, including well known companies like Waste Management, Sunbeam, Cendant, Rite-Aid, and, of course, Enron. Today, we are fast approaching the point where 1 in 10 Americans—1 in 10 of America's public companies will have recently been forced to restate its earnings. That's more than the few bad apples the President claims have a problem.

Our system of investor protections was ostensibly designed with these many bad apples in mind. It was designed to work, not just when corporate executives are honest and forthcoming and aboveboard, but also when they are greedy, unethical, and deceptive. That's why we have standardized disclosure rules and SEC oversight and ratings agencies and corporate board audit committees. And, above all, it is why we require an outside, independent auditor to review and approve a company's financial statements.

In the recent rash of accounting frauds and failures, all of those safeguards failed. The accounting rules failed to produce an accurate picture of company finances. Corporate boards failed to ask tough questions, challenge questionable practices, or require more transparent disclosures. Auditors signed off on financial statements that clearly presented a misleading picture of companies' finances or missed altogether Mount Everest-sized reporting errors. In many cases, years had passed since the SEC last reviewed the company and questioned its financial statements.

At the end of the day, one conclusion is inevitable. The system of corporate governance that we have long and rightly touted as the world's best is just not adequate to ensure that investors receive accurate information about the companies in which they invest. And that has led to the current crisis of investor confidence. Although most investors instinctively understand that not all com-

panies are corrupt, they also know that they can't, on their own, reliably tell the difference between those whose finances toe the mark and those with troubling secrets hidden in the footnotes or kept out of the financial statements altogether. And they have experienced firsthand how quickly the bottom can drop out of a once high-flying stock when questions about its accounting emerge.

If we want average Americans to continue to view our financial markets as a place where they can entrust their long-term savings, then we need to provide them with a reasonable assurance that our system of investor protections is once again functioning as it should, and that will require comprehensive reforms. Not just a little—not "reforms," comprehensive reform. Not just a little reform; comprehensive reforms.

While a strong civil and criminal enforcement program is a crucial element of such a plan, the President's plan just does not go far enough. First, he's given no indication that he's willing to fund the increased enforcement he's highlighting. His recent speech said nothing about new funding for the Department of Justice, which is already struggling with massive new responsibilities from the war on terror. And the added hundred-million dollars he has proposed for the SEC is like throwing a drowning man a toothpick when what he needs is a lifeboat.

The House bill is even worse, much worse. It does nothing to enhance auditor independence beyond what the major firms have said they would do on their own. The bill's supposedly independent oversight board for auditors would have a majority of accountant representatives. How can you possibly stand up and support such legislation? It is sham reform that perpetuates the current system of self-regulation.

Nor does the Senate's accounting reform bill do the job, although it is far superior to the President's proposal and the House-passed bill. It would be far better, for example, if it included your amendment, Senator Dorgan, to open up the proceedings of the Accounting Oversight Board to the public. It's a shame that that was not included. Or amendments offered by you and Senator McCain to ensure that the SEC imposes a broad ban on consulting services by accounting firms when they are also auditing a particular company. Or Barbara Boxer's amendment to prevent an accounting industry takeover of the oversight board.

But the Senate bill does take a number of meaningful steps forward to strengthen oversight of the accounting industry. It is the minimum bill needed to improve investor confidence in the reliability of corporate disclosures. I believe the House should just accept the bill in the conference committee, because there is virtually nothing—and I mean nothing in the House bill worth keeping.

If the House refuses, then, at the very least, Senators should insist that all conference negotiations are held in public. That would minimize the danger that opponents of reform would try to sneak in anti-investor proposals behind closed doors.

In my written testimony, I mention a number of additional reforms that should be enacted. I will not talk at length about these measures now, but they include requiring corporations to list stock options as an expense. They are and they should be listed as an expense. Also requiring corporate boards to improve their oversight

of company management and eliminating unwarranted restrictions in current law on private securities lawsuits.

In closing, let me say that I am nervous—very nervous, Mr. Chairman—and uncomfortable that the current SEC will be overseeing the new accounting board when it is enacted into law, whether in the House or the Senate version. Unfortunately, the Chairman's ties to the accounting industry and his disappointing showing so far in addressing these issues undermines his credibility as the right man to fulfill this role. It is time for him to prove conclusively that he's protecting the public interest, not special interests, or step aside so that—for someone who will. Frankly speaking, the President never should have appointed him, who had represented so many of the accounting firms, in the position to which he had been named.

To be specific, the Chairman needs to get off the sidelines and push the House to adopt the Senate bill. He needs to develop a real plan to restore independence to the so-called independent audit, and he needs to, and we need to, see to it that members appointed to the new oversight board will represent investors' interests, not the accounting industry, if the Senate bill becomes law.

It would be good if the Chairman were to make his intentions known now. If the Chairman doesn't take these steps as soon as possible—he could move on the first two items immediately, for example—it is time for new leadership at the SEC. I want to repeat that. If he doesn't move immediately with respect to the first two items I mentioned, then it is time for new leadership at the SEC.

Thank you, Mr. Chairman, for the opportunity to offer my comments. It's a privilege to appear with these other——

Senator DORGAN. Senator Metzenbaum, thank you very much.

You haven't changed very much since you've left the Senate. I must say, having listened to your testimony.

Senator METZENBAUM. I'm sorry that I soft-pedaled it, Mr. Chairman.

[Laughter.]

[The prepared statement of Senator Metzenbaum follows:]

PREPARED STATEMENT OF HON. HOWARD M. METZENBAUM, (RETIRED SENATOR), CHAIRMAN, CONSUMER FEDERATION OF AMERICA

Good morning, Chairman Dorgan, Senator Fitzgerald and Members of the Subcommittee. My name is Howard M. Metzenbaum and I now serve as Chairman of the Consumer Federation of America (CFA). CFA is a non-profit association of some 300 pro-consumer organizations with a combined membership of over 50 million Americans. Ensuring adequate protections for the growing number of Americans who rely on financial markets to save for retirement and other life goals is one of CFA's top priorities.

I appreciate your invitation to offer my comments on the very important issue of corporate responsibility. I am especially pleased to appear before you, Senator Dorgan, because you have done so much to highlight corporate abuses of late and to propose real reform.

I spent my career in the U.S. Senate working to prevent corporations from running roughshod over the rights of consumers and workers. I have to tell you that I have never seen a more appalling example of heartless, unfettered corporate greed than that revealed by the recent, widespread accounting scandals. Companies like Enron and WorldCom lied to their investors, lied to their employees, hid crucial information about their finances and, in some cases, tried to improperly influence government officials. The executives behind what appears to have been massive frauds on a grand scale should be brought to justice quickly. This includes officers at companies like WorldCom, if they are found to have committed fraud, as well as the

individuals at accounting firms who should have known when their clients were cooking the books.

The truth is this country finds itself in the midst of a corporate crime wave. And while average citizens ponder their diminishing retirement accounts and wonder whether they will be next to lose their jobs, a debate rages in Washington over whether this is the product of a few bad apples or evidence of a systemic breakdown. While that may seem to be an arcane argument in the face of so much real world pain, the implications of this debate are significant because the outcome will determine whether Congress and the administration adopt an effective policy response.

The administration has been cynically arguing the "bad apple" theory. They have used this theory to justify a policy that allows them to talk tough about sending corporate crooks to jail without forcing them to impose real reforms on the corporate interests that so generously fund their campaigns. Now most of us can agree that corporate crooks should spend some time behind bars, but this argument misses on two counts. First, what we are looking at here is more than a few bad apples. Secondly, what we have is a system of investor protections specifically designed to eliminate the bad apples; a system that clearly is not working.

One measure of the scope of the problem is the recent dramatic rise in companies forced to restate their earnings. Back in the early 1990s, that number used to run at a predictable 45 or so a year, but around the middle of the last decade, it took off. From 1997 through 2001, there were 1,089 restatements, according to a recent study by the Huron Consulting Group. The number grew every year over that five-year period, from 116 in 1997 to 270 in 2001. The companies involved include such well-known examples as Waste Management, Sunbeam, Cendant, Rite Aid, and, of course, Enron—accounting failures that together cost investors hundreds of billions of dollars in lost market capitalization. But, they do not include Adelphia or Xerox or WorldCom or any of the other companies whose actions have promised to make 2002 another record-breaking year. Today, we are fast approaching the point where one in ten of America's public companies will have recently been forced to restate its earnings. That is a lot of bad apples.

Furthermore, the companies involved are not unknown fly-by-night operations, but the very symbols, in many cases, of innovative American capitalism—Enron, WorldCom, Qwest, and Xerox—a company that, as one writer put it is "so established that its name has become both noun and verb." Even if you were to accept the argument that we are dealing with isolated cases of wrong-doing, when they involve the nation's leading companies, does that not tell you the system is fundamentally broken?

But the real point is that our system of investor protections was ostensibly designed with the bad apples in mind. It was designed to work, not just when corporate executives are honest, forthcoming and aboveboard, but also when they are greedy, unethical, and deceptive. First and foremost, it is why we require an outside, independent auditor to review and approve a company's financial statements. It is why we have standardized rules that govern what companies have to disclose and how. It is why the SEC reviews financial disclosures for accuracy, completeness, and compliance with appropriate accounting rules. It is why rating agencies pore over massive amounts of information to determine the creditworthiness of companies that issue debt. It is why corporate boards have audit committees, made up primarily of board members who are supposed to be "independent," to supervise the audit.

In the recent rash of accounting frauds and failures, all of those safeguards failed. The accounting rules failed to produce an accurate picture of company finances. Corporate boards failed to ask tough questions, challenge questionable practices, or require disclosure that is more transparent. Auditors signed off on financial statements that clearly presented a misleading picture of company finances—or missed altogether Mt. Everest sized reporting errors. In many cases, years had passed since the SEC last reviewed the company in question's financial statements.

At the end of the day, one conclusion is inevitable. The system of corporate governance that we have long, and rightly, touted as the world's best is not adequate to ensure that investors receive accurate information about the companies in which they invest. And that has led to the current crisis of investor confidence. Although most investors instinctively understand that not all companies are corrupt, they also know that they can not—on their own—reliably tell the difference between those whose finances toe the mark and those with troubling secrets hidden in the footnotes or kept out of the financial statements altogether. They have experienced first-hand how quickly the bottom can drop out of a once high-flying stock when questions about its accounting emerge.

Another aspect of the current debate swirls around the question of whether this recent explosion of corporate greed is something new or not. The latter argument is based on the theory that the recent revelations of corruption in the boardroom are simply the inevitable hangover from the market boom—that this is simply how markets "correct" themselves, and we should simply get out of the way and let the market do its work.

This argument also ignores an important point—that our markets are no longer simply a place where the rich get richer. Increasingly, the financial markets are where average, middle class Americans put their money to save for retirement, to buy a home, or to send their children to college. Since the time when the first President Bush took office, the number of Americans investing in our markets has grown by roughly 60 percent. Today, approximately half of all households have money invested either directly or indirectly in the stock of American companies. It is this massive new influx of capital from average Americans that provided the fuel for our recent period of unprecedented economic growth.

When the bottom drops out, what these middle class families have at risk is not whether they can vacation in Tuscany this year, or if they will have to stay a little closer to home. It is not whether they have to give up the private jet, or delay their plans to build a vacation home in Aspen. What is at risk is whether they will be able to retire in reasonable comfort, or even retire at all. What is at risk is whether their children will be able to attend the college of their choice, settle for a less expensive alternative, or miss out on college altogether. What is at risk is whether they will have to delay indefinitely their ability to participate in the American dream of owning their own home. So, what is new is not just that the investor losses from the recent spate of accounting failures are unprecedented in their size, but that families who are far less able than the investing class of the past to absorb such losses are feeling them.

If we want average Americans to continue to view our financial markets as a place where they can entrust their long-term savings, then we need to provide them with reasonable assurance that our system of investor protections is once again functioning as it should. That will require comprehensive reforms. While a strong civil and criminal enforcement program is a crucial element of such a plan, the President's plan does not go far enough. He has given no indication that he is willing to fund the increased enforcement he is highlighting. His recent speech said nothing about new funding for the Department of Justice, which is already struggling with massive new responsibilities from the war on terror. The added $100 million he has proposed for the SEC is like throwing a drowning man a toothpick when what he needs is a lifeboat.

The House bill is a disaster. It does nothing to enhance auditor independence beyond what the major firms have said they would not oppose. Its supposedly independent oversight board for auditors would allow a super-majority of industry representatives. And the mechanism it relies on to create the board—where a board applies for the job—invites an industry take-over. This is sham reform that, in all but name, perpetuates the current system of self-regulation.

Nor does the Senate accounting reform bill do the job, although it is far superior to the President's proposal and the House-passed bill. It would be far better, for example, if it included your amendment, Senator Dorgan, to open up the proceedings of the Accounting Oversight Board to the public or amendments offered by you or your colleague Senator McCain to insure that the SEC imposed a broad ban on consulting services by accounting firms when they are also auditing a particular company. It would be far better with the amendments offered by Senator Boxer to enhance the independence of the oversight board.

Although we were very disappointed that these amendments were never voted on and that this important opportunity to improve the bill was missed, make no mistake about it. The Senate bill is still by far the best reform proposal on the table. It is the only proposal to create a strong, effective new oversight board for auditors; to include significant provisions to strengthen corporate board oversight of the audit and enhance its independence; to lengthen the statute of limitations for securities fraud; and to protect the independence of the Financial Accounting Standards Board. Like the House, but unlike the President's proposal, the Senate bill authorizes a meaningful and much needed increase in SEC resources.

In short, the Senate bill is the minimum needed to justify renewed investor confidence in the reliability of corporate disclosures. To ensure that the best possible bill is passed as quickly as possible, the House should accede to the Senate bill. If it refuses, then at the very least, Senators should insist that the conference is held in public. That would minimize the danger that the opponents of reform, who are nervous about gutting the bill in public, would be bolder in behind-closed-doors bargaining sessions.

But even if the Senate bill is adopted intact, more needs to be done. In developing an agenda of additional reforms, policy makers need to recognize that one reason the system has run amok is that too many of the financial incentives reward doing the wrong thing. If you want to bring about a new era of corporate responsibility, you are going to have to eliminate those perverse incentives.

Stock Options Should Be Expensed

The Senate bill would enhance the independence of the Financial Accounting Standards Board. Maybe that will give FASB the courage to do what it was intimidated to do nearly 10 years ago—require that stock options be reflected as an expense on corporate balance sheets.

Proponents of stock option compensation argue that this practice benefits shareholders by aligning the interests of company executives with those of company shareholders. But that is clearly not true. As Paul Krugman recently wrote in *The New York Times*, options allow executives to "get a share of investors' gains if things go well," but don't force them to "share the losses if things go badly." As a result, and because of the massive size of many options grants, they offer executives massive personal financial incentives to take whatever risks necessary to drive up the stock price in the short term.

Clearly, granting executives shares of company stock, and forcing them to hold that stock until after they leave the company, would do a far better job of aligning their interests with those of typical shareholders. But our accounting rules favor stock option compensation over grants of company shares. This is because the grant of company shares would have to be reflected immediately as an expense on balance sheets, while the stock options can be relegated to the footnotes without denting earnings. That makes no sense. As others have pointed out—while it may be difficult to pin a precise value on options when they are granted, the one thing we do know is that their value is not zero.

If we truly want to align company executives' interests with shareholders—a laudable goal—we need to remove this perverse incentive in our accounting rules to use stock options rather than grants of company shares to provide incentive compensation to executives. But, despite the admirable efforts of Senators Levin and McCain, this aim was not included in the recent Senate corporate reform bill. The bill is incomplete without it.

Improve Corporate Board Oversight of Management

With all the focus on stock options, it is important to remember that personal greed is not the only factor encouraging company executives to push share prices ever higher. As Steve Liesman wrote in the *Wall Street Journal* last January, "stocks have become a vital way for companies to run their businesses." Companies use stock to make acquisitions and to guarantee the debt of off-the-books partnerships. They rely on the stock market as a place to raise capital. As a result, as Leisman said, "a high stock price can be the difference between failure and success."

Clearly, simply fixing the accounting for options will not be enough to eliminate the incentive for corporate executives to do whatever it takes—including cooking the books—to create the financial picture necessary to produce a rising stock price. Corporate boards are going to have to do a better job of keeping management on the straight and narrow.

In theory, corporate board members are supposed to represent shareholders. But shareholders don't pick board members, CEOs do. Recent proposals by the New York Stock Exchange and Nasdaq take a step in the right direction by strengthening the independence requirements for independent board members and by requiring that all members of the audit and compensation committees be independent members. However, they are not enough to overcome the influence management has by virtue of the fact that it selects the board—and can stack it with cronies and "yes" men or boot those board members they view as trouble makers.

If we want corporate boards to represent shareholders, we need to do a better job of giving shareholders a say in the selection of board members. This is an area that we believe deserves additional attention in the coming months.

Make the Independent Audit Truly Independent

Ultimately, however, the ability to ensure reliable disclosures comes down to the effectiveness of the independent audit. Nothing else can substitute for having a skeptical, independent outsider who thoroughly looks over the books. But, here again, auditors faced with bogus accounting have overwhelming financial incentives to look the other way. Challenging management could cost them the audit engagement. Given the decades-long relationships that are typical between auditors and their clients, that means losing not just this year's audit fee, or next year's audit

fee, but decades of expected income. If the client is a big one, the incentive to back down is enormous.

One thing that dramatically ups the ante is the increasingly common practice among auditors of also providing consulting services to their audit clients. The practice has become all but universal among large companies, and the dollar amounts on the table for consulting contracts are typically two or three times the audit fees. In some cases, however, the imbalance is much greater, with consulting fees in some cases bringing in twenty or thirty times the audit fees.

It is no wonder that expert after expert who testified before House and Senate committees said no reform would be complete without a broad ban on consulting services and mandatory rotation of audit firms. Unfortunately, these central reforms never made the cut. The House bill simply does what the major accounting firms said they would not oppose—it expands the current ban to include internal audits and financial system design and implementation. The Senate bill expands the list a little further. But neither bill requires the rotation of audit firms.

Where the Senate bill stands head and shoulders above the rest in this area is with its requirement that board audit committees, made up exclusively of independent board members, pre-approve any decision to hire the auditor to perform non-audit services. Also key is the Senate bill's provision making audit committees directly responsible for hiring and compensating the auditor and for overseeing the audit and giving the audit committee the tools it needs to do that job effectively.

While we respect the efforts the Senate has made to improve the oversight of the audit, we do not believe reform will be complete until auditors are forced to be truly independent from their audit clients. That means the kind of broad ban on consulting services that has been proposed by Senators Nelson, Carnahan, and McCain and mandatory rotation, as included in the Nelson-Carnahan bill.

Improve Audit Standards

Because they lack those broad auditor independence reforms, the House and Senate bills rely heavily on the new auditor oversight board to ensure quality audits. But only the Senate bill gives its new board the standard-setting authority that is key to its effectiveness. The House bill leaves authority for setting standards with the accounting profession. Even under pressure from recent scandals, the accounting profession uses its authority to write audit standards that are full of suggestions rather than mandates—standards that are more geared toward minimizing accounting firms' liability than ensuring high quality audits.

The Senate bill provides ample opportunity for industry participation in this process, but it charges the oversight board with final responsibility. That should ensure that those whose job it is to protect the public interest, not the special interests, make decisions. Of course, even if the House bill gave its regulatory board the necessary authority, it would not matter. That is because, as we mentioned earlier, the House bill is custom designed to ensure maximum industry influence over its new "regulator." It is essential that the Senate oversight board structure and authority be adopted in the final bill.

Increase Deterrence

The Senate bill includes an impressive package of criminal and civil penalties for corporate crimes. These should send the same powerful message to white collar crooks that we have sent to street criminals—don't do the crime if you can't do the time. The Senate and House have also authorized dramatically increased funding to put more cops on the beat at the SEC. You know as well as I do, however, that authorizing funding and appropriating it are two very different things. Particularly in light of the lack of administration support, members will need to be vigilant to ensure that this promise of increased resources is realized.

We also continue to believe that private lawsuits form an essential supplement to regulatory enforcement efforts, particularly if you are unwilling to adequately fund enforcement, as the President appears to be. Unfortunately, the deterrent effect of such lawsuits is limited by a number of factors, including the unreasonably high pleading standards plaintiffs must satisfy before getting access to discovery, the unreasonably short statute of limitations that governs such suits, and the lack of aiding and abetting liability.

The Senate bill would address one of those problems, lengthening the statute of limitations to 2 years from discovery, but no more than 5 years from the wrongdoing. This will make it more difficult for those who commit fraud to escape liability simply by keeping their fraud hidden for a short time. It will also make it less likely that suits against secondary defendants are dismissed because the statute of limitations has run while the motion to dismiss was pending, blocking access to discovery.

Senator Shelby was prepared to offer another important amendment, to restore aiding and abetting liability under the securities laws. Unfortunately, like so many other important amendments that we have discussed today, he was prevented from offering that amendment. This reform is highly relevant to the current crisis since the lack of aiding and abetting liability has been used by defendant after defendant in the Enron lawsuits to argue that they cannot be held accountable for assisting the fraud.

If you cannot fix this glaring shortcoming in our laws now under the current environment, it is hard to imagine when that will be possible. But perhaps when these lawsuits have worked their way through the court system and we find that the victims have recovered only a pittance, if anything, of their losses, perhaps then will certain members be willing to abandon their phony rhetoric about frivolous lawsuits and recognize that our legal system stands in the way of full and fair redress in even the most meritorious of cases.

Conclusion

The recent corporate crime wave has delivered a wake-up call. The system of corporate governance that we have grown accustomed to touting is broken. The Senate has started down the road to reform. But our system will remain vulnerable until we tackle the fundamental incentives that encourage our corporate executives to do the wrong thing and our auditors to turn a blind eye.

We have been given a wake-up call.

Senator DORGAN. Next, let me ask for testimony from the Honorable Richard Moore, State Treasurer for the State of North Carolina. Mr. Moore, you may proceed, and we will include your entire statement in the record, so you may summarize.

STATEMENT OF HON. RICHARD MOORE, TREASURER FOR THE STATE OF NORTH CAROLINA

Mr. MOORE. Thank you very much, Senators. Thank you for this opportunity.

I come before you today as North Carolina's elected guardian of the State Treasury and as the sole trustee of $62 billion in public money, most of which is the pension funds for the 600,000 active and retired public workers of our great state—the teachers, fire and rescue workers, nurses, police officers, sanitation workers, and state and local government employees of North Carolina.

I come here today as an owner who needs help exercising the full rights of ownership—nothing more, nothing less. Now, in my prepared remarks, I have some quotations that go back and show that, since Alexander Hamilton's day and George Washington's first address to this body, we've always understood that the power of the marketplace needs to be regulated for the good of us all.

We can go back through the Great Depression. I wanted to point out that the deep corruption of our public markets brought about the passage of the Securities Acts of 1933 and 1934 and the passage of the Glass-Steagal Act. I am extremely proud that my grandfather, as a member of this body, played a significant role in drafting and championing many pieces of these necessary reforms. And we find ourselves, 70 years later, right back in very, very similar situations. Those reforms produced a fair and stable marketplace that's been the envy of the world for almost 70 years.

And I give you this historical background to make what ought to be an obvious point. It is important to remember that we are addressing regulations that apply only to public companies and that no one forces a company to become public. The choice to do so means that its corporate leaders voluntarily give up some of their autonomy and agree to be regulated.

The tradeoff, which has been significant over the past 20 years, is that those companies may access capital at a severely discounted rate to traditional sources. Even today, most businesses and most of the folks I talk to in my home state are not regulated, the businesses on Main Street across America. And when they need additional capital, they pay a premium for it.

Publicly traded companies have been and must always be regulated to make sure that the individual investor can properly value his or her risk before an ownership decision is made. This obvious point has been overlooked by many who are afraid that additional government regulation will foul the market.

Today, more than 80 million Americans have decided to take part in these public marketplaces, either through mutual funds or pension plans. This, in itself, is remarkable. They have been enticed—and I want to repeat that—they have been enticed, through tax policy and professional advice, to participate and share in this part of the American dream. It is not your job, nor is it the job of corporate America, to ensure that this dream comes true. However, it is your job to make sure that the marketplace is fair to all so that some don't profit while others lose from the exact same investment.

Our markets today contain about $12 trillion in assets. More than $2 trillion of that is held by pension funds, like the one that I run in North Carolina. Approximately—but here's the point that a lot of people don't understand—while $8 trillion is controlled by mutual funds, most of the large mutual funds' largest clients are pension funds like myself. So we have tremendous clout in the marketplace, clout that I don't think we have fully utilized or understood how to wield.

Institutional ownership has evolved over the last 30 years, and I think that's one of the reasons we're not prepared. As a result, we find ourselves, collectively, the largest shareholders in virtually every major company in America. The founder or the founder's descendants, at the same time, in many instances, are no longer seated at the board table advocating, out of self-interest, the interest for the shareholders. It is truly a setting very much like government, where people are spending other people's money.

Therefore, we, as institutions, must act like the owners that we are. However, we cannot do it alone. We need Congress and the Administration to help make sure we can properly exercise our prerogatives of ownership. We need your help to make sure that we can tell whether the interests of management and shareholders are properly aligned. We need your help in making sure that we, as investors, can properly price risk. We need your help to make sure that the cops on this particular beat have the resources and tools to do their job effectively. We need your help now more than ever. And I won't recap all of the events that happened.

I firmly believe that the vast majority of today's corporate managers are smart and honest, but it is disconcerting to see so many of them unmasked, not as captains of industry, but as captains of greed, with callous disregard for the welfare of the people whose money grows their company. Simply put, where I come from, we know that the fox cannot guard the hen house. No matter how well-meaning, at some point the temptation to gorge will prevail.

Without proper regulation, history has proven that hardworking Americans always pick up the tab—the Great Depression, the savings and loan debacle, during which I was a white-collar federal prosecutor, with nowhere near the resources to do the job properly, 12 years ago; and, most recently, as the Chairman has referred to, the power shortage in California.

In carrying out my fiduciary duty to 600,000 beneficiaries, we have begun to more actively exercise our ownership rights. Last month, I was joined by the Comptroller of New York—he and I are the two largest sole trustees in America—the Treasurer of the State of California, Phillip Angelides, and the Attorney General of New York, Elliott Spitzer, to announce important investment protection principles. These proposals embody simple, common sense, market-based solutions to some of the problems that we face.

We, as owners, are exercising our ownership rights when we put new terms on the table. If you want our money, this is what we need from you. We're demanding that broker/dealers and money managers eliminate actual and potential conflicts of interest from the way they pay their analysts and conduct their affairs, and we appreciate your help in this. We are asking that the managers that we utilize look closer into the areas of financial transparency and corporate conduct. As fiduciaries, we must and will become more assertive in our ownership role.

Now, in closing, I would like to say that, as investors, we cannot properly price our risk without getting fair and accurate information regarding financial transparency and corporate conduct. We must be able to assess accurate earnings and the future impact of corporate initiatives on those earnings. You have already signaled your willingness to help in that area. And for that, I thank you.

In some areas, we need specific prohibitions. And Senator Metzenbaum has hit on many of those. In other areas, this may be unwise. I ask that in the areas that you feel outright prohibition is unwarranted or unnecessary at this point, do make disclosure standards tougher. Just as you have done in food labeling and countless other areas, it is prudent and appropriate to require that certain financial information be prominently displayed in plain language in proxy statements and annual reports. If you will help the large and small investor alike learn how to find the information to properly price "option overhangs" and "option run rates," the market will go a long way in ridding itself of the truly abusive practices.

I would also ask—remind Congress that this situation has shown that the defined benefit plans, in many ways, are far more secure and better than defined contribution plans, as someone who runs both of them. My defined contribution investors—I had a lady stop me yesterday. Her money—they had put $300,000 away as a public investor. Today she has only $120,000 in that account, and she's grateful that my funds were properly diversified and we haven't taken that kind of hit. So I encourage you to look at those roles again.

The importance of the task before us cannot be overstated. We must restore investor confidence. It is the pillar upon which one of the great institutions of our society rests, the open and fair marketplace.

Thank you.
[The prepared statement of Mr. Moore follows:]

PREPARED STATEMENT OF HON. RICHARD MOORE, TREASURER FOR THE STATE OF NORTH CAROLINA

I come before you as North Carolina's elected guardian of the state treasury, and as the sole trustee of $62 billion in public money, most of which is the pension funds for the 600,000 active and retired public workers of our great state—the teachers, fire and rescue workers, nurses, police officers, sanitation workers, and state and local government employees of North Carolina. And, I have come here today as an owner who needs help exercising the full rights of ownership—nothing more, nothing less.

As a student of history, I recognize that capitalism has never been totally unrestrained in this country. Those leaders who have championed capitalism and the building of economic markets have understood that unregulated and unchecked, a pure *laissez-faire* marketplace is a dangerous thing. In arguing that markets could never regulate themselves, Alexander Hamilton wrote in his 7th *Federalist* paper that "the spirit of enterprise" when "unbridled," leads to "outrages, and these to reprisals and wars." He later stated that we Americans had "a certain fermentation of mind, a certain activity of speculation and enterprise which if properly directed may be made subservient to useful purposes; but which if left entirely to itself may be attended with pernicious effects."

This mindset put forth by the founders of our nation has always been understood by our nation's leaders. Agreeing with President Theodore Roosevelt, President Woodrow Wilson felt that without "the watchful interference, the resolute interference of the government, there can be no fair play between individuals and such powerful institutions as [corporations]."

The Hamiltonian views were again embraced after the Great Depression. The deep corruption of our public markets brought about the passage of the securities acts of 1933 and 1934 and the passage of the Glass Steagell Act. I am extremely proud that my grandfather, Frank W. Hancock, Jr., as a business-oriented member of the House Banking Committee, played a significant role in drafting and championing many pieces of these necessary reforms.

The result of these and other reforms produced a stable and fair public marketplace that has been the envy of the world for almost 70 years.

It is important to remember that we are addressing regulations that apply *only* to public companies, and that no one forces a company to become public. The choice to do so means that its corporate leaders voluntarily give up some of their autonomy and agree to be regulated. The trade off, which has been a significant advantage over the last 20 years, is that those companies may access additional capital at a discount to traditional sources. Even today, most businesses in this country—those located on main streets across America—are not publicly regulated, and when they need additional capital, they must pay a premium for it.

Publicly traded companies *have been and must* be regulated to make sure that the individual investor can properly value his/her risk before an ownership decision is made. This obvious point has been overlooked by some who fret that additional government regulation will foul the market.

Today, more than 80 million Americans have decided to take part in these public markets. Either directly or indirectly through mutual funds and other pension plans, they have placed their hard earned savings in these marketplaces. This in itself is remarkable. They have been enticed through tax policy and professional advice to participate and share in the American dream. It is not your job, nor is it the job of corporate America, to insure that this dream comes true. However, it is your job to make sure that the marketplace is fair to all so that this dream does not turn into the nightmare of losing the family nest egg.

Our markets today contain approximately $12 trillion in assets. More than $2 trillion of that is held by pension funds like the one that I run in North Carolina. Approximately $8 trillion of this marketplace is controlled by mutual funds. Many of the largest investors in mutual funds are pension funds, so we institutional investors have tremendous market clout—clout that I do not think we have yet fully utilized to bring about positive change.

Institutional ownership has evolved over the last 30 years. As a result, we find ourselves collectively as the largest stockholders in virtually every major company in America. The founder, or the founder's descendents, in many instances are no longer seated at the board table advocating—out of self-interest—for the interest of shareholders. It truly is often a setting where people spend other people's money.

We must act like the "owners" that we are. However, we cannot do it alone. We need Congress and the Administration to help make sure we can properly exercise our prerogatives of ownership. We need your help to make sure that we can tell whether the interest of management and shareholders are properly aligned. We need your help in making sure that we, as investors, can properly price risk. We need your help to make sure the cop on this particular beat has the resources and tools needed to do their job effectively.

We need your help now more than ever. The events of the last few months have shown that our system is currently missing effective and necessary checks and balances to insure that the fine line between proper incentive and destructive greed is not crossed. I firmly believe that the vast majority of today's corporate managers are smart and honest, but it is disconcerting to see so many unmasked not as captains of industry, but as captains of greed, with callous disregard for the welfare of the people whose money grows their company.

Simply put, we know that the fox, no matter how well meaning, cannot guard the hen house. At some point, temptation prevails. Without proper regulation, history has proven that hard working Americans always pick up the tab—the Great Depression, the savings and loan debacle, and most recently, the power shortage in California.

In carrying out my fiduciary duty to my 600,000 beneficiaries, we have begun to more actively exercise our rights of ownership. Last month, I was joined by the Comptroller of New York, H. Carl McCall, the Treasurer of California, Philip Angelides, and the Attorney General of New York, Eliot Spitzer, to announce important investment protection principles. These proposals embody simple, common sense, market-based solutions to some of the problems that we face. We, as owners exercising our ownership rights, have put new terms on the table—if you want our money, this is what we need from you. We are demanding that broker/dealers and money managers eliminate actual and potential conflict of interest from the way they pay analysts and conduct their affairs. We are asking the money managers we utilize to look closer into the areas of financial transparency and corporate conduct. As fiduciaries, we must and will become more assertive in our ownership role.

To date, we have been joined by several other large funds in our initiative, with more who will likely follow.

As investors, we cannot properly price our risk without getting fair and accurate information regarding financial transparency and corporate conduct. We must be able to assess accurate earnings and the future impact of corporate incentives on those earnings. You have already signaled your intent to help us in these areas, and for that I thank you.

In some area, we need specific prohibitions. In other areas, this may be unwise. I ask that in areas where you feel outright prohibition is unwarranted, do make disclosure standards tougher. Just as Congress has done in food labeling and other areas, it is prudent and appropriate to require that certain financial information be prominently displayed in plain language in proxy statements and annual reports. If you will help the large and small investor alike learn how to find the information needed to properly price "option overhangs" and "option run rates," the market will then go a long ways in ridding itself of truly abusive practices.

In the past 25 years, retirement savings have been systematically shifted from defined benefit to defined contribution plans. While this shift has been highly profitable to the mutual fund industry and corporations, it has not strengthened overall retirement savings. The 401(k), IRA and Roth IRA are excellent supplementary savings plans. However, they are insufficient, as has been evident in the past 2 years, for many Americans attempting to prepare for a comfortable retirement.

Moreover, defined contribution plans leave matters of corporate governance and transparency in the hands of individuals who have little time or money to study these issues. In 401(k) plans, these issues are left in the hands of trustees who have little incentive to press mutual fund managers or the underlying companies. Ownership in equities is a proven way to build retirement wealth. However, it requires careful attention to the demands of ownership.

I urge Congress to enact legislation promoting the expansion and establishment of defined benefit plans. These plans are the foundation of retirement security, and without them, I fear many hard working Americans will face difficult retirement years. These plans should be portable. We must recognize that lifetime employment is no longer feasible or practical in our modern economy. These plans need to run on assumptions that are realistic and fair.

The importance of the tasks before us cannot be overstated. We must restore investor confidence. It is the pillar on which one of the great institutions of our society rests—the open and fair marketplace.

JULY 1, 2002—STATE TREASURER RICHARD MOORE ANNOUNCES LANDMARK PUBLIC PENSION FUND INVESTMENT INITIATIVE

RALEIGH—As North Carolina's State Treasurer, Richard Moore manages the 10th largest public pension fund in the United States and the 24th largest in the world. Add to that the funds managed by Moore's counterpart New York State Comptroller H. Carl McCall, and you have a total investment portfolio of nearly $170 billion. When that much money talks, Wall Street takes notice.

That's why Treasurer Moore and Comptroller McCall have teamed up with New York State Attorney General Eliot Spitzer to launch a major initiative to establish stronger corporate disclosure standards for investments made with public pension funds, the money that pays the retirement of public workers. Under this initiative, which Moore and McCall as sole trustees have implemented for their respective pension fund investment portfolios effective immediately, the North Carolina Public Employees' Retirement Systems and the New York State Common Retirement System will require the following of investment banking and money management firms that do business with the two pension funds:

- Investment banking firms must adopt the conflict of interest principles set forth in the agreement that New York Attorney General Spitzer reached with Merrill Lynch in May of 2002 (referred to as the "Spitzer Principles.")
- Money management firms must make disclosures regarding portfolio manager and analyst compensation, the use of any broker dealers that have not adopted the Spitzer Principles, and any potential conflicts of interest arising from client and corporate parent relationships.
- Money management firms must adopt safeguards to ensure that there are no potential conflicts of interest as a result of the method compensation is provided to analysts that could influence investment decisions made on behalf of the pension funds.
- Money management firms must scrutinize more closely the auditing and corporate governance practices of companies in which pension fund monies are invested.

"Recent conflict of interest and insufficient corporate governance stories coming out of Wall Street firms have shaken the confidence of investors, big and small," said Treasurer Moore. "On behalf of the hard-working public employees and retirees whose pension funds Comptroller McCall and I manage, we are using our clout as large public fund investors to set a higher standard. Because people are counting on us to ensure their pension funds are secure, we must be able to know the information we use to make sound, prudent investment decisions is reliable."

"I have been working for months on common sense, market-driven solutions that will ensure that our funds are invested safely. I am grateful for Attorney General Spitzer's guidance and to Comptroller McCall for joining this effort."

California Treasurer Philip Angelides today also pledged his support for these measures, and will attempt to get them adopted by CalPERS and CalSTRS (both $100 billion plus California public employee pension funds).

"I am today sending out a letter to other pension fund managers encouraging them to adopt similar measures, and will also be reaching out to other large investors. Public pension funds also have assets of about $2.3 trillion. I am, therefore, confident that we can build enough support to bring about significant change, with or without Congressional or administration action."

The North Carolina and New York pension funds contract with dozens of investment banking firms, and requiring those firms to adhere to the Spitzer Principles will benefit all investors, not just pension funds. In addition, public confidence in the stock market has a great impact on the future growth of the pension funds. Adoption of these principles should help restore confidence in the marketplace, which will have a positive impact on both pension fund beneficiaries and individual investors.

A copy of the Public Pension Fund Investment Protection Principles adopted by North Carolina and New York is attached.

State and Public Pension Fund Investment Protection Principles

A. Effective July 1, 2002, every financial organization that provides investment banking services and is retained or utilized by the State Treasurer of North Carolina, the Comptroller of the State of New York, or the State Treasurer of California (hereinafter "the State Investment Officers"), including but not limited to organizations retained by the North Carolina Public Employees Retirement Systems and the New York State Common Retirement Fund (hereinafter "the Pension Funds"), should adopt the terms of the agreement between Merrill Lynch & Co., Inc. and

New York State Attorney General Eliot Spitzer dated May 21, 2002 (hereinafter "the Investment Protection Principles"). In retaining and evaluating any such financial organization, the State Investment Officers will give significant consideration to whether such organization has adopted the Investment Protection Principles.

The Investment Protection Principles are as follows:

- sever the link between compensation for analysts and investment banking;
- prohibit investment banking input into analyst compensation;
- create a review committee to approve all research recommendations;
- require that upon discontinuation of research coverage of a company, firms will disclose the coverage termination and the rationale for such termination; and
- disclose in research reports whether the firm has received or is entitled to receive any compensation from a covered company over the past 12 months.
- establish a monitoring process to ensure compliance with the principles;

B. Effective July 1, 2002, every money management firm retained by a State Investment Officer, as a condition of future retention, must abide by the following:

1. Money management firms must disclose periodically any client relationship, including management of corporate 401(k) plans, where the money management firm could invest State or Pension Fund moneys in the securities of the client.

2. Money management firms must disclose annually the manner in which their portfolio managers and research analysts are compensated, including but not limited to any compensation resulting from the solicitation or acquisition of new clients or the retention of existing clients.

3. Money management firms shall report quarterly the amount of commissions paid to broker-dealers, and the percentage of commissions paid to broker-dealers that have publicly announced that they have adopted the Investment Protection Principles.

4. Money management firms affiliated with banks, investment banks, insurance companies or other financial services corporations shall adopt safeguards to ensure that client relationships of any affiliate company do not influence investment decisions of the money management firm. Each money management firm shall provide the State Investment Officers with a copy of the safeguards plan and shall certify annually to the State Investment Officers that such plan is being fully enforced.

5. In making investment decisions, money management firms must consider the quality and integrity of the subject company's accounting and financial data, including its 10–K, 10–Q and other public filings and statements, as well as whether the company's outside auditors also provide consulting or other services to the company.

6. In deciding whether to invest State or Pension Fund moneys in a company, money management firms must consider the corporate governance policies and practices of the subject company.

7. The principles set forth in paragraphs 5 and 6 are designed to assure that in making investment decisions, the money management firms give specific consideration to the subject information and are not intended to preclude or require investment in any particular company.

NORTH CAROLINA, DEPARTMENT OF STATE TREASURER
Raleigh, NC, July 1, 2002

<<Name>>
<<Title>>
<<Company>>
<<Address1>>
<<City>>, <<State>> <<Postal Code>>

Dear <<Salutation>>:

Recently, I joined New York Attorney General Eliot Spitzer and the Comptroller of New York State, H. Carl McCall, to announce public pension fund investment protection principles that we are asking broker/dealers and money management firms to adopt as a condition of future retention by our pension funds. A copy of those principles is enclosed for your review.

In light of the many incidents on Wall Street over the last nine months, I feel these principles are necessary to ensure that the firms managing the pension funds of North Carolina's hard-working employees and retirees are doing business the

right way. As two of the largest pension funds in the marketplace, I believe North Carolina and New York will be able to have some positive effect on the market. It is important to publicly spell out what we, as fiduciaries of these pension funds, expect firms to do if they want to keep us as customers.

I would like to ask for your feedback regarding the enclosed principles, and would be interested in hearing if you have considered similar measures. As you will see, in addition to requiring the use of the Spitzer/Merrill Lynch conflict of interest principles, I hope to institutionalize the reporting and benchmarking of accounting practices and corporate conduct. I hope you will consider joining in our efforts to add additional safeguards to the management of our funds. I believe this measure will not only benefit institutional investors, but also the effects will reach down to the average citizen who invests his or her money, as well.

I thank you for your assistance and input in this matter, and look forward to working with you in the future.

Sincerely,

RICHARD H. MOORE

Contacts for Top 25 Public Pension Funds

California Public Employees' Retirement System
James E. Burton, Chief Executive Officer
Mark J.P. Anson, Chief Investment Officer
400 P Street
Suite 3340
Sacramento, CA 95814

California State Teachers' Retirement System
Jack Ehnes, CEO
Chris Ailman, Chief Investment Officer
P.O. Box 15275
Sacramento, CA 95851

Florida State Board of Administration
Tom Herndon, Executive Director
1801 Hermitage Blvd.
Tallahassee, Florida 32317–3300

Teacher Retirement System of Texas
Charles L. Dunlap, Executive Director
John Peavy, Chief Investment Officer
1000 Red River
Austin, TX 78701–2698

New York State Teachers Retirement System
George M. Phillip, Executive Director
10 Corporate Woods Drive
Albany, NY 12211–2395

New Jersey Public Employees' Retirement System
Steven Kornrumpf, Director, Division of Investment
Thomas J. Bryan, Director, Division of Pensions & Benefits
50 W. State Street
Trenton, NJ 08625–0295

Wisconsin Investment Board
Patricia Lipton, Executive Director
P.O. Box 7842
Madison, WI 53707–7842

New York City Employees Retirement System
John J. Murphy, Executive Director
335 Adams Street
Suite 2300
Brooklyn, NY 11201–3751

Public Employees Retirement System of Ohio
Neil Toth, Investment Director
Laurie Fiori Hacking, Executive Director
277 East Town Road
Columbus, OH 43215

Michigan Department of Treasury
Alan H. Noord, Chief Investment Officer
Lansing, MI 48922

Pennsylvania Public School Employees' Retirement System
Dale Everhart, Executive Director
James H. Grossman, Jr., Chief Investment Officer
P.O. Box 125
Harrisburg, PA 17108

State Teachers Retirement System of Ohio
Herb Dyer, Executive Director
Robert A. Slater, Deputy Executive Director—Investments
275 East Broad Street
Columbus, OH 43215–3771

University of California Retirement Plan
P.O. Box 24570
Oakland, CA 94623–1570

Washington State Investment Board
2424 Heritage Court
Olympia, WA 98504–0916

Teachers' Retirement System of the City of New York
40 Worth Street
NewYork, NY 10013

Minnesota State Board of Investment
Howard Bicker, Executive Director
60 Empire Drive
Suite 355
Saint Paul, MN 55105–3555

Teachers' Retirement System of Georgia
Jeff Ezell, Executive Director
Two Northside 75
Suite 400
Atlanta, GA 30318

Oregon Public Employees Retirement System
Jim Voytko, Executive Director
11410 SW 68th Parkway
Tigard, OR 97281

Retirement Systems of Alabama
David Bronner, CEO
135 South Union Street
Montgomery, AL 36104

Public Employees' Retirement Association of Colorado
Meredith Williams, Executive Director
1300 Logan Street
Denver, CO 80203

Massachusetts Pension Reserves Investment Management Board
James B.G. Hearty, Executive Director
84 State Street
Suite 250
Boston, MA 02109

State Retirement Agency of Maryland
Peter Vaughn, Executive Director
Carol Boykin, Chief Investment Officer
120 East Baltimore Street
16th Floor
Baltimore, MD 21202

Senator DORGAN. Mr. Moore, thank you very much for your excellent testimony.

Next, we will hear from Joan Claybrook, President of Public Citizen.

Ms. Claybrook.

STATEMENT OF JOAN CLAYBROOK, PRESIDENT, PUBLIC CITIZEN

Ms. CLAYBROOK. Good morning, Mr. Chairman. Thank you very much.

The epic crime wave with pervasive wrongdoing that has unfolded in recent months is no accident, and it's not limited to a few bad apples. It's the predictable result of a coordinated campaign with tons of campaign money over the last quarter century to remove government oversight and regulation of business practices and reduce or eliminate the accountability of corporations and their officers to the investors and the public.

This attack—it has covered not only financial, but health, safety, environmental, investor, telecommunications, energy, and consumer safeguards, as well as the civil justice system—has now come home to roost, and it has devastated families across America. It is time to restore accountability to corporate America.

President Bush has talked tough about corporate crime, but his proposals are meager and would make little change. He should start by relieving Army Secretary Thomas White of his duties. Mr. White headed a subsidiary of Enron that bilked families and the State Treasury of California by cruelly and fraudulently manipulating the deregulated energy markets. His division, Enron Energy Services, colluded with other Enron divisions to deceive the operators of California's electricity grid into believing that transmission capacity was full, triggering rolling blackouts and payments to Enron to ease congestion on transmission lines, which was false.

In the first 3 months of the year 2001, at the height of the California energy crisis, Mr. White's division traded more than 11 million megawatts of electricity in the California market, making nearly 98 percent of those trades with other Enron units at astronomical prices. In addition to this profiteering at the expense of California consumers and taxpayers, Enron Energy Services participated in the accounting trickery that artificially boosted stock prices and ultimately led to Enron's collapse, causing many investors and employees to lose their life savings.

Enron is under investigation for multiple criminal violations. Mr. White was an intimate part of Enron's criminal conduct. In 2001, he was paid $5.5 million, and he sold $12 million in Enron stock just before the company collapsed last December. If Mr. White is not accountable for his company's actions, why was he paid all this money? That's crony capitalism at its worst. White has millions in assets from Enron days in addition. He and his colleagues should be required to restore and provide restitution, just like any other criminal or thief, for his ill-gotten gains.

But until President Bush purges corporate malefactors from his own Administration, it will be difficult to convince the public that he is up to the task of reforming corporate America. And what kind of example is this for our children, who are told to obey the law and not to lie?

Turning to specific reforms, Public Citizen applauds the Senate passage of the Sarbanes' bill. This is a remarkable turnaround for the Senate on regulatory matters, one I hope heralds a new mind set when it comes to government's proper role in protecting consumers and workers and the environment from the consequences of misdeeds wrought by greedy and unethical corporate executives. But more is needed.

Congress should correct the way that corporate stock options are treated in the corporate books. The common thread in the recent

scandals is the fact that corporate boards lavish millions of dollars in stock options on top executives, giving them a strong incentive to cook the books to cause short-term spikes in stock prices so they could cash in. Enron CEO Ken Lay exercised $180 million in stock options from 1998 to 2000. And Jeffrey Skilling cashed in $117 million in options. Even though these options dilute shareholder value, they are not counted against profits and losses, and this is a scam on investors that must be stopped.

One of the ways of measuring the extent to which a company is involved in the option business is something called the "run rate," which compares the number of options to the number of shares, and generally it's conceded it should not exceed 1 percent. The 200 largest corporations in America have 2.6 percent; whereas, in 1990, it was 1.08.

The Sarbanes' bill rightly curtails the widespread practice of accounting firms providing non-auditing consulting services at the same time they are auditing a company's books, but it does not have an outright ban to this blatant conflict of interest, and it should.

In my full testimony today, which I ask to be in the record, the Public Citizen is releasing an analysis of accounting and consulting fees paid to the top 20 companies in the United States, and another 29 companies that are embroiled in accounting scandals, and comparing the two. We found there was a very close parallel between the two groups in terms of the percentage of total accounting fees that went to non-auditing consulting.

In 2001, the top 20 of the Fortune 500 paid a total of $880 million to accounting firms. That's $880 million, and 72 percent of that went for consulting services. Compare that to Enron, where it was about 50 percent. So the top 20 companies in the United States, in 2001, paid 72 percent to their auditors in consulting amounts.

The 29 companies in trouble paid 75 percent, very close to that. In other words, the incentive to falsify earnings is in place in the top 20 corporations, as well as the ones in trouble. And that's very close to the numbers for the year 2001.

Haliburton Company would have been in this group, except that in the year 2001 it was reduced. But in the year 2000, the last year of Vice President Dick Cheney's tenure as Haliburton CEO—Haliburton paid—86 percent of its fees went to consulting or non-audit services.

While legislation pending in Congress rightly addresses abuses in accounting, the one thing it does nothing for is the investor. It does nothing to help the investor recover the losses experienced because of fraud. Teachers, firefighters, police, factory workers, mail carriers, secretaries, small businesses—these are the people who do the work of America. These are the people who have lost the most in the stock market, in terms of their pensions and other investments for the future and their college savings.

Congress should reexamine three laws and one Supreme Court decision, the *Central Bank* case, that passed in the 1990s that seriously have undermined corporate accountability by making it exceedingly difficult for individual investors to recover damages for securities fraud. These actions helped create the climate of "anything goes" arrogance in the corporate boardrooms.

And I would point out that there was an article yesterday in *The Washington Post* that I would like to submit for the record, which indicated that when these shareholders' lawsuits are filed, it's a hint to the auditors that something is awry. The headline is "The Shareholder Lawsuit: A Red Flag for Auditors?"

[The article mentioned follows:]

[From the Washington Post, July 17, 2002]

THE SHAREHOLDER LAWSUIT: A RED FLAG FOR AUDITORS?

(By Jonathan Krim, Washington Post Staff Writer)

Corporate directors and auditing firms serious about preventing future accounting scandals might find clues in a place they typically revile: shareholder lawsuits.

Suits alleging financial improprieties preceded scandalous revelations at several companies, including WorldCom Inc., Tyco International Ltd. and Rite Aid Corp. Although the suits did not pinpoint the precise irregularities that have made recent headlines, accounting and legal experts say they can be valuable harbingers of lax financial standards.

Instead, shareholder suits often are treated as nuisance actions filed by predatory trial attorneys seeking to capitalize on a company's financial troubles, these experts contend.

They argue that as Congress and regulators grapple with an array of proposals for restoring public faith in corporate America's books, simply increasing the attention paid to the issues raised in such suits—even if they are unlikely to be successful in court—could help companies head off festering financial problems before they damage corporations, employees and investors.

"What usually happens is that the suits go to the legal department, and when they are mentioned if at all at board meetings, it's like swatting a fly or a gnat," said Ralph Estes, emeritus professor of accounting at American University and longtime advocate of more accountable corporate governance.

Estes and others say word of such suits should spur board members and outside auditors to inquire more aggressively and seek deeper financial reviews.

"Now, especially, boards need to ask more questions," said Peter Gleason, chief operating officer of the National Association of Corporate Directors. "How did this issue make its way to a lawsuit?"

Rick Antle, an accounting professor at Yale University, said that auditors "should not just balance the checkbook, and audit the company from a business point of view."

Shareholder suits grew in popularity with the onset of the technology bubble in the mid-1990s and its reversal of fortune in early 2000. When a company announced unexpectedly bad news, or its stock price dropped after earnings failed to meet market expectations, attorneys for shareholders would jump in to examine whether management had misled investors before the news surfaced. Lawsuits quickly followed.

Companies, especially technology firms whose stocks were volatile, fought back in Congress, arguing that the suits often were without merit and mere harassment. Industry won changes to the law that made suits more difficult to bring, after Congress overrode a veto by President Clinton.

But suits continue to be filed regularly. According to the Securities Class Action Clearinghouse at Stanford University Law School, 485 suits were filed in 2001 and 127 so far this year.

In WorldCom's case, shareholders filed suit last summer alleging a variety of fraudulent accounting practices, including failure to write off accounts that were unlikely to ever be paid and deliberately understating expenses overall. The suit was dismissed in March.

Last month, the company announced that it had improperly reclassified $3.9 billion in operating expenses as capital expenditures, enabling the firm to bolster its bottom line by spreading costs over several years.

One person familiar with the matter said that when the suit was raised at a WorldCom board meeting, it was not clearly presented as being focused on accounting issues.

Late last month, the former chief executive of the Rite Aid Corp. drugstore chain was indicted on charges of inflating the company's earnings, destroying evidence, witness tampering and moving company funds into a personal real estate business. Three other executives also were charged. The actions took place between May 1997

and May 1999, during which time several executives also received large bonuses from the firm.

Rite Aid was sued by shareholders in March 1999, when the company restated earnings and erased $1.6 billion in profit. The company paid out $193 million in claims.

"The indictments of Rite Aid management late in June 2002, which include charges of lying to and misleading the auditors, and the actions brought by the Securities and Exchange Commission at that time, affirm our position that Rite Aid represents a clear example of an auditing firm being victimized by company management," said KPMG spokesman Robert Zeitlinger.

At Tyco International, shareholders charged in late 1999 that the company issued materially false and misleading statements about key acquisitions. The suit also alleged that during the period, certain officers of the company sold Tyco shares at artificially inflated prices, for proceeds of at least $270 million.

Early last month, Tyco chief executive L. Dennis Kozlowski resigned, a day before he was indicted by a New York state grand jury on charges of evading more than $1 million in sales taxes on $13.2 million in rare paintings. Investigators also are looking at whether Tyco improperly paid for an $18 million Manhattan apartment and a $2.5 million home in Boca Raton, Fla., that belonged to a British nobleman who joined Tyco's board in 1997.

"Whenever there is a shareholder lawsuit, we look into the allegations carefully and defend ourselves where appropriate," said Tyco spokesman Gary Holmes.

Representatives of the major accounting firms said that they, too, respond to shareholder suits.

"If the auditors become aware of information that they think may have an impact on the financial statements . . . they are required to determine if the information is accurate and reliable," said Chuck Landis, head of auditing standards for the American Institute of Certified Public Accountants, a trade group. "Maybe that's going to management, unless the suit alleges fraud by management . . . then it might be going to the audit committee."

Landis said shareholder allegations, and the response from management, should be treated by the auditor with "professional skepticism."

A former audit manager for Arthur Andersen, which approved WorldCom's books during the time of its improper accounting, testified before Congress that he was aware of the suit against WorldCom, and claimed he took it into account.

"Any time when Andersen or any auditor does an audit, there is an examination and review of litigation filed against a client," said Andersen spokesman Patrick Dorton. "It's a component of generally accepted auditing standards and Arthur Andersen policy and audit methodology."

A spokesman for Ernst & Young declined to comment.

Attorneys for shareholders, many of whom were federal securities prosecutors, say that what happens in practice is different.

"From the time I was a criminal prosecutor . . . I would say, 'Why didn't you guys do anything with the class-action lawsuit?'" said Kenneth Vianale, a partner of the class-action law firm of Milberg Weiss Bershad Hynes & Lerach, which has pending cases against nearly 75 companies. "The answer was 'That's just a class-action lawsuit . . . we don't pay any attention to that.'"

Vianale, a former U.S. attorney in New York who prosecuted securities cases, said he is amazed at the number of companies that are sued by shareholders, pay out claims and then end up being sued again for similar problems.

He cited the case of Sensormatic Electronics Corp., which late last year was bought by Tyco. The Florida-based manufacturer of security systems was sued by shareholders in 1995 for improper accounting practices. It ultimately settled for $53 million.

The company has now been sued again by shareholders who charge company officials with making false statements about the company's sales.

Auditing firms also have been the targets of lawsuits, or are named as co-defendants. Last year, Arthur Andersen paid part of a $229 million settlement with shareholders of Waste Management Inc.

Landis of the auditing institute said that in such cases, "the auditors must ask themselves . . . whether by being named in a suit puts them in a position where they may no longer be objective" to conduct further audits.

It is a red flag for auditors. And yet in three statutes passed by the Congress in the 1990s, every effort was made to cut back on the capacity of the individual investor to regulate the corporations

that are misbehaving by filing lawsuits for their own protection and recovery.

The Private Securities Litigation Reform Act that was approved over President Clinton's veto in 1995 radically diluted laws against making false earnings projections, which we've certainly heard a lot about recently, and prevented fraud victims from obtaining the evidence they needed to survive a defendant's motion to dismiss. A securities fraud case against WorldCom, for example, was dismissed earlier this year, because, among other things, the Court found that the plaintiff's complaint did not attain the heightened pleading standard requirements for this type of case under the 1995 law.

Again, the corporate lobby came roaring back to further cut investors' rights after they passed the 1995 law. In 1996, Congress enacted the National Securities Markets Improvements Act which preempted much state regulation of securities transactions. And in 1998, they came back again, with Congress passing the Securities Litigation Uniform Standards Act, which forced virtually all securities fraud class-action lawsuits to be tried in the federal courts under weakened federal standards, taking away stronger protection for small investors under tougher state class-action laws, such as longer statute of limitations, aiding and abetting liability, and joint and several liability. The consumer who invests has been really harmed by the Congress' actions in the 1990s, and it has freed up these megacorporations to misbehave again and again.

After the disastrous manipulations of the California energy market, I am astounded that the Senate voted to repeal the Public Utility Holding Company Act of 1935 (PUHCA), one of the most basic protections that consumers have against rapacious energy companies. This is included in the energy bill passed by the Senate, not in the House bill.

Enron was able to manipulate markets and build a vast, impenetrable network of subsidiaries primarily because of loopholes that were created in PUHCA, and the law was not properly enforced. We must keep this important law on the books and ensure that the regulators enforce it, and we must see that these loopholes are closed.

One interesting report that was released yesterday on NBC Evening News was about the fees to the SEC. Each year, about $2.1 billion in fees are paid by investors for their transactions, but only $412 million of this goes to the SEC. Since 1991, $11.7 billion in fees have been paid, and only $3 billion have gone to the SEC. In other words, over $7 billion that the SEC could have had from the fees that are paid have been taken by the Treasury and not been given to the SEC.

In conclusion, Ms. Chairman and Mr. Chairman, let me say that corporate America loves Uncle Sugar. Uncle Sugar supplies subsidies, tax breaks, and all the other goodies that corporations love. But they don't like Uncle Sam. And Uncle Sam is now, it seems to me, beginning to take back the driver's seat. We urge that the Congress pass not only the Sarbanes' bill, but additional laws as I have recommended in a long list of remedies in my testimony so that the consumer and the investor is properly protected for the future.

Thank you very much, Mr. Chairman.
[The prepared statement of Ms. Claybrook follows:]

PREPARED STATEMENT OF JOAN CLAYBROOK, PRESIDENT, PUBLIC CITIZEN

The financial horror show that the American public has watched unfold across the corporate landscape over the past few months is nothing less than a corporate crime wave of epic proportions. We have seen the rise and fall of a new generation of robber barons, bearing striking resemblance—at least in greed and arrogance—to the Gilded Age executives of a century ago and to the corporate titans of the 1920s, when corruption in the boardrooms helped usher in the Great Depression. And to think it has been only a decade or so since taxpayers lost billions to the high-living thieves who raped the nation's savings-and-loan industry and drove it into the ground. How soon we forget.

We should not fall victim to the corporate apologists who would have us believe that this is the inevitable and natural consequence of the economic boom of the 1990s and that there are only a few bad apples involved. In fact, it is the opposite. We now are finding out that this speculative bubble grew larger and larger precisely because corporate executives were defrauding investors through accounting measures that hid the true nature of their profits and losses. And they had plenty of incentives to do so, because cozy board members, many with insider deals, granted them stock options and cheap loans that encouraged CEOs to cheat in order to run up stock prices in the short term so they could cash in.

These are not victimless crimes. The victims are policemen and firefighters, teachers, assembly line workers, mail carriers, secretaries and, yes, honest business men and women—the people who do the work of America, who live paycheck to paycheck and who fuel this economy with their work and their spending. The victims are the children whose college funds have evaporated, and the elderly, whose savings have been stolen.

The American people are angry. And they should be. Since March 2000, when the stock markets peaked, investors have seen $7 trillion evaporate into thin air. That's an unfathomable number for most of us. But it means real pain for millions of Americans who have been encouraged to invest their savings. Spurred on by corporate and government policies that have reduced and in many cases eliminated the old system of guaranteed pensions—and even facing the possibility that Social Security as we know it will be phased out—Americans have entrusted their retirement savings to the stock market. And now they find out the game has been rigged, and that they go broke while the crooks, who pay protection money to politicians, walk away with millions.

This corporate crime wave is no accident. It is the result of a well-focused political drive over the past quarter century to remove government oversight of business practices and reduce or eliminate the accountability of corporations and their officers to investors and the public. Corporate America has campaigned with a full-scale attack on regulation of the financial securities markets and energy markets as well as the health, safety and environmental regulations that are designed to protect the public from death, injury and disease and ensure healthy, sustainable ecosystems, fisheries and wildlife.

Following the impressive citizen gains of the late 1960s and early 1970s—when Congress enacted a raft of new health, safety, environmental, consumer and civil rights protections—corporate America launched a cynical campaign to limit the government's power. This coordinated attack on citizen safeguards has been propelled by literally billions of dollars of shareholder money for political contributions, right-wing think tanks, lobbyists, smear campaigns, TV advertising and fake grassroots organizations. Both major political parties have seen a dramatic increase in contributions from big companies. Corporations have accounted for nearly 90 percent of all soft money contributions to the parties since 1995, according to the Center for Responsive Politics. Corporate soft money grew from $209 million in the 1996 cycle to $383 million in 2000. The corporate leaders who give shareholder money to politicians demand—and usually get—something in return for this political investment.

Corporate America's campaign of deceit portrays government regulation as inherently evil, as an unwarrranted intrusion into the free market system and as a drain on capital investment, profitability and U.S. competitiveness. It also mocks and denigrates the judicial system, which punishes wrongdoing, imposes discipline on corporations when regulations fail, and allows injured parties to recover damages. According to corporate America's mythology, free markets can solve all our problems and government should just, as former President Reagan said, "get off our backs." Privatization of schools, Social Security, Medicare, water supplies and other com-

mons are sought. This free market ideology, of course, does not extend to corporate welfare. The very corporations that sponsor this hypocritical campaign continue to feed at the public trough, using their political connections to obtain tax breaks, subsidies, inflated contracts and other government largess. This ideology is useful, it seems, only when it lines the pockets of those preaching it.

This campaign by big business has severely distorted government's purpose and its functions. Enforcement budgets have been slashed. Health, safety and environmental protection rules have been sacrificed to the altar of self-regulation and an unfounded trust in corporate leaders. Congress and state legislatures across the country have erected new barriers to prevent injured consumers from obtaining justice in the courts. We now have a government that responds more to the greed motive of corporate leaders than to the legitimate needs of people. The system is rigged in favor of the business elite. And the public is mad.

I am amazed by the breadth and depth of the corporate corruption now being unraveled. But I am not surprised. Unfortunately, the weak financial regulatory system that has failed the American people is only one piece of deregulation. We have also seen politicians of both parties rush to assuage their campaign contributors by whittling away vital health, safety and environmental protections at the behest of powerful corporate entities that fill their campaign coffers.

Corporate leaders remind me of Chicken Little. The sky is always falling. Seldom is there a new regulatory proposal that does not elicit howls of protests, typically characterized by complaints that new consumer safeguards will harm the economy or U.S. competitiveness. These complaints typically prove fallacious.

We should remember that government regulations do not just drop from the sky without warning. They are almost universally based on real societal needs, as demonstrated by deaths and injuries from faulty products and workplace hazards, devastated ecosystems, polluted groundwater, unhealthy air, and rivers laden with PCBs and other toxic chemicals. Years of research, analysis and public debate precedes the final implementation of most rules. In the 1960s, for example, we lobbied for the first regulations to cover the safety of automobiles. The automobile companies fought back furiously. Today, as a direct result of improving automobile designs, cars and trucks are vastly safer. In 1966, there were 5.5 fatalities for every hundred million miles traveled by the American public. By 2000, that ratio had dropped to 1.5—a remarkable difference. Despite their dire warnings, the automobile companies are still in business and still making lots of money.

There are many, many more examples. So many, in fact, that Americans now take these safeguards for granted. They know the air is healthier than it was in the 1960s. They know rivers, lakes and bays are cleaner. They know that many unsafe pharmaceutical drugs and other products have been taken off the market, yet corporate America continues to peddle its siren's song—that government regulation is the enemy of free enterprise and profits. And their revolving-door lobbyists are able to make headway because the road is paved with the gold of massive campaign contributions.

This campaign money buys more than access. It buys policy. How else can one explain the incredible deference paid by this Congress to the pharmaceutical industry? This industry, in the current election cycle alone, has given more than $10 million in unregulated soft money to politicians of both major parties. This industry spent obscene amounts of money on lobbying in 2001—$78 million—according to a recent Public Citizen report, and employed 623 lobbyists—more than one for every member of Congress. This money has stymied efforts to enact a meaningful prescription drug plan under the Medicare program.

Another example is the nuclear industry, which just won passage of legislation to build a massive nuclear waste dump at Yucca Mountain, Nevada, requiring the transportation of 77,000 tons of high-level nuclear waste through major population centers by truck, train and barge over 30 years. Since 1997, the nuclear industry has contributed more than $30 million in individual, PAC and soft money donations to federal candidates and parties, 68 percent of which went to Republicans. Why do they give this money if not to influence policy? And how can anyone justify making government decisions based on campaign money?

The point is that corporate America exercises far too much control over what passes—or doesn't pass—through the Congress. It is time for corporate rule to end. We must restore integrity to our business entities and to the political process. To do that, the Congress and the White House must stand up to the corporate lobbyists and start legislating and governing on behalf of the American people. We need strong regulation of corporations—standards that will prevent wrongdoing and then punish executives who violate the public trust.

Army Secretary Thomas White

President Bush, who recruited his top government officials liberally from the corporate boardrooms, is talking tough about accountability for corporate leaders. But does he mean it? I would like to read a quotation about corporate accountability for CEOs from Treasury Secretary Paul O'Neill, from the July 11 edition of USA Today: "Whatever happens in your organization, you're responsible for it. There aren't any excuses for you to say, 'I didn't know. I didn't understand.'"

I agree wholeheartedly with Secretary O'Neill. To meet this standard of conduct, and to begin restoring his credibility on this issue with the American public, President Bush should immediately relieve Army Secretary Thomas White of his duties. Mr. White is the poster boy for corporate abuse. But instead of being held accountable, he now has his hand on the Army's massive budget.

Before being appointed to his position, Mr. White headed a subsidiary of the infamous Enron Corp. that blatantly manipulated the energy market in California to cause an artificial shortage of electricity, lied to state officials and cheated hard-working consumers out of literally millions upon millions of dollars with intricate schemes designed to rig the energy-trading markets and unfairly inflate company profits. According to numerous sources, his division also employed the same type of questionable accounting measures that have defrauded investors and enriched corporate insiders at other companies.

Let me review the publicly available facts surrounding Mr. White's tenure at Enron. Up until the day he was nominated by President Bush and confirmed by the Senate in May 2001 to serve as Secretary of the Army, Thomas White was a high-ranking executive at Enron, where he had worked for 11 years. Since 1998, Mr. White served as vice chairman of Enron Energy Services, a retail services and wholesale energy trading subsidiary of Enron. As vice chairman, Mr. White shared oversight of the division's responsibilities with Lou Pai.

As vice chairman, he was in charge of negotiating many of Enron's retail energy contracts. During his tenure, Enron Energy Services became one of Enron's fastest-growing subsidiaries through the use of questionable accounting practices. Enron Energy Services' revenues climbed 330 percent to more than $4.6 billion in 2000—up from $1 billion when Mr. White became vice chairman in 1998. Much of this revenue increase is attributable to aggressive accounting techniques, including so-called "mark-to-market" bookkeeping, under which Enron booked much of the long-term retail contracts' revenue immediately—providing the company with inflated revenues.

For example, in February 2001, Mr. White played a role in the high-profile signing of a retail energy services contract with Eli Lily. Enron claimed it was a 15-year deal worth $1.3 billion, but the details of the contract show that Enron paid Eli Lily $50 million up front as an enticement to sign the deal. Former employees of the division allege Mr. White's division used questionable accounting practices to create illusory earnings. Using "mark-to-market" accounting, Enron Energy Services would, for example, estimate that the price of electricity would fall over the life of a contract, and the unit would book an immediate profit on the contract.

Glenn Dickson, an Enron Energy Services director laid off in December, claimed that both Mr. White and Mr. Pai "are definitely responsible for the fact that we sold huge contracts with little thought as to how we were going to manage the risk or deliver the service."

While Enron Energy Services' reputation on Wall Street was as a retail supplier of energy, the division also was one of Enron's four registered power marketers, trading substantial amounts of energy in deregulated wholesale markets during Mr. White's tenure. According to internal Enron memos obtained by the Federal Energy Regulatory Commission and released in May, Mr. White's division played a key role in manipulating the West Coast energy market from May 2000 until the day he left in June 2001. Enron Energy Services colluded with other Enron divisions to deceive operators of California's energy grid into believing that transmission capacity was full. In the first three months of 2001—at the height of skyrocketing prices and rolling blackouts—this division traded more than 11 million megawatts of electricity in the California market alone, making nearly 98 percent of these trades with other Enron divisions at astronomical prices up to $2,500 per megawatt hour.

This type of manipulation scheme was damaging because it led California officials to believe that transmission lines were clogged, and so power was intentionally shut off to millions of Californians. Meanwhile, Enron was able to profit by getting the state to pay Enron for relieving congestion on transmission lines. This naked profiteering and fraudulent activity by Enron caused a massive disruption in the economy of California and the lives of citizens there. Electricity rates soared. Small businesses suffered. Rolling blackouts cut power to millions. Pacific Gas and Electric, California's largest investor-owned utility, was victimized by exorbitant wholesale

rates that it could not recover and sought bankruptcy protection in April 2001. California Edison also went deeply into debt, but has not filed for bankruptcy. The state of California was forced in January 2001 to begin spending billions of dollars to purchase power for its residents.

Regulators found it difficult to trace Enron's trades because the company had four separate divisions interacting in the wholesale and retail markets, and with each other, with little transparency. These practices also allowed various Enron units to overstate revenues and contributed to the accounting gimmickry that artificially inflated the company's share prices.

While it is unclear as to whether or not Mr. White personally knew all of the details of these fraudulent trading practices, it is very clear that he profited from them.

When President Bush nominated Mr. White for the post, he cited his experience as a top Enron executive as a primary qualification. Mr. White made tens of millions of dollars during his tenure at Enron. In 2001 alone, he was paid $5.5 million in performance-based salary and he sold $12.1 million in Enron stock just before the company collapsed in December 2001. Last year Mr. White owned three opulent homes and condos, with a total value of more than $16 million.

And just like President Bush, Mr. White had a problem reporting some of these stock sales to the Securities and Exchange Commission, as required by law. Here is an excerpt from page 29 of a Schedule 14a filed by Enron with the SEC on March 27, 1995: "Section 16(a) of the Securities Exchange Act of 1934 requires Enron's executive officers and directors, and persons who own more than 10 percent of a registered class of Enron's equity securities, to file reports of ownership and changes in ownership with the SEC and the New York Stock Exchange. Based solely on its review of the copies of such reports received by it, or written representations from certain reporting persons that no Forms 5 were required for those persons, Enron believes that during 1994, its executive officers, directors and greater than 10 percent stockholders [sic] complied with all applicable filing requirements, except that Thomas E. White failed to timely file one report for one transaction."

In addition, Mr. White has been habitually late in reporting to Senators when asked to disclose his Enron holdings after being named Army Secretary. He agreed to divest all of his Enron holdings within 90 days. He subsequently received at least two extensions from the Senate Armed Services Committee. But he was reprimanded by the leadership of the Committee when members learned that he continued to hold a large chunk of Enron stock options into January 2001 and had failed to inform them that he had accepted a pension partly paid by Enron.

Mr. White's ethical lapses continued, when in March 2002, he flew on an Army jet with his wife at taxpayer expense to Aspen, Colorado, to sign the papers on the sale of a $6.5 million estate.

While at Enron, Mr. White became a very wealthy man. What was the purpose of his compensation? If he is not accountable for what went on in his company, then why was he paid these millions? Was it because of his business acumen? Was it because of his connections to the Defense Department at a time when Enron was trying to win military contracts? The bottom line is that if Mr. White knew what was going on with Enron Energy Services, he has no business running the Army. If he did not know, he is an incompetent manager and therefore should resign his post.

President Bush has appointed many others from the corporate boardrooms, giving Americans the sense that the foxes are indeed guarding the henhouse. No wonder the stock market has been plunging since the president gave a tepid speech on Wall Street last week. The former lawyer and chief lobbyist for the Big Five accounting firms, who opposes the Sarbanes bill's independent accounting standards board, now heads the Securities and Exchange Commission. And Deputy Attorney General Larry D. Thompson, the president's choice to lead his new corporate fraud task force, used to sit on the board of Providian Financial Corp., a credit card company that paid more than $400 million to settle allegations of consumer and securities fraud. Mr. Thompson, according to the Washington Post, sold stock worth nearly $5 million just a few months before Providian began to disclose business problems that led to a collapse in the company's stock price. That is the same pattern that we have seen with other corporate scandals. President Bush himself, as well as Vice President Dick Cheney, also have been implicated in possible accounting irregularities and stock sales that preceded sharp drops in stock prices.

We are not inspired by President Bush's recent call for $100 million to be added to the SEC's budget, after he earlier sought to slash the agency's budget. Under Bush's recommendation, the SEC would have a budget of $513 million, a pittance compared to the Drug Enforcement Agency's budget of $1.8 billion. Much more is needed. And we should examine the penalties meted out to white-collar criminals. The average sentence for white-collar criminals is less than 36 months. By compari-

son, non-violent, first-time federal drug offenders get an average sentence of more than 64 months.

We hope that President Bush is serious about putting corporate criminals in jail. But the government's record over the past 10 years is not good. The SEC has referred 609 offenders to the Justice Department for criminal prosecution. Of those, 187 faced criminal charges, and only 87 went to jail.

Incentives to Cook the Books

Fortunately, the Senate on July 15 passed legislation to begin addressing these corporate abuses. Most unfortunately, the measure, the Sarbanes bill does nothing to help defrauded investors. But Public Citizen strongly endorses it as an important step because it: (1) begins to put an end to the failed self-regulation of the accounting industry by establishing an independent Public Company Accounting Oversight Board to monitor the accounting industry; (2) forbids some—but not all—non-auditing services performed by accounting firms that are simultaneously providing auditing services (although the Senate bill allows for case-by-case exemptions); (3) promotes a "fresh pair of eyes" by forcing accounting firms to rotate the lead accounting partners (but not accounting firms) on audits after five years; (4) addresses revolving-door conflicts of interest by prohibiting accounting firms from auditing companies whose top executives worked for the firm during the year before the audit; (5) strengthens the Financial Standards Accounting Board and gives it more independence from the industry; (6) requires CEOs and CFOs of public companies to personally vouch for the accuracy of financial reporting; (7) requires disclosure of insider stock trading within two days; (8) prevents executives from selling stock during employee stock sale blackout periods; (9) financially penalizes executives for earnings restatements; (10) restricts loans to executives; and (11) makes securities fraud a criminal offense and increases prison sentences for fraud.

It is unfortunate that the bill does not address one of the major underlying incentives that have prompted crooked executives and accountants to cook the books—the practice of granting stock options. The common thread woven through virtually all of the ongoing corporate scandals is the fact that executives were granted exorbitant stock options. Corporate boards have handed out stock options like candy, and they are not required to count them as an expense on their balance sheet, even though they dilute shareholder equity as surely as if the payments were made in cash. Because corporations do not have to account for these expenses, they have become an insider scheme to enrich executives. Though they were once believed to align the interests of management with shareholders, perversely, the opposite has occurred. As we've learned from Enron and other companies like Global Crossing, WorldCom and Qwest, the allure of stock options can drive executives to intentionally distort the numbers to create temporary run-ups in stock prices so they can cash out quickly, while investors are left to soak up the losses.

Research shows that more and more corporations are turning larger shares of their earnings over to insiders by increasing the number of stock options issued to executives and directors. At Enron, for example, Ken Lay exercised $180.3 million in stock options from 1998 to 2000, and Jeffrey Skilling cashed in $111.7 million in options.

"Stock option overhang" is a measure of the number of stock options granted to employees and directors (both the number already issued and the number of options promised in the near future) compared to the total number of shares held by investors and employees. This measure can estimate the potential of investors' shares to be diluted by stock options policy. Many institutional investors, such as large pension funds, don't want a stock option overhang to exceed 10 percent of shares outstanding. A February 2002 survey by the Investor Responsibility Research Center showed that the stock option overhang for the S&P 500 was 14.3 percent. And 13 of the 50 largest U.S. corporations had a stock option overhang that exceeded 14.3 percent. J.P Morgan Chase, for example, had an option overhang of more than 20 percent. Morgan Stanley was one of the highest at 36 percent.

Another way to measure the potential negative impact of stock options is the "stock option run rate." This adds up the stock options granted over the past three years, divides by three, and then divides by the total number of shares held by all investors and employees. Many experts agree that a stock option run rate exceeding 1 percent is excessively diluting investors' equity. Two hundred of the largest U.S. companies have stock option run rates of 2.6 percent, more than double the rate of a decade ago (1.08 percent in 1991), according to compensation consultants Pearl Meyer & Partners. Although a stock option run rate of 3 percent may look small at first glance, if these current scandals return the market to its historical 10 percent annual rate of return, that would mean a company with a stock option run rate

of 3 percent would see one-third of the company's value siphoned off by the time the stock options expire in 10 years.

It's also important to note the share of all stock options enjoyed by the top executive. A CEO holding more than 5 percent of all stock options should be considered excessive. So what to think about the CEO of Freddie Mac (10.9 percent), American International Group (10.6 percent), Fannie Mae (7.4 percent) and Wells Fargo (5.6 percent)?

This is a scam on investors. Companies are currently allowed to deduct these stock options as an expense in figuring their tax liabilities—but are not required to do so in reporting profits or losses to shareholders. Companies would not be so free in handing out so many options if they were counted as an expense. Plus, there should be requirements for executives to hold stock options for the long-term—not cash in during stock price spikes or shortly before the company announces bad news.

On July 16, the International Accounting Standards Board announced a unanimous decision to require that executive stock options be counted as a business expense by 2005 in the EU and Australia. The U.S. legislation should be identical.

Another common thread in the scandals is the practice by accounting firms of providing consulting services at the same time they are auditing the finances of corporations. Accounting firms that collect large consulting fees from the corporations they audit have a strong incentive to look the other way when corporations cook the books. In essence, the auditors are in part auditing their own company's work. The big accounting firms, which are supposed to audit the books of public corporations and certify to the board, public and investors that they accurately portray a company's financial status, have been seduced and corrupted by multimillion-dollar consulting services that they also provide to the same companies they are auditing. This creates an enormous and unconscionable conflict of interest that leads to the type of abuses we have seen in Enron, WorldCom, Tyco, Halliburton, Global Crossing, Adelphia, Xerox and others. The previous head of the SEC, Arthur Levitt, sought to end this conflict, but in the deregulatory climate of the 1990s, his proposal was quashed. And now working Americans are paying a severe price.

While S. 2673, the Public Company Accounting Reform and Investor Protection Act of 2002, does address these conflicts of interest by banning certain types of consulting contracts, it still allows many damaging consulting services—such as providing tax shelter advice—to be performed by companies that are in charge of audits.

Submitted with my testimony today is a new study by Public Citizen of these fees (see Appendix A and B). Public Citizen found that the 20 largest companies in the United States all had consulting relationships with their accounting firms in 2000 and 2001 that, at the very least, created incentives for cheating. In the aggregate, 72 percent of the $880 million in fees paid by these Fortune 500 companies to their accountants in 2001 were for consulting services—meaning that at the same time accounting companies were supposed to be looking out for shareholders, they were also helping their clients develop accounting schemes to hide income from taxation, or conceal debt and revenues from regulators and investors.

Some examples from the year 2001: AT&T paid $78 million to PricewaterhouseCoopers, 86 percent of which went for non-audit services. ExxonMobil paid $87 million to PricewaterhouseCoopers, 80 percent for non-audit services. General Motors paid $102 million to Deloitte & Touche, 79 percent for non-audit services. Chevron paid $64 million to PricewaterhouseCoopers, 83 percent for non-audit services. Duke Energy paid $15 million to Deloitte & Touche, 78 percent for non-audit services. Bank of America paid $74 million to PricewaterhouseCoopers, 81 percent for non-audit services.

We also looked at corporations whose practices have come under recent scrutiny. Enron was one of the best. It paid $52 million to Arthur Anderson in 2000, a mere 52 percent for non-audit services. The highest percentage we found was for BristolMyersSquibb, which in 2001 paid $41 million to PricewaterhouseCoopers, 93 percent for non-audit services. Halliburton in 2001 paid $27 million to Arthur Anderson, 73 percent for non-audit services. The year before, Halliburton paid $52 million to the company, 86 percent for non-audit services. Global Crossing in 2000 paid $14 million to Arthur Anderson, 84 percent for non-audit services. Tyco paid $35 million in 2001 to PricewaterhouseCoopers, 62 percent for non-audit services. WorldCom paid $17 million to Arthur Anderson in 2001, 74 percent for non-audit services.

How can this possibly be justified? Unless accountants are completely banned from providing both auditing and consulting services simultaneously to the same client, these conflicts of interest will continue to plague the industry.

In addition to these regulatory failures dealing with stock options and accounting rules, the rights of investors to protect themselves and recover for losses due to fraud have been severely curtailed by Congress and the U.S. Supreme Court. This has allowed corporate criminals to swindle investors with the knowledge that there was little they could do in return.

Laws Protecting Investors' Rights are Weakened

In the 1980s, a key target of this business attack on laws punishing financial fraud was the civil RICO (Racketeer Influenced and Corrupt Organizations Act) law. Amazingly, this onslaught was initiated in the midst of the revelations of self-dealing, insider trading and fraud by the savings-and-loan thieves. The scandal put a public face on this arcane but potent law. For a number of years, Public Citizen fought tooth-and-nail against the accounting industry lobbyists, who liberally lathered both Democratic and Republican Members of Congress with campaign money to obliterate this very effective law prohibiting conspiracy to defraud with its important attorney fees and treble damages for the victims. Without the determination and persistence of Senator Howard Metzenbaum, we would not have succeeded in stopping this corporate juggernaut. Without civil RICO, the bondholders in the Charles Keating S&L fraud would not have been fully compensated. The S&Ls and accounting firms paid out some $1.4 billion in damages for their fraudulent practices.

In the 1990s, two key Supreme Court cases were decided by 5-to-4 votes, and after the Republicans took over the Congress in 1995, three key pieces of legislation were enacted, the first one over President Clinton's veto, that, together, have taken the federal, state and investor cops off the corporate crime beat and have left many securities fraud victims without a remedy. At the same time, the funding of the Securities and Exchange Commission was not increased as the financial markets grew exponentially. Predictably, a business ethics gap matured into full flower, and we are now experiencing a corporate crime wave of untold proportions that is undermining public trust in our markets and robbing citizens of their pensions and life savings and kids of their college tuition nest eggs. Not surprisingly, the accounting industry gave liberally to Members of Congress from both parties. From 1990 to 2002, this industry gave almost $57 million dollars in campaign money, $24 million to Democrats and $33 million to Republicans.

In 1991, the U.S. Supreme Court in *Lampf, Pleva* limited the federal statute of limitations to one year from the discovery of securities fraud or three years from the violation, whichever is earlier, shortening the time that was allowed under federal law previously, when courts borrowed the generally longer state law limitation periods. In 1994, in the *Central Bank* case, the Court came down with a strict construction decision, holding that those engaged in "aiding and abetting" are not liable in consumer or investor federal securities fraud cases because these words are not specifically in the statute. Aiding and abetting had been universally recognized as a federal violation for 60 years since the enactment of the federal securities laws and was accepted in every federal circuit. The S&L scandal could not have been perpetrated without the active and knowing assistance of numerous professionals, particularly lawyers and accountants. By allowing these professionals to escape liability, this decision undercut recovery by the victims and diminished the incentive to exercise due care and prevent reckless or knowing misconduct in assisting in the perpetration of a fraud in violation of federal securities laws. Needless to say, Vinson & Elkins and Kirkland & Ellis—Enron's lawyers—have cited *Central Bank* in recent motions to dismiss shareholder litigation. We all know the power of corrupt lawyers and accountants. They are the engines that drives corporate fraud. They must be held accountable.

In 1995, following a massive lobbying campaign, Congress passed the Private Securities Litigation Reform Act over President Clinton's veto. It was promoted as necessary to stop so-called "frivolous" lawsuits, even though investor lawsuits had barely increased in the seven years prior to its enactment. But it was a nuclear bomb used to quash an ant hill. The act for the first time radically diluted laws against making false earnings projections (sound familiar today?). By rejecting an amendment to overrule the *Central Bank* decision, it also gave protection to accounting firms that approved false earnings statements, such as those issued by Arthur Andersen for Enron's massive deception. It granted companies and their accountants "safe harbor" protections, which Public Citizen criticized at the time. Thus accountants who failed to spot or disclose fraud could be given immunity from private lawsuits, as were companies issuing false earnings projections, even if they lied.

The act also forced defrauded investors to meet a high pleading standard with respect to a corporate officer's state of mind (generally only required in criminal cases); stayed discovery proceedings until the defendant's motion to dismiss is de-

cided, thus preventing fraud victims from obtaining the very evidence needed to defeat the motion; for the first time limited liability of auditors and other conspirators from full accountability under "joint and several liability"; failed to extend the statute of limitations imposed by the Supreme Court; eliminated treble damages as punishment for deliberate fraud under civil RICO; failed to restore private liability for aiding and abetting securities fraud; and for the first time required plaintiffs to divulge in the complaint any confidential sources, thus preventing fraud victims from gathering key evidence from confidential informants such as whistleblowers, employees, ex-employees, competitors and media.

The absence of these protections is directly related to the corporate fraud and failures we have been witnessing with dismay day after day. A securities fraud case against MCI WorldCom was dismissed earlier this year because, among other things, the court found that the plaintiff's complaint "does not attain the heightened pleading standard requirements for this type of case" under the 1995 law. The case alleged that the company and its top executives had "cooked the books" and fraudulently misled investors by artificially inflating the financial condition of the company, but the court found that there were not enough facts showing CEO Bernard Ebbers had acted with "actual knowledge or conscious misbehavior."

Also, a 1999 securities fraud case against Tyco International Ltd. was thrown out because of the 1995 law. It was filed after reports of spectacular earnings increases and huge stock sales by executives and directors, including Chairman and CEO Dennis Kozlowski, who sold $187 million in stock, Director Michael Ashcroft, who sold $37.4 million, and General Counsel Mark Belnick, who sold $7.6 million. There was a total of $252.8 in insider stock sales. Tyco then "restated" its financial statements after a limited SEC review. After two years of attempting to meet the harsh pleading standards of the 1995 law, the investors' action was dismissed by the court. Today, top executives are fired, indicted or under investigation, and many walked away with millions of dollars. The investors have not recovered their losses and the shortened statute of limitations has run. As the Washington Post headlined on July 17, 2002, "The Shareholder Lawsuit: A Red Flag for Auditors," these lawsuits serve a multitude of purposes—compensation for victims, deterrence and notice to auditors, the board and government enforcers.

Not satisfied with these cutbacks severely limiting the possibility of recovery by victims of securities fraud, the Congress in 1996 enacted the National Securities Markets Improvements Act, which preempted much state regulation of securities transactions. Again in 1998, the Congress cut back investor protection. It passed the Securities Litigation Uniform Standards Act, which forced virtually all securities fraud class action lawsuits to be tried in federal courts under the weakened federal law, taking away stronger protection for small investors under tougher state class action laws, such as longer statute of limitations, aiding and abetting liability, and joint and several liability.

At the same time, the independent Securities and Exchange Commission under Chairman Arthur Levitt was trying to change SEC rules to eliminate conflicts in the accounting companies by separating auditing and consulting services. The number of financial fraud cases, in Levitt's words, "absolutely exploded." Three big accounting firms—Arthur Andersen, Deloitte and KPMG—said, in Levitt's words, "We're going to war with you. This will kill our business. We're going to fight you tooth and nail. And we'll fight you in the Congress and we'll fight you in the courts."

Sure enough, Levitt shortly thereafter received a demand letter from three top chairmen on the House Commerce Committee: Tom Bliley, Mike Oxley and Billy Tauzin, making 16 demands for extensive information that tied the agency up for weeks and in Levitt's words "intended to really stand in the way of the rulemaking we had in mind." Levitt has described how the heat was kept up with "telephone calls, congressional hearings, and ultimately by threatening the funding of the agency . . . threatening its very existence." He was also threatened with a rider on his appropriations bill if he proceeded. Another letter came from Senate Banking Committee members Rod Grams, Evan Bayh, Phil Gramm, Charles Schumer, Mike Crapo, Rick Santorum, Chuck Hagel, Jim Bunning, Wayne Allard and Robert Bennett, opposing auditor independence rulemaking. After being urged again by many Members of Congress to make peace with the audit companies, Levitt agreed to a compromise rule that just called for corporations to bring to their Boards' audit committees any consulting contracts that they had made with their auditor. At Enron, Wendy Gramm, former chair of the Commodity Futures Trading Commission, sat on the audit committee.

As if these laws and court decisions had not harmed investors enough, now securities firms are using mandatory arbitration agreements to force aggrieved investors into a company's own, costly private judicial system, where there is limited dis-

covery, limited recovery and where arbitrators must depend on the defendants for repeat business.

I recently received a letter from a member of Public Citizen who wrote that he opened an investment account with Payne Webber and was required to sign a statement agreeing to arbitration in the event of a dispute with the company. He did this only after researching virtually every stock broker in the country and finding that he could not buy stocks without agreeing to arbitration. "This is a tragedy," he wrote.

One more way that corporate America has put the screws to the people without whom it could not survive.

Public Utility Holding Company Act

Particularly relevant to the fraudulent dealing and manipulation at Enron in which Army Secretary Thomas White participated is deregulation as it applies to energy policy. Despite the California electricity scandals, the unraveling of the stock market and almost daily revelations of new corporate abuses, we continue to see a drive to deregulate business—even in the energy sector. There is a provision in the recently passed energy legislation that will have a devastating impact on consumers and lead to more Enron-style abuses. On April 25, the Senate voted to repeal the Public Utility Holding Company Act (PUHCA). This vote to repeal PUHCA comes at a time when courts are finally using the law to rescue consumers. At a time when the Enron disaster and the failure of electricity deregulation across the country (a dozen states have repealed or delayed their deregulation laws) illustrate how vulnerable consumers and investors are to impenetrable corporate structures and unaccountable markets, PUHCA's protections are needed now more than ever.

PUHCA was enacted in 1935 in response to the United States' first Enron-style energy crisis in the 1920s. A handful of energy companies, employing business strategies strikingly similar to Enron's, held consumers hostage with complex, multi-state pyramiding schemes. These holding companies purchased financial, fuel and construction businesses through a complex web of subsidiaries. Not only did consumers pay inflated prices for energy to fuel the acquisition and operations of businesses unrelated to the core energy concerns, but investors were robbed because the holding company's assets were artificially inflated. These pyramiding schemes finally collapsed, ringing in the stock market crash of 1929 and the Great Depression.

The Securities and Exchange Commission is supposed to enforce PUHCA, which protects consumers by ensuring that multi-state utility companies re-invest ratepayer money into providing affordable and reliable electricity. A corporation must register as a "holding company" if it owns at least 10 percent of the stock of an electric or natural gas utility. Consumers benefit from PUHCA's requirements that holding companies invest only in "integrated systems"—utilities that are "physically interconnected"—thereby maximizing economies of scale by operating a single, coordinated system. PUHCA has historically prohibited holding companies from investing ratepayers' money in areas that will not directly contribute to low bills and reliable service, such as out-of-region power plants or non-electricity industries such as water and telecommunications.

PUHCA is the most important protection the federal government provides for electricity consumers. But the law's potency has been eroded over the past decade. Enron, with help from regulators and Congress, helped undermine the act's effectiveness by creating new loopholes. Incredibly, rather than proposing to close these Enron exemptions to prevent other energy companies from abusing consumers and investors, the response by the Bush Administration and Congress (including the Senate Democrat energy bill) is to repeal the entire law. Repealing PUHCA will lead to a rash of mergers, further threatening consumers.

PUHCA has lost much of its teeth as a result of deregulation, Enron's lobbying, and decisions by the SEC to simply ignore the law. First, Congress undermined PUHCA by passing the 1992 Energy Policy Act, permitting holding companies to invest ratepayer money in foreign power projects and divert resources away from American consumers. Second, Enron pushed a gaping hole in SEC regulation when the SEC, in response to a petition by the company, exempted power marketers like Enron from PUHCA on Jan. 5, 1994. As a result, power marketers—creatures of deregulation that don't own power plants but rather speculate on and trade electricity contracts—can trade free from government oversight in deregulated markets across the country. Finally, the SEC has refused to enforce the investment provisions of PUHCA, instead rubber-stamping mergers that are in direct violation of PUHCA's consumer protections—including the foreign acquisition of several U.S. utilities.

These loopholes have already resulted in a significant increase in utility consolidation. In 1992 (prior to the passage of the loophole-creating Energy Policy Act) the 10 largest utilities owned one-third of the national generating capacity. By 2000, the

top 10 owned half of all capacity, while the top 20 owned 75 percent. These numbers will become more concentrated if PUHCA is repealed, inevitably resulting in monopoly pricing.

Although proponents of repealing PUHCA claim that the law's ownership restrictions hinder adequate investment, corporate leaders appear to be more interested in repealing PUHCA to satisfy their craving for Enron-style accounting freedom and convergence. If PUHCA is repealed, a flurry of mergers will bury our electricity markets, rendering states incapable of regulating sprawling multi-state holding companies. The already overwhelmed Federal Energy Regulatory Commission (FERC) will face a daunting task in trying to regulate all energy markets. Both Democrats and Republicans propose replacing PUHCA's consumer protections with weaker ones that would be under the jurisdiction of FERC, which the GAO recently concluded was deficient in handling its current responsibilities. But these huge holding companies will have incentive to cover their tracks with Enron-esque accounting, and no state or federal agency will be able to verify the accuracy of the bookkeeping.

Enron's collapse exposed consumers and investors to the dangers of inadequate government oversight inherent in electricity deregulation. The combination of deregulated state wholesale electricity markets, federal deregulation of commodity exchanges and the creation of loopholes in PUHCA removed accountability and transparency from the energy sector. Had PUHCA's loopholes been closed and the law properly enforced, *Enron's fraud against shareholders and consumers never could have occurred!* PUHCA's ownership limits would have prevented the company from hiding revenues and debts in offshore tax havens and failed foreign projects, such as Enron's Dabhol power plant in India.

The solution is to strengthen PUHCA rather than repeal it. First, Congress must require the SEC to strictly enforce the act, and beef up funding and staff for the SEC. Second, the harmful loopholes pushed through by Enron and other energy companies must be closed. Holding companies must no longer be allowed to divert funds secured from consumers for this essential commodity to invest in foreign countries, and power marketers must be subject to PUHCA. Third, Congress can improve PUHCA by using it to address issues of market power. For example, Congress should grant federal and state regulators the authority to order holding companies to divest assets, expand anti-trust investigations and enforcement, and create non-profit, consumer-owned regional transmission councils to ensure non-discriminatory access to the grid.

It is important to note a recent court decision that could require the SEC to enforce PUHCA. In January 2002, the U.S. Court of Appeals for the District of Columbia ordered the SEC to revisit its decision to approve a merger between American Electric Power (AEP) and Central & South West (CSW). Public Citizen had maintained that the SEC's earlier decision to approve this merger between Ohio-based AEP and Texas-based CSW violated PUHCA's requirements that holding companies have interconnected systems. The SEC had ruled that because the two utilities are connected by a lone, 250-mile transmission line owned by an unrelated company that the merger satisfied PUHCA! The judge's decision illustrates that the court has finally noticed that the SEC has refused to enforce the law and will force the review of other recently approved mergers that clearly violate PUHCA (Progress Energy, a union between Florida Progress and Carolina Power & Light; Exelon, a product of PECO Energy and Unicom; Xcel, a merger between Northern States Power and Public Service Co., and the foreign acquisition of Oregon-based Pacificorp by Scottish Power).

Remedies

The public is paying a dear price for the follies of the 1990s. The dreams and hopes of tens of millions of families across America are being dashed by the misbehavior of unethical companies spurred by greed. The Congress has permitted this disaster, and we are pleased to see it taking some corrective action. We support the new corporate accountability requirements contained in the Sarbanes bill but believe Congress must go further to protect consumers, investors and employees of corporations. We applaud the criminal penalties it contains. They should apply as well to knowingly selling defective products that kill or injure.

One critical ingredient that is still missing is the ability of investors to recover damages when regulators fail to prevent harm. We all know that regulations alone are not sufficient to deter wrongdoing. Federal agencies are often underfunded and are sometimes poorly managed. Congress and several court decisions have undercut the ability of citizens to seek proper justice in the courts. These rights must be restored.

In addition, there are key consumer protections contained in the Public Utility Holding Company Act, which is repealed in the Senate's energy legislation. This law has been weakened in piecemeal fashion by a lack of enforcement and Congressional actions. It should remain on the books, be improved and be enforced vigorously. Finally, even with the Sarbanes bill, there remain problems with corporate governance and possible conflicts of interest in the accounting industry.

The following are Public Citizen's specific recommendations:

Investor Recovery for Fraud

The two Supreme Court decisions and the three statutes cutting back liability to investors for corporate fraud must be changed, as I have testified. Professionals, including accountants and attorneys, must be liable for aiding and abetting. And the statutes of limitation must be longer, as provided in the Sarbanes bill, given the difficulty of learning the truth about fraudulent activity.

The Private Securities Litigation Reform Act must be largely repealed to give investors a level playing field in their efforts to recover against corporate giants who control all the information about any financial misbehavior. And federal laws should not limit state regulation or state courts from protecting investors merely because some states have more progressive laws than the existing federal law. Further, securities firms should not be allowed to impose their own private legal system of mandatory predispute arbitration that prohibits court adjudication of disputes. If companies know there is a strong likelihood of federal or state government or private enforcement, they will be far more likely to behave.

Gag orders in the settlement of litigation, often demanded by corporations, must be prohibited if they would result in covering up corporate fraud against investors.

Restoring Strong Regulation to Energy Markets

Do not repeal the Public Utility Holding Company Act in the pending energy bill.

Re-regulate energy trading. Pass Senator Feinstein's bill, which would restore accountability in energy markets by overturning the 1993 decision to not extend CFTC jurisdiction over energy trading contracts and the Commodity Futures Modernization Act of 2000 (which deregulated over-the-counter energy trading), allowing companies like Enron to operate unregulated power auctions.

Strengthen the regulatory and enforcement power of the Securities and Exchange Commission by extending jurisdiction over power marketers.

Amend the Federal Power Act, forcing the Federal Energy Regulatory Commission to revoke market-based rates and order cost-based pricing in all wholesale electricity markets.

Corporate Executive Obligations and Limits

First and foremost, stock options must be treated as an expense by corporations, as Senator McCain has so effectively argued. Overuse of options has distorted the financial markets, diluted shareholder value, and encouraged greedy executives to manipulate corporate books to drive stock prices higher in the short term at the expense of long-term stability and financial health. If options are exercised, as Senator McCain suggests, the net gain after taxes should be held in company stock until 90 days after departure from the company.

Repricing or swapping of stock options for executives must be prohibited (Business Week reports that 200 companies regularly did this for the corporate elite).

Top executives and board members should be prohibited from selling company stock while still employed or serving there.

Company loans to corporate officers or directors must be prohibited. (412 of 1,000 U.S. companies lent money to top executives, often at low interest rates, from 1991 to 2000—almost double the number from the prior decade.)

Executives must return all compensation, as Senators Dorgan and McCain have urged, that is directly derived from proven misconduct. While the SEC already has authority to require disgorgement of ill-gotten gains, in 2002 it has requested it in only four cases out of hundreds of "restatements" and dozens of investigations of accounting failures.

Auditor Responsibility

The Sarbanes bill properly requires auditors to report to the Board (which is supposed to represent shareholders, not be handmaidens to management). The bill limits auditors from providing many consulting services and requires preapproval by the Board audit committee where allowed. Consulting services by auditors should be completely prohibited.

The Sarbanes bill requires the audit personnel to rotate every five years but does not require a new audit company. A new audit company is needed to take a fresh look at the company's books.

Corporate Governance

The corporate compensation committee must be composed of board members with no personal relationship with management or special relationship with the company. The compensation, audit and nominating committees should be made up of only independent members.

No more that two board members should be insiders.

Directors should not serve on more than three boards.

If shareholder resolutions pass by a majority of votes cast for three consecutive years they should be considered adopted.

Shareholder meetings should be held in locations where the largest number of shareholders reside, not in remote locations where most cannot attend.

Securities and Exchange Commission

In addition to increasing staffing and funding for the SEC, the SEC must ensure transparency of its actions and of reporting by companies in formats that enhance the ability of shareholders to evaluate this complex information.

Pension Reform

Limit the percentage of a company's stock that can go into a pension fund;

Allow employees to move investments in pension plans from company stock to other securities (a right denied to Enron's unfortunate employees).

Require employees to have equal representation on the 401(k) boards that oversee pension systems.

Require investment advisers to be independent, without ties to the company.

There are five attachments to my testimony: (A) a Public Citizen compilation of spending for accounting services—auditing versus non-auditing services—by corporations that have recently been implicated for questionable accounting, for the years 2000 and 2001; (B) a Public Citizen compilation of spending by the nation's 20 largest corporations on accounting services in 2000 and 2001—auditing versus non-auditing services; (C) a copy of the April 17, 2000, letter from the leadership of the House Commerce Committee to then-SEC Chairman Arthur Levitt, referenced in my testimony; (D) a copy of a Sept. 20, 2000, letter from Enron CEO Ken Lay to then-SEC Chairman Arthur Levitt, commenting on the SEC's proposed rulemaking regarding auditor independence; and (E) a list of 50 thoughtful recommendations for stemming corporate abuses, taken from "Corporate Crime and Violence," a 1988 book written by Russell Mokhiber, who is the editor of the weekly newsletter Corporate Crime Reporter.

I would like to finish with a quote from the May 6, 2002, edition of Business Week. It says that "the challenge in coming years will be to create corporate cultures that encourage and reward integrity as much as creativity and entrepreneurship. To do that, executives need to start at the top, becoming not only exemplary managers but also the moral compass for the company. CEOs must set the tone by publicly embracing the organization's values. How? They need to be forthright in taking responsibility for shortcomings, whether an earnings shortfall, product failure, or a flawed strategy and show zero tolerance for those who fail to do the same."

Thank you very much.

Appendix A.—Corporations Embroiled in Scandal and Fees Paid to Accountants

Fees in millions ($)	2000	Percent of fees for consulting	2001	Percent of fees for consulting	Accountant	Scandal in Brief
Adelphia Communications	$3.5	62	n/a	n/a	Deloitte & Touche	Investigations by the SEC and 2 grand juries.
auditing	1.3		n/a			
non-audit and consulting	2.2		n/a			
Bristol Myers Squibb	25.7	89	41.3	93	PricewaterhouseCoopers	Under investigation by the SEC.
auditing	2.8		2.7			
non-audit and consulting	22.9		38.6			
Cendant Corp.	27.9	80	32.4	79	Deloitte & Touche	Former Chairman indicted for accounting scheme.
auditing	5.6		6.9			

Appendix A.—Corporations Embroiled in Scandal and Fees Paid to Accountants—Continued

Fees in millions ($)	2000	Percent of fees for consulting	2001	Percent of fees for consulting	Accountant	Scandal in Brief
non-audit and consulting	22.3		25.5			
CMS Energy	3.9	60	5.6	71	Arthur Andersen	Embroiled in energy trading/accounting scandal.
auditing	1.6		1.6			
non-audit and consulting	2.3		3.9			
Computer Associates International	2.9	42	n/a	n/a	KPMG	Paid fine to Justice Dept., under investigation by SEC.
auditing	1.7		n/a			
non-audit and consulting	1.2		n/a			
Dollar General Corp.	1.4	7	1.3	8	Ernst & Young	
auditing	1.3		1.2			
non-audit and consulting	0.1		0.1			
	0.7	67	n/a*		Deloitte & Touche	Settled a class-action lawsuit for $162 million for accounting problems.
auditing	0.2					
non-audit and consulting	0.5					
Duke Energy	15.2	78	15	78	Deloitte & Touche	Investigations by the SEC, CFTC over trading and accounting problems.
auditing	3.4		3.3			
non-audit and consulting	11.8		11.7			
Dynegy	7.3	56	8.0	59	Arthur Andersen	Investigations by the SEC, CFTC over trading and accounting problems.
auditing	3.2		3.2			
non-audit and consulting	4.1		4.7			
El Paso	5.9	68	12.3	65	PricewaterhouseCoopers	Embroiled in energy trading/accounting scandal.
auditing	1.9		4.3			
non-audit and consulting	4.0		8.0			
Enron	52.0	52	n/a	n/a	Arthur Andersen	Took advantage of lax regulations to defraud consumers & investors.
auditing	25.0		n/a			
non-audit and consulting	27.0		n/a			
Global Crossing	14.2	84	n/a	n/a	Arthur Andersen	Under investigation by the FBI and SEC for accounting fraud.
auditing	2.3		n/a			
non-audit and consulting	12.0		n/a			
Halliburton	51.5	86	26.5	73	Arthur Andersen	In May the SEC began investigating Dick Cheney's role
auditing	7.4		7.2			

Appendix A.—Corporations Embroiled in Scandal and Fees Paid to Accountants—Continued

Fees in millions ($)	2000	Percent of fees for consulting	2001	Percent of fees for consulting	Accountant	Scandal in Brief
non-audit and consulting	44.1		19.3			
IMClone Systems	0.2	63	0.4	58	KPMG	CEO arrested for insider trading, Martha Stewart also under investigation.
auditing	0.1		0.2			
non-audit and consulting	0.1		0.2			
Kmart	12.8	91	n/a**		PricewaterhouseCoopers	Under investigation by the SEC for accounting fraud.
auditing	1.1					
non-audit and consulting	11.7					
Lucent Technologies	n/a		62.6	88	PricewaterhouseCoopers	Under investigation by the SEC for accounting fraud.
auditing			7.6			
non-audit and consulting			55.0			
Martha Stewart Living Omnimedia	1.0	69	0.8	64	Arthur Andersen	Martha Stewart is under investigation by the SEC for insider trading.
auditing	0.3		0.3			
non-audit and consulting	0.7		0.5			
Merck & Co	6.3	33	6.5	34	Arthur Andersen	Shareholder lawsuits concerning accounting problems.
auditing	4.2		4.3			
non-audit and consulting	2.1		2.2			
MicroStrategy	2.1	62	1.4	36	PricewaterhouseCoopers	Settled a suit brought by the SEC for accounting fraud.
auditing	0.8		0.9			
non-audit and consulting	1.3		0.5			
Mirant	13.5	84	13.1	77	Arthur Andersen	Embroiled in energy trading/accounting scandal.
auditing	2.2		3.0			
non-audit and consulting	11.3		10.1			
Network Associates	5.0	71	4.0	61	PricewaterhouseCoopers	Under investigation by the SEC for accounting fraud.
auditing	1.5		1.6			
non-audit and consulting	3.5		2.4			
Peregrine Systems	1.0	82	n/a	n/a	Arthur Andersen	Under investigation by the SEC for accounting fraud.
auditing	0.2		n/a			
non-audit and consulting	0.9		n/a			
PNC Financial Services Group	19.1	85	18.8	79	Ernst & Young	Forced to restate $155 million after SEC investigated.
auditing	2.9		3.9			

Appendix A.—Corporations Embroiled in Scandal and Fees Paid to Accountants—Continued

Fees in millions ($)	2000	Percent of fees for consulting	2001	Percent of fees for consulting	Accountant	Scandal in Brief
non-audit and consulting	16.2		14.9			
Qwest Communications	7.9	86	11.8	89	Arthur Andersen	Under investigation by the SEC for accounting fraud.
auditing	1.1		1.4			
non-audit and consulting	6.8		10.5			
Reliant Energy	22.1	84	33.2	87	Deloitte & Touche	Embroiled in energy trading/accounting scandal.
auditing	3.6		4.3			
non-audit and consulting	18.5		28.9			
Rite Aid	20.6	50	7.9	37	Deloitte & Touche	Indicted by the SEC for accounting fraud.
auditing	10.4		5.0			
non-audit and consulting	10.2		2.9			
Tyco	n/a	n/a	34.9	62	PricewaterhouseCoopers	Under investigation by the SEC for accounting fraud.
auditing	n/a		13.2			
non-audit and consulting	n/a		21.7			
Waste Management	79.0	39	23.3	41	Arthur Andersen	Fined by the SEC for accounting fraud.
auditing	48.0		13.7			
non-audit and consulting	31.0		9.6			
WorldCom	26.7	86	16.8	74	Arthur Andersen	Under investigation by the SEC for accounting fraud.
auditing	3.8		4.4			
non-audit and consulting	22.9		12.4			
Xerox	18.8	40	n/a	n/a	KPMG	Paid a $10 million fine to the SEC for accounting fraud.
auditing	11.3		n/a			
non-audit and consulting	7.5		n/a			
Totals, Corporate Scandals	$448.3	67	$377.9	75		
auditing	$149.1		$94.2			
non-audit and consulting	$299.1		$283.7			

*Deloitte & Touche was dismissed as the auditor in September 2001.
**Filed for bankruptcy 8 days before they would have been required to disclose for 2001.

Appendix B.—America's 20 Largest Corporations and Consulting Fees Paid to Accountants

Fortune 500 rank	Fees in millions ($)	2000	Percent of fees for consulting	2001	Percent of fees for consulting	Accountant
15	AT & T	56.2	86	78.2	92	PricewaterhouseCoopers
	Auditing	7.9		6.6		
	Non-Audit & Consulting	48.4		71.6		
16	Boeing	34.8	70	28.2	52	Deloitte & Touche
	Auditing	10.5		13.4		
	Non-Audit & Consulting	24.3		14.8		
17	El Paso	5.9	68	12.3	65	PricewaterhouseCoopers
	Auditing	1.9		4.3		
	Non-Audit & Consulting	4.0		8.0		
18	Home Depot	4.5	78	6.2	81	KPMG
	Auditing	1.0		1.2		
	Non-Audit & Consulting	3.5		5.0		
19	Bank of America	49.4	73	74.2	81	PricewaterhouseCoopers
	Auditing	13.2		14.0		
	Non-Audit & Consulting	36.3		60.2		
21	JP Morgan Chase	105.5	80	75.0	62	PricewaterhouseCoopers
	Auditing	21.3		28.8		
	Non-Audit & Consulting	84.2		46.2		
	Total Top 20 Fortune 500	$938.6	74	$880.4	72	
	Auditing	$243.9.		$244.5		
	Non-Audit & Consulting	$694.7		$635.8		

Top 20 Fortune 500 companies as determined by the April 15, 2002 issue of Fortune magazine.
* 2000 ChevronTexaco includes only Chevron corp.
JP Morgan Chase, ranked 21st by Fortune, replaces Fannie Mae, ranked 20th, because Fannie Mae does not file Schedule 14a filings.
Source: Company Schedule 14a filed with the Securities and Exchange Commission. Compiled by Public Citizen www.citizen.org/cmep

Introduction of letter to Arthur Levitt, Chairman, Securities and Exchange Commission, from Kenneth L. Lay

At the height of the debate over auditor independence in 2000, Ken Lay sent this eye-opening letter to Arthur Levitt, then Chairman of the SEC, urging him to back down on his efforts to eliminate the potential conflicts of interest created when accountants provide both auditing and consulting services to a single client. The letter argued that Levitt was jeopardizing the productive relationship Enron had built with Andersen, one in which Andersen had become so deeply intertwined with Enron that its staff had moved into the same building, taken over much of the internal auditing usually left to Enron employees, and expanded rapidly into the highly profitable area of consulting. Andersen touted this "integrated audit" as a new paradigm in corporate accounting.

Although ostensibly from Lay, the letter was secretly co-authored by Andersen partner David Duncan in consultation with the firm's lobbyist in Washington as a part of the accounting industry's massive lobbying effort against Levitt's reforms. Letters such as this one, coupled with enormous pressure from Congress, forced Levitt to back down on the issue of auditor independence and eventually to adopt a less stringent rule, a move he later called the "biggest mistake" of his time at the SEC.

ENRON CORPORATION
Houston, TX, September 20, 2000

Hon. ARTHUR LEVITT,
Chairman,
Securities and Exchange Commission,
Washington, DC.

Dear Chairman Levitt:

I would like to take this opportunity to comment on the Securities and Exchange Commission's proposed rulemaking regarding auditor independence, on behalf of Enron Corporation. Enron is a diversified global energy and broadband company that prides itself on a uniquely entrepreneurial business philosophy and on creating knowledge-based value in emerging markets.

For the past several years. Enron has successfully utilized its independent audit firm's expertise and professional skepticism to help improve the overall control environment within the company. In addition to their traditional financial statement related work, the independent auditor's procedures at Enron have been extended to include specific audits of and reporting on critical control processes. This arrangement has resulted in qualitative and comprehensive reporting to management and to Enron's audit committee, which has been found to be extremely valuable. Also, I believe independent audits of the internal control environment are valuable to the investing public, particularly given the risks and complexities of Enron's business and the extremely dynamic business environment in which Enron and others now operate.

While the agreement Enron has with its independent auditors displaces a significant portion of the activities previously performed by internal resources, it is structured to ensure that Enron management maintains appropriate audit plan design, results assessment and overall monitoring and oversight responsibilities. Enron's management and audit committee are committed to assuring that key management personnel oversee and are responsible for the design and effectiveness of the internal control environment and for monitoring independence.

The proposed rule would preclude independent financial statement auditors from performing "certain internal audit services." The description of inappropriate activities included in your current proposal is so broad that it could restrict Enron from engaging its independent financial statement auditors to report on the company's control processes on a recurring basis as the company has now arranged. I find this troubling, not only because I believe the independence and expertise of the independent auditors enhances this process, but also because Enron has found its "integrated audit" arrangement to be more efficient and cost-effective than the more traditional roles of separate internal and external auditing functions. Frankly, I fail to understand how extending the scope of what is independently audited can be anything but positive.

The SEC has supported a number of measures to ensure that audit committees are informed of auditor's activities and feel the burden of determining auditor independence. Enron's audit committee takes those responsibilities very seriously. Given the wide-ranging impact of your proposed changes, I respectfully urge the Commission to reassess the need for such broad regulatory intervention when the business environment is more dynamic than ever. I also respectfully suggest the SEC give the new measures regarding the enhanced role of audit committees in ensuring auditor independence a chance to work before regulations of this magnitude are considered.

Sincerely,

KENNETH L. LAY
Chairman and CEO, Enron Corporation

U.S. HOUSE OF REPRESENTATIVES,
Committee on Commerce, April 17, 2000.

Hon. ARTHUR LEVITT,
Chairman,
Securities and Exchange Commission,
Washington, DC

Dear Arthur:

In connection with its oversight of the securities markets, the Committee has a number of questions relating to accounting practice. Pursuant to Rules X and XI of the U.S. House of Representatives, please respond to the following questions:

1. What empirical evidence, studies or economic analysis does the SEC possess that demonstrates accounting firms having consulting relationships with audit clients are less independent than firms that do not have such relationships? Are there any specific administrative findings that have concluded the provision of consulting services resulted in a specific audit failure by the same firm?

2. What empirical evidence, studies or economic analysis does the SEC possess that demonstrates accounting firms providing tax advice to audit clients are less independent than those firms that do not provide such advice? Are there any specific administrative findings that have concluded the provision of tax advice resulted in a specific audit failure by the same firm?

3. What are the investment restrictions to which employees of the SEC are subject? How are they different from restrictions placed on accountants? What is the rationale for those differences? Is there evidence that share ownership by SEC per-

sonnel compromises their independence or ability to discharge their duties in accordance with the public interest? What are the similarities in access to material non-public information shared with auditors and with the SEC staff reviewing statements filed with the Commission? Estimate the number of violations that would exist if the stock restrictions applicable to the accounting profession were to be applied to the SEC and its staff on January 2, 2000.

4. You and members of the Commission staff have suggested a new regulatory oversight and disciplinary process for the accounting process be adopted. Is the SEC developing recommendations on this proposal? How would the SEC receive input on its recommendations? Under what specific grant of statutory authority would the SEC propose to implement these recommendations?

5. We understand the SEC has expressed its views on the question of independence primarily in interpretive guidance or no action letters issued by the staff. Have the policies in this interpretive guidance ever been subject to rulemaking subject to notice and comment? Identify all guidance which was adopted by rulemaking and the date of consideration and adoption.

6. Members of the SEC staff have publicly supported restricting the scope of services offered by accounting firms to audit clients beyond current restrictions such as the prohibition on audit firms acting in a management capacity for audit clients. Are such considerations currently under consideration by the SEC or the staff? How would the SEC receive input on and implement such changes?

7. Under Section 3(f) of the Exchange Act and Section 2(b) the Securities Act [sic], the SEC is required to consider efficiency, competition, and capital formation when engaging in rulemaking under the public interest standard. The legislative history accompanying these provisions, as well as a plain reading of the statute, makes clear a thorough cost benefit analysis performed by the office of the Chief Economist must be undertaken prior to any such rulemaking. Has the SEC commenced cost benefit analysis of proposed changes to limitations on the scope of services offered by accounting firms to audit clients? If so, what are the findings of this cost benefit analysis?

8. Regulation S–X provides that the SEC "will not recognize any certified accountant or public accounting who is not in fact independent." Has the SEC defined the principles by which it determines that an accountant is not in fact independent? [sic]

9. Does the fact that audit firms are compensated for their services create an "appearance of conflict" problem? If direct compensation does not create an unacceptable appearance of conflict issue, how are more attenuated relationships between an auditor and its clients, such as the ownership of share in an audit client by a spouse, child or son or daughter-in-law of an audit partner determined to be unacceptable violations of independence?

10. What is your view on the proper role of the SEC and its chief accountant regarding the Financial Accounting Standards Boards's ("FASB") agenda? What is the proper role of the Commission and its Chief Accountant regarding FASB's deliberation on new GAAP rules? Please identify all no-public meetings between SEC personnel and members of the FASB or the FASB staff concerning recent proposals to change the accounting treatment of business combinations.

11. Identify all private sector committees, commissions, boards or other groups created at the request of the Commission or yourself during your tenure at the SEC. For each group, identify the method and criteria by which members of these boards were selected, including the role you played in selecting members. What is the legal status of each of these commissions or boards? What are the terms of existence of these boards and the terms of their constituent members?

12. In what ways did the SEC seek to influence the actions of the NASD and the NYSE as they considered the recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Audit Committees? Did SEC officials meet with self-regulatory groups charged with reviewing the recommendations regarding listing qualifications?

13. What is the status of SEC consideration of rules issued by the Independence Standards Board (ISB) last December relating to investments in mutual funds and related entities? Given the consideration of these rules would be made under a public interest standard, what specific criteria would the SEC use to reject a proposed ISB standard?

14. The SEC Chief Accountant stated the SEC intends to move forward with proposals to modify independence rules. Is it the SEC's intention to make recommendations to the ISB for action, or to undertake action outside the ISB process?

15. In the area of rules and guidance on auditor independence please indicate whether each of the following situations would be a violation of auditor independ-

ence. For those that are a violation, justify why the situation should be grounds for an independence violation:

• A partner's spouse participates in an employer sponsored benefit plan that invests in securities issued by an audit client with which the partner has no direct contact or responsibility. The benefit plan is the only option offered to the spouse by the employer.

• A partner's spouse participates in an investment club that owns 100 shares of stock of an audit client of the firm's Detroit office. The partner works out of the Seattle office and has no involvement with the client. The investment is not material to either spouse.

• The son-in-law of a partner is the beneficiary of a blind trust that has a *de minimis* investment in an audit client of the firm's Boston office. The tax partner works out of the Atlanta office and has no involvement with the client.

• A partner has a brokerage account with a securities firm that is not audited by the accounting firm. Cash in the brokerage office is automatically swept into a mutual fund that is audited by the firm's New York office. The partner works out of the Denver office, provides no services to the mutual fund, and is unaware the mutual fund is a client.

• The grandparents of a partner's children purchase a share of an audit client and hold the share pursuant to the Uniform Gift to Minors Act. The partner has no control over the purchase or disposition of the stock and does not work for the client.

For the following situations also indicate what alternatives the couples would have to come into compliance with independence restrictions.

• A partner's spouse is an executive at company A, and through the only reasonable employer benefit plan has holdings in the company. The partner works for a firm which audits company B, though neither the partner's office nor the partner perform any work for company B. Companies A and B merge and the spouse retains both holdings and employment. The holdings are material to the couple. The firm audits the merged company.

• The spouse of a partner works in a non-management capacity for a non-public company that is an audit client. The spouse has holdings in the company which are material to the couple. Neither the partner's office nor the partner perform [sic] any work for the company. The company goes public.

• A manager's spouse is promoted to CFO of an audit client company. Neither the manager's office nor the manager perform [sic] any work for the company. The manager is promoted to partner.

• A partner's spouse works for a company as a non-management employee and participates in the stock option and 401(k) program. Neither the partner's office nor the partner perform [sic] work for the company. Due to fluctuations in stock price, the value of stock in the company represents 5.1 percent of the couples [sic] net work on particular days.

16. Accounting independence prohibitions were drafted at a time when few women worked outside the home. Given the prevalence of women in the workforce, both as accounting partners and as workers, managers or executives in public companies, does the SEC agree current independence restrictions are outdated and in need of modernization? Do the restrictions as they stand discourage wives and daughters from participating in the workforce?

Please respond to these questions 2 weeks from the date of receipt of this letter. These responses will help to determine if hearings on the SEC's oversight of the accounting profession are warranted.

Sincerely,

TOM BLILEY,
Chairman.

MICHAEL G. OXLEY,
Chairman, Subcommittee on Finance and Hazardous Materials.

W.J. "BILLY" TAUZIN,
Chairman, Subcommittee on Telecommunications, Trade, and Consumer Protection.

Senator DORGAN. Ms. Claybrook, thank you very much for your testimony.

I just received a call from Senator Byrd, the Chairman of the Appropriations Committee, and the conference on the supplemental appropriations bill is convening at this moment. I'm a conferee, so

I'm going to briefly go to that conference. Senator Boxer will continue to chair the hearing. We, have been joined by Senator Edwards, as well.

Senator Boxer, thank you very much.

Senator BOXER [presiding]. Thank you. Let me tell you what the plan is. I'm going to give a very brief opening statement. Then I'm going to call on Senator Edwards. And then we're going to go to Ms. Minow, and then we have some questions.

STATEMENT OF HON. BARBARA BOXER,
U.S. SENATOR FROM CALIFORNIA

Senator BOXER. I'm going to put my entire statement in the record, but I want to just thank my Chairman, who just left, for his steadfast adherence to justice. And if it wasn't for him, and for Senator Hollings, we wouldn't have been able to take a look at Enron and the larger issues that we're beginning to look at today. So let me put that on the record.

Senator Metzenbaum and Joan Claybrook are institutions unto themselves, and they both have a long history of fighting for consumers. The organizations that they lead, the Consumer Federation of America and Public Citizen, and the groups they work with provide the invaluable service of, frankly, educating lawmakers on the rights and interests of American consumers. And sometimes it's a lonely battle for you. And I've been very proud to stand with you on many of those battles.

But I believe if WorldCom and Enron and Tyco and Merrill Lynch and the other corporate players, past and present, had one-tenth of the ethics of both of you, we wouldn't be in trouble today, and I think that's the basic point. Now, we can't legislate that, but we can sure say that's the standard we want to see, and people will have to pay the price if they don't adopt new ethics.

Decades ago, when I was a stockbroker on Wall Street, it was very different—very, very different. Granted, it was, when I had a 12-million-share day in those days, it was a big deal. There were fewer players. But the fact remains, the system could have been gamed, and, of course, once in awhile, it was, but really you didn't have what you have today.

When you had one of the big accounting firms sign off on a balance sheet, on a statement, you could take it to the bank. And now you take it to bankruptcy. Something is rotten, awful. There's no check and balance here, and that's what we need to do in Congress today, is to get a check and balance on this type of behavior.

I've watched in horror to see consultants who were auditors and analysts, who are supposed to be honest, telling you what to buy, being rewarded with inside stock deals, and CEOs who don't care about anyone but themselves. It is more than a scandal. It's a moral crisis in our country. Corporate irresponsibility has turned our nation's free market system into a free for all for the privileged few. And when companies lie and cheat and steal—and I want to say they're not companies; they're people in companies—lie, cheat, and steal, it causes a devastating ripple effect to the workers in those companies who end up losing their jobs and their dreams and their investments and their 401(k)'s and their savings.

And I'll tell you, I just don't want to see another group of people coming up here in tears saying, "All I wanted to do was take my grandchildren to Disneyland or something, and I can't even do that," or read about people who were ready to retire who are now saying, even though they're tired, they have to work another 5 years at least, because of what has happened. This isn't a theoretical discussion, as you know. This is about real people.

Fifty percent of all Americans invest in the stock market. That's way up. It's at historic highs. And they count on those investments to send their kids to college. And we don't want them to walk away from being able to invest in a healthy economy in a healthy stock market. But if you can't believe what you read in a corporate statement, you're going to think twice. And if you don't, you're making a mistake.

So what we're doing here I consider to be business-friendly, because if we can restore confidence in business by setting rules and regulations and checks and balances, we will go back to having a healthy business climate.

So I'll put the rest of my statement in the record and say that my state has suffered. On WorldCom, alone, pensions in my state lost $1.2 billion, just from WorldCom alone. So, again, it's very, very serious, and we all have to work together.

And I agree with the statements you've made. The Sarbanes' bill is the best we've got. Yes, I had some amendments I was hoping to get, and I'm going to talk about them later. But it's, by far, the stronger bill, and I'd like to see the President get behind it. I'd like to see the House Republicans change their tune and get behind it. The Senate Republicans, for the most part, did. I'm very glad of that. So we have some opportunities.

[The prepared statement of Senator Boxer follows:]

PREPARED STATEMENT OF HON. BARBARA BOXER, U.S. SENATOR FROM CALIFORNIA

Mr. Chairman, thank you for calling this hearing on improving corporate responsibility and for inviting such formidable consumer advocates to testify before the committee.

Senator Metzenbaum and Joan Claybrook are both institutions unto themselves who both have a long history of fighting for consumers. The organizations they lead, the Consumer Federation of America, Public Citizen, and the groups they work with provide the invaluable service of educating lawmakers on the rights and interests of American consumers. That information helps counteract the well-funded efforts of high-paid K Street lobbyists working to weaken the government agencies and regulations that were created to protect Americans from unethical corporate practices.

WorldCom, Enron, Tyco, Merrill Lynch, and the other corporate scandals on today's front pages reflect structural flaws in our system. But the Administration would have us believe that these are just a few bad apples rather than worms of greed that have infested the corporate orchard. The Administration wants to act on a case-by-case basis, only grudgingly accepts the need for meaningful reform, and refuses to acknowledge that the government has a responsibility to establish and enforce rules that really protect workers and investors from abuse.

When we succeed in passing the legislation and enforcing the stronger regulations necessary to improve corporate responsibility, it will have been over the decades long objections of the right and in spite of, rather than because of, the President.

Let's examine the record. This Administration refuses to force corporate polluters to pay for the harm they inflict on our environment. It has designed an energy package gift wrapped for corporations while ignoring the needs of consumers or the long-term interests of the people and the environment. It has failed to fully support the Senate passed reform bill because its corporate friends claim the new rules would be too stringent.

Even with workers losing retirement savings and the elderly struggling to pay for prescription drugs, the Administration still refuses to support meaningful pension reform or a prescription drug program that works for all Americans.

Americans know who fights for them. For the last two decades, some have fought to dismantle the rules and institutions that protect the people. Too often, lawmakers have behaved as if they work at the U.S. Chamber of Commerce rather than the U.S. Congress. The time to restore corporate responsibility is now and the way to do it is for public leaders to fight to protect consumers from corruption instead of fighting to protect the corrupt from regulators.

Mr. Chairman, I look forward to hearing the testimony of our witnesses and to working with you to move necessary reforms forward. Thank you.

Senator BOXER. With that, I'll call on Senator Edwards and then on Senator Fitzgerald, whom I welcome to the hearing.

STATEMENT OF HON. JOHN EDWARDS,
U.S. SENATOR FROM NORTH CAROLINA

Senator EDWARDS. Thank you. Thank you very much.

I first want to just echo what Senator Boxer just said. It is so important not just to business and for the investors, but for the entire economy, for us to restore some level on confidence. I mean, I think there's no question that that's playing a major role on what we're seeing both in the stock market and Wall Street, but also what we're seeing with our economy today. I think we have a responsibility to lead on this issue and send a strong signal to the American people that we're willing to do what's necessary to protect investors, to restore confidence in corporate America, and, as a result, restore confidence in the investments that they're making, knowing that the information they get they can rely on, that it's accurate.

I also want to say a word about our State Treasurer, who we're so glad to have here, Richard Moore, who's an old friend of mine. He's a wonderful leader. We're very proud of what you're doing, Richard, because you've really taken a lead nationwide working with the folks in New York, the Attorney General of New York and saying what needs to be said by more people, which is, as the manager of the tenth largest public pension fund in American, if you don't do right, if you don't do what needs to be done to be responsible, we're not going to invest with you. And I think if others would follow your lead, and I'm hopeful that they will, that it would go a long way towards doing what needs to be done, along with the work that's being done here with the Senate with Sarbanes' bill here in the Congress.

So welcome. We're glad to have you here, very proud of you. We've been watching your leadership on this issue, and we couldn't be prouder of the work that you're doing.

I also want to say just a quick word to my friend Joan Claybrook, who's just been such an incredible advocate for consumers in this country who need a voice. Lots of other powerful interests have voices up here, as she well knows, and it's a good thing for there to be at least one loud, strong voice for regular folks and for consumers in this country. We're proud of what you're doing, and Senator Metzenbaum, who's been a great champion for a long time of the little guy. We're very proud of you, too, Senator Metzenbaum. We're happy to have all the witnesses.

And, Madam Chairwoman, I thank you for letting me go.

Senator BOXER. Thank you so much, Senator.

Senator Fitzgerald.

STATEMENT OF HON. PETER G. FITZGERALD,
U.S. SENATOR FROM ILLINOIS

Senator FITZGERALD. Thank you, Madam Chairman, and thank all of you for testifying today. I want to welcome you all to the Committee.

And, Nell Minow, I want to especially welcome you. You grew up in Illinois, and I consider you on honorary constituent for that reason, and I compliment you for your work as editor of The Corporate Library. And I know you've been involved in many of these issues for years and years.

I wanted to ask some questions regarding the accounting for stock options. I actually believe that the Sarbanes bill was a very good bill. It was very well thought out, very well put together. I think it does make some incremental improvement. But I think both houses of Congress are ignoring a fundamental problem here, and that is the lack of expense recognition for stock options to corporate management and to employees.

Back in 1993, the Financial Accounting Standards Board wanted to require companies to expense stock option compensation. And yet corporate America came to Washington and got politicians in Washington to thwart FASB. A resolution was introduced in the Senate condemning FASB for having the audacity to suggest that stock option compensation be recorded on the earnings report, and a separate bill was introduced in the Senate that would have eviscerated FASB and put them out of business if they didn't back down. So FASB backed down. They wanted to stay in existence. And since that time, there has been a gargantuan, humongous acceleration in the issuance of stock options.

And you can see why. It's almost irrational, if you can get a tax deduction for your stock-option compensation expense, but you don't have to record it as an expense on your income statement, you'd almost be irrational to pay your employees and management in cash. Why not use stock options? You get the tax deduction, but you treat it like manna from heaven on your earnings report.

There is an analysts' accounting observer Jack—gosh, Ciezelski, I think—is that the proper pronunciation? He has just issued a report that indicates that the Standard and Poors 500 companies, that the lack of expense recognition for stock options caused the earnings reports of the S&P 500 companies in 2001 to be overstated by 31 percent. And there are a number of companies that he points out—and they have enough enemies already; I won't read these companies out—but there are many companies in America that all of their earnings last year were delivered to the employees and management via stock options. And had they taken an expense for their stock option compensation, there would have been no recorded earnings.

My question to you is——

Senator BOXER. Well, we're not asking questions yet——

Senator FITZGERALD. Oh, you're not?

Senator BOXER.—because we haven't heard from the last witness. We'll come back to you——

Senator FITZGERALD. OK. All right. Well, I'll rephrase things. I guess the point I would want to make is, in part, what's going on in the market now is that sophisticated investors, led by the institutions, have figured out that there's no reason to be a shareholder in companies that take all of their profits and give it to their management and, in some cases, their management employees. They've removed the incentive to be a shareholder in one of these companies. And I think those companies are getting their comeuppance now on the market.

I am much chagrined that there have been continued attempts in Congress to thwart any kind of effort to deal with this issue, because I believe that this is the root cause of all the earnings restatements and debacles and corporate scandals we've seen in recent months. The top 29 managers at Enron cashed out $1.1 billion in stock options before the company went bankrupt. And there's a recurring pattern at many of the corporations that we have seen embroiled in scandal, that management there was gorging themselves on stock options, they'd cash out their options, many of them would then just leave the company, knowing that it was going to hit the wall sooner or later.

At a certain point, while stock options might be a good, healthy incentive that, to some extent, aligns the interests of employees and management with the shareholders, at a certain point, when there's too heavy an issuance of options, then the management gets very short-term incentives, starts thinking about keeping their own options in the money. And when they start doing that, they're acting adversely to the interests of the long-term shareholders.

And I think that there needs to be some discipline on options, and certainly one discipline would be to require the expense to be reflected in the earnings report. And I will be interested in hearing from the panel on their thoughts on this issue.

I want to thank Senator Boxer for chairing this hearing.

Senator BOXER. Thank you. Before you came, I want you to know that a couple of our people did talk at length about options. They agree with you. They—we haven't heard from Ms. Minow. We're going to in a moment.

But I just want to say, in the interest of an interesting debate, that I don't think the root cause of the scandals we're facing now are stock options. I think the root cause of the scandal is thieving corporate leaders. Thieving, breaking laws, hiding losses, and also treating expenses as income.

Now, the stock option is another question, but it isn't illegal, what they did. I would certainly like to make it illegal to do some of the things that these corporate leaders did with their stock options. I want to see them have longer holding periods. Maybe they don't get to cash in until they leave the company for a few years. Then maybe they'll have, you know, the desire to do right by the company, not just to do what you correctly stated, which is to phony up the earnings. That's no question, but let's keep our eye on the prize here. We didn't have any accountants that blew the whistle on these other matters.

And I do want to put on the record the fact that I come from a state where stock options have been used by 100 percent in some companies. I have letters that I'll put in the record from women

who are on the bottom of the ladder in the company who were able to use their options.

[Letters are not available.]

Senator BOXER. So what I want to do with options is not something really simple that eliminates them for the little guy and keeps them for the big guy and allows the big guy—if you just did expensing tomorrow, this is my prediction, because 11 million people have stock options, the top guys will still get them, and they'll still abuse them unless we change the laws surrounding what they can do with them.

So I think it's a very interesting debate, and I'm working very hard to make sure that when we do make our move on this issue that we move on it in a right fashion so that the little guy doesn't get it in the neck again, but the big guy does. And it makes a lot more sense.

So I don't think that there's division in our Senate at all. I think the division is exactly what you do about it. But everyone sees it as an evil that needs to be addressed, where you keep the good side of it, but you get rid of the bad side of it.

But I just would disagree that the cause of the scandal now is stock options. They're a real problem. The causes of the scandal are illegal acts, and that's why I'm so proud that Senator Leahy and Members of the Judiciary Committee on both sides were able to put together some stronger penalties.

But, with that, let's call on Ms. Minow, and we welcome you. The whole panel has just been wonderful so far. I'm sure you will continue in that tradition. I ought to say that you are the editor of The Corporate Library.

STATEMENT OF NELL MINOW, EDITOR, THE CORPORATE LIBRARY

Ms. MINOW. Thank you very much, Madam Chairman. And, Senator Fitzgerald, I may just have to move back to Illinois so I can vote for you. I appreciate what you said very much. Thank you.

I want to begin, again, by thanking you for inviting me to appear today. I've been working in this field, corporate governance, for 16 years, and it's really been a shock to my system not to have to explain to anybody anymore what that is.

American investors, consumers, and employees have been very deeply shaken by the stories of corporate corruption, and it has been very gratifying to see the Senate and Congress move so quickly to respond. I really want to emphasize that if there was ever an issue that required bipartisanship and even statesmanship on behalf of the Senate and the Congress in accepting responsibility for the causes of this problem and in developing a response, this is definitely it. The one thing that the Senate and Congress could do that would really create more problems of investor confidence is turn this into a partisan matter.

The discussion of investor confidence reminds me of a story about my dad, Newton Minow, who is a resident of Illinois. He was asked to speak to a group of young lawyers at his firm, and he told them that the most important thing that you could do as a lawyer was to get the client to trust you. And one of the hotshot young lawyers raised his hand, and he said, "Well, Mr. Minow, how do I do that?"

My father said, "Well, you could start by being trustworthy." And that is a lesson that our corporations must learn. There is nothing that we can do to solve that problem for them. We can create more penalties, we can remove improper incentives, but they've got to learn that themselves.

In a way, we've all been enablers for bad behavior by corporate managers and directors. We've been rewarding them at a level unprecedented since they used to pay people their weight in gold. Unfortunately, like that thankfully outdated form of compensation, ours have not provided optimal incentives, and the managers, therefore, have opted for short-term self-dealing rather than long-term sustainable growth and shareholder value.

It was interesting that Madam Chairman referred to the "root cause." This really has been like a root going off in a lot of different directions. There are many different causes here. And the challenge is that there have been so many failures by so many different entities that it's difficult to provide an effective and coordinated response.

I'm a big fan of everybody on the panel, but I have to disagree. I think that Harvey Pitt is going to do a very good job. He's very committed to doing a good job and just needs some additional support to do it.

And I also have to disagree on the Securities Litigation Reform Act. It was not a perfect act. Obviously anything could be improved, but I personally have filed lawsuits under the Reform Act, and the amount of settlements that, not only I received, but other people have received have been unprecedented. So I think it's actually been a net improvement.

I do want to talk a little bit about stock options and pay disclosure. We have to take some responsibility for the problem here. I really appreciate that Senator Fitzgerald mentioned the way that Congress interfered with what FASB wanted to do previously. I'd like to have Congress get out of the way so that FASB will do the right thing now.

Going back to your point, Madam Chairman, the issue of how long the employees must hold the exercised options I think is a terribly important one. I'd like to see them not be allowed to cash out until 3 years after leaving the company to make sure that their perspective is a long-term one.

I particularly want to point out the fact that the SEC, not too long ago, changed the rules to allow a cashless exercise of options. I think that that has been insidious. Executives can exercise the options and sell them immediately without having to put any money down, and I think that that has created a terribly perverse set of incentives.

What Congress should do is revisit the tax code to redefine performance-based pay. The last time pay was an issue, Congress tried to fix it by setting the million dollar pay cap and then giving a get out of jail free card, basically, to performance-based pay. I've brought a report from The Corporate Library on the failure of U.S. stock option plans to tie pay to performance. I don't intend to clog up the record here with it, but I'm making it available to the staff.

I think what we need to do is instead of discouraging indexed options tied to the performance of the individual company, which our

tax code right now makes almost impossible, we need to encourage them.

Furthermore, there is this trend in corporate America that I call the Leona Helmsley trend, the only "little people pay taxes" trend, and that is to "gross up" CEO pay, meaning that not only does the company pay the CEO, the company pays the taxes of the CEO. I have to pay my taxes. You have to pay your taxes. We should not allow that anymore.

My second point has to do with the enforcement of existing laws. The SEC, under Mr. Pitt's predecessor, in particular, had a terrible relationship with the Justice Department. And, therefore, there was very little criminal enforcement. I think that the Senate should require the SEC and the Justice Department to work better to eliminate petty bureaucratic differences and present a meaningful plan for enforcing the laws already on the books. And it would help if we had a full SEC and perhaps fewer people with ties to the accounting world.

The failures at all of the companies we've listed today are not necessarily the failures of the accountants, analysts, or regulators. It was really the boards of directors, and we need to think carefully about a system that takes capable, honorable, experienced people and puts them into a board room where there's something about the oxygen that causes them to lose half of their IQ points and all of their courage. We need to really get out of their way.

And, in particular, we need to work on the fact that, the Federal Government has more of a say in what goes on in your local elementary school than it does in a board room because of the deference to state law, meaning Delaware. If shareholders could pick the state of incorporation, we'd have some competition in the states to do better by them.

I support the New York Stock Exchange's proposals, which I think are very constructive, but I worry that the NASDAQ proposals are disappointing and make it harder for the New York Stock Exchange to uphold the high standard.

Most important, all of the reform proposals currently focus on what I call the supply side of corporate governance, what companies, directors, and auditors must do. And none of this will work unless we focus on Mr. Moore's side, the demand side, what shareholders can and must do. I'm really happy to see North Carolina weighing in here. Of course, your state, Madam Chairwoman, has been the leader in this field, but what is wrong with the other 48 states? Why don't we get the public pension funds playing more of a role?

In the hotly contested Hewlett-Packard merger this year, every vote counted. It was closer than Bush-Gore. In the equivalent of the butterfly ballot, we had Deutsche Asset Management, one of Hewlett-Packard's largest investors, voting against the deal, and then getting paid a million dollar fee from Hewlett-Packard; and then voting for the deal; and then, of course, being upheld by the friendly courts of Delaware. If we're going to allow that level of corruption on the shareholder side, we will never have any meaningful oversight. I draw your attention to the work done in the U.K. by the Myners' Commission, which has been very, very worthwhile in this area.

One thing that Senators understand better than anyone else is the importance of a system of checks and balances to guide the exercise of power and protect citizens from abuse. The corporate system of checks and balances has been allowed to all but tip over completely. The failures at what I believe are the edges of the system have taught us some important lessons about the obstacles to market efficiency, what we need to do to make sure that the checks and balances are restored, and I hope to be a constructive voice in that process.

Thank you, again. I welcome your questions.

[The prepared statement of Ms. Minow follows:]

PREPARED STATEMENT OF NELL MINOW, EDITOR, THE CORPORATE LIBRARY

Mr. Chairman and members of the committee, I want to begin by thanking you for inviting me to appear today. American investors, consumers, and employees have been deeply shaken by the stories of corporate corruption, and it has been very gratifying to see the Senate and Congress move so quickly to respond.

My father, asked to speak to a group of new young lawyers at his firm, told them that the most important goal was to get the client to trust you. One young man asked him how to do that, and my father responded, "Well, you can start by being trustworthy."

This is a lesson that our corporate leaders must learn. In a way, we have all been enablers for bad behavior by corporate managers and directors, rewarding them at a level unprecedented since they used to give kings their weight in gold. Unfortunately, like that thankfully outdated form of compensation, ours have not provided optimal incentives, and managers have therefore opted for short-term self-dealing rather than long-term, sustainable growth in shareholder value.

The complicating factor here is that there have been so many failures by so many different entities that it is a challenge to provide an effective and coordinated response.

I want to speak briefly about five problem areas and the place most likely to provide some improvement. The one area I do not plan to address is accounts and accounting firms, because I believe that it has been thoroughly covered by the pending legislation. I will be happy to answer questions about that issue as well as the others I am raising at the end of my testimony.

1. Stock Options and Pay Disclosure

We all have to take a moment to accept some responsibility for the problem here. Stock options would not have gotten so out of hand if not for our last attempt to address these problems, back when CEO pay was grabbing headlines in 1991. The result was a classic lesson in the law of unintended consequences. Congress amended the tax code to put a ceiling on deductibility of CEO cash compensation at $1 million, but no limit on performance-based pay, meaning options. The result: all base pay got raised to $1 million and the average option grant went from the thousands to the millions. The stock doesn't have to do very well for 2 million options to be worth a lot of money. Seventy percent of option gains are attributable to the overall market, not the performance of an individual company, much less the individual recipient of the options. And the tax code provides enormous obstacles to the most legitimate option grants, indexed options, which would make sure that the executives are rewarded only for their company's performance.

To make things worse, the SEC changed the rules to permit "cashless exercise" of options instead of encouraging or requiring executives to hold on to the shares.

I do not believe Congress should get involved in setting accounting standards. In fact, Congress was the problem the last time this came up, with an unprecedented interference with FASB's attempt to require that option grants be expensed. FASB wants to do the right thing, and has additional support from the investor community and the International Accounting Standards Board. All we need to do is get out of their way and protect FASB from political interference.

What Congress should do is revisit the tax code to redefine performance-based pay. Our recent report compares U.S. option grants, which are generally not linked to performance, to those in the UK. Our tax code should encourage compensation plans that truly link pay to long-term performance and not short-term books-cooking.

The SEC should rescind its rule and prohibit cashless exercise of stock options.

Finally, the SEC should go back to its original disclosure requirement for the top five highest paid executives. That rule was changed to apply only to "officers," creating a huge loophole that permits companies to evade disclosure of crucial information.

2. Enforcement of Existing Laws

The SEC under the previous administration and the one before that has done a poor job of coordinating with the Justice Department and as a result, there have been far too few criminal prosecutions for securities fraud. Oversight committees should insist that the SEC and DOJ work closely together to eliminate petty bureaucratic differences and present to Congress a meaningful plan for enforcing the laws already on the books and making it so painful to violate securities laws that the bad guys will reconsider and try something a little less risky.

It would help a lot if we had a full set of SEC Commissioners, and now would be a good time to put one or two investor advocates on the commission, instead of the usual suspects who come from the other side. One action has already been thrown out because two of the three sitting SEC commissioners had conflicts. Let's get five commissioners on board, with backgrounds with enough diversity that we will not have that problem again.

3. Boards of Directors

The greatest failure at Enron, WorldCom, Adelphia, Global Crossing, and Tyco was not the failure of the accountants, analysts, or regulators. It was the boards of directors. We need to think carefully about a system that takes capable, honorable, experienced people and puts them into a situation that does not allow them to do a good job. What is it about the atmosphere of the boardroom that causes the most distinguished people in America to lose half of their IQ points and all of their courage?

Unfortunately, the Federal Government plays more of a role in a local elementary school than it does in the boardroom. Our tradition is to leave that role to the states, and that means Delaware, which long ago won the race to the bottom by providing the most management—and director-friendly legislature and court system in the country. Now, of course, Bermuda beckons, and I hope Congress will cut off that route before any other companies escape American law entirely.

But if we are to leave it to state law, we must create a race to the top by allowing shareholders to choose the state of incorporation. Every 5 years, shareholders should be allowed to submit a proposal to change the state of incorporation. That would encourage experimentation, innovation, and, especially, consideration of shareholder rights.

The SEC should also require additional disclosure, including all relationships between directors and officers of the company. And we at The Corporate Library are hoping that our new board effectiveness rating will someday become as important a part of the risk assessment of an investment as the company's credit rating and performance history.

4. The Exchanges

The Self-Regulatory Organization structure has permitted the foxes to guard the chicken coop. No wonder the chickens are scared. The exchanges usually act as though they work for the issuers. In a rare exception, the NYSE has produced a truly outstanding proposal for enhancing its listing standards. NASDAQ, on the other hand, has produced a proposal most charitably described as disappointing. If the NYSE is not going to run the risk of scaring its listed companies over to the more forgiving confines of the NASDAQ, the SEC has to have authority to require it to match the NYSE's standards.

5. The Shareholders

All of the reform proposals currently focus on what I call the "supply side" of corporate governance—what companies, directors, and auditors must do. None of this will work unless we also focus on the "demand side," what shareholders can and must do.

Institutional shareholders manage the largest accumulation of investment capital ever assembled. They include pension funds, mutual funds, foundations, endowments, and others. There was a lot of information about the potential problems at Enron, Global Crossing, Adelphia, and WorldCom. Why didn't they act on it?

In the hotly contested merger at Hewlett Packard and Compaq this year, every vote counted. One of HP's largest shareholders, Deutsche Asset Management, voted against the merger. Then they got a million dollar fee from the company. Then they changed their vote. Then the merger passed.

This was challenged in the Delaware courts. But the Delaware court upheld it, partly because, as I said earlier, they cater to management because they want to keep that nice, clean income from the companies "domiciled" there. But the other reason was that the challenge was to HP, and whether what they did was fair to HP shareholders. Putting that issue aside, who is going to challenge it from the Deutsche Asset Management side, and ask whether what they did was fair to the people whose money they manage, the people who trust them to buy, sell *and vote* stock based on what is right for them, regardless of what fees they generate for themselves?

Where are the SEC and DOL? They both have the right to investigate the exercise of proxy votes by institutional fiduciaries. But despite extensive evidence of the deepest level of corruption and mismanagement, there has never been a single enforcement action brought because of the failure to exercise shareholder rights, including proxy voting, in the interests of investors or plan participants.

Both agencies should issue prompt, clear, and unequivocal statements to the institutional investors under their jurisdiction calling for the strictest possible controls to ensure that proxy votes are cast with integrity.

Institutional investors should have to disclose their proxy voting policies and any votes inconsistent with those policies. They should log every attempt to get them to change a vote.

Here is why these issues are suddenly so striking: The rising tide lifted all the boats and the boom market hid a multitude of shortcuts and fudges. But as the tide went out, boats foundered on the rocks, and some of the rocks fell over, revealing some nasty creatures underneath.

One thing that Senators understand better than anyone else is the importance of a system of checks and balances to guide the exercise of power and protect the citizens from abuse. The corporate system of checks and balances has been allowed to all but tip over completely. The failures at what I still believe are the edges of the system have taught us some important lessons about the obstacles to market efficiency and about what we need to do to make sure that the checks and balances are restored. I hope to be a constructive voice in that process.

Thank you again, and I welcome your questions.

Senator BOXER. Thank you to the whole panel.

Here's what we're going to do. We have a vote on the Senate floor. I'm going to stay here till Senator Fitzgerald comes back, then he's got some questions. And at that point, Senator Dorgan should be back, so we're just having a little rolling chairmanship here.

Mr. Moore, I also want to commend you for exposing conflicts of interest at Merrill Lynch, working with Elliot Spitzer, who you probably know we had before us. And I talked a little bit about that. And on the Sarbanes' bill, I had an amendment which was blocked by Senator Phil Gramm which would have said that not only does an analyst have to say that he or she owns the stock when they're making a recommendation, but that members of the immediate family, that has to be disclosed, as well.

I think that's important information, for two reasons. One, you may decide, well, if the guy believes so much in it and he has it, maybe it's a good thing; or, maybe it's a way to push the stock up. And that's up to you. But at least it's what you said; it's disclosure. And I wonder how you felt about my amendment, if you thought that was a good idea, because we still want to try to make the bill stronger in the conference.

Mr. MOORE. Well, I've never seen a situation where disclosure is not a good thing. And I think one of the things—one of the reasons that I felt so strongly about this over the last few months is that the leaders of Wall Street and the leaders of corporate America, they're spending other people's money, and it struck me as odd—they were much more like you and me, who answer to the voters. And I remember the first time I signed a bond offering document

coming to the public marketplace to borrow money for my state, I signed under the oath of perjury. I mean, I faced a penalty that the corporate executives did not.

So the more disclosure—we live in a glass bowl spending other people's money—the better. And I'm not saying they have to publicly disclose, but they should at least disclose to their customers like me.

Senator Boxer, I would support that. I think you will see, thanks to your state and your State Treasurer, who is my good friend, we have more—as of 2 days ago, we have more than $600 billion behind the proposals that Elliott Spitzer and I wrote. I don't think the market is going to be able to tell us no on this, because what we're asking for is reasonable and right and they owe us a clear fiduciary duty. So I think we're going to get a lot of disclosure.

Senator BOXER. Good, because if you don't, then you don't know who to believe or what to believe. It's sad that—you know, we used to count on, as Ms. Minow said and I said before, the checks and balances, that if something went through the system, that at least the auditor would find it, somebody in the corporation would speak up, so on and so forth.

And what we're seeing is just everybody's in the tank, you know, from the—we heard that from Mr. Spitzer, from reading his materials, and I'm sure you know this, that there was one period of time where Merrill Lynch never issued a sell order. They never suggested that a company they recommended be sold, because they had all this involvement with them. It's just absolutely stunning.

So, you know, we try to clean that up, but we also want to have a layered defense, which is, if you don't trust that person, let's get to the disclosure. And I really—I really want to thank you.

I'm going to ask one question.

Ms. CLAYBROOK. Senator Boxer, could I——

Senator BOXER. Yes. Please.

Ms. CLAYBROOK —comment on that?

Senator BOXER. Please.

Ms. CLAYBROOK. I got a letter the other day from a member of Public Citizen. He's a lawyer. He said he was trying to decide what stockbroker to hire, and he looked at the different forms that you have to sign when you hire a stockbroker. And he said every single one of them required him to agree to arbitration and to give up his right to go to court if he wanted to challenge something that the company had done.

And, you know, here we have Merrill Lynch, who happens to be my stockbroker, having engaged in these tremendous wrongs. And when you sign that form, you have to agree to go to arbitration. And the problems with arbitration are you have to put the money up front—you, the consumer—in order to have an arbitrator. These arbitrators again and again represent the business defendants, so they don't want to irritate them too much, because they won't be hired in the next arbitration by that business defendant. And there's no discovery, there's no opportunity for class actions, that is, for a lot of small people harmed to joined together.

And so it seems to me this is an issue that should also be addressed here, that this is like a private judicial system that's being created, and it protects companies like Merrill Lynch and others

from ever having to disclose anything. So you talk about public disclosure—well, it's one thing to require regular disclosure. It's another thing when they misbehave to get disclosure. And one of the ways that you get disclosure is through lawsuits and discovery. And if you can't file a lawsuit and you can't get discovery, the likelihood of your succeeding as an individual investor is zilch.

Senator BOXER. Well, I want to thank you for that point. And I think that you're right. And you're absolutely right. If people know that there's no price they have to pay at the end of their lies and their cheating and their scandalous behavior, they'll just continue it. You know that's what we're seeing. It's a very sad day in America, but that's what we're seeing.

And this whole notion, I never thought about arbitrators as being perhaps in another conflicted situation, so I think we need to take a look at how we can avoid that, because you're right, if they want to be hired again, then they ought to come down on the side of the business.

Ms. CLAYBROOK. Well, the key issue here is it's mandatory predispute arbitration. I love arbitration. I think arbitration is fine. But if I'm required to go to arbitration——

Senator BOXER. I hear you.

Ms. CLAYBROOK.—before the harm ever occurs, in order to even get a stockbroker. That is where the wrong is. And this individual who wrote to me said he checked every major stockbroker in America and could not find one that didn't insist on arbitration. So there's essentially a collusion among the stockbrokers in America to insist that you have arbitration so that there's no penetration of the wrongs that they do by litigation.

Senator BOXER. Right. Well, you've raised yet another layer of an issue that we have to get to.

Because I'm going to be late now, I was hoping that Senator Fitzgerald would come back, but he should be back shortly, or Senator Dorgan, and so I will say adieu for the moment while I go vote, and we'll stand adjourned until the next chair returns.

[Recess.]

Senator FITZGERALD [presiding]. We're going to call this meeting back to order. I appreciate your indulgence while we had a vote. I voted, and then—now Senator Boxer's voting. And at 11 o'clock, actually, we're supposed to go to a second hearing on somewhat different matters. And I do want to wrap up with some rounds of questioning that will have to be brief by necessity, and we apologize for that.

I know Senator Boxer discussed stock analysts, and I do believe, to some extent, we addressed that in the Sarbanes bill. But, again, I wanted to follow up on my comments from the opening round about the lack of expense recognition of stock-option compensation expense on earnings reports. And I noted in my opening remarks that, according to a recent study, the earnings of the Standard and Poors 500 companies in 2001 were overstated by over 30 percent.

And I'd like to start with Ms. Minow. What effect do you think this news coming out, that earnings reports are inflated, is having on the stock market now? Do you think that is inhibiting institutional and other investors because they're really not sure that they can rely on the earnings reports of companies that are out there?

Ms. MINOW. Senator, I believe that there are a number of reasons that investors feel that they can't rely on the earnings reports. I had a reporter call me yesterday on this issue of expensing stock options, and he said, "Well, we just really don't know how to value them, so how can we value them?" I said, "Well, right now we are valuing them. We're valuing them at zero." We're valuing them at a lot more than zero when we give them away. But when we tell the shareholders what we've done, we're saying that they're not worth anything. And if they're not worth anything, then why don't you give them to me? I'll take them. So I think that this is one of many reasons that investors are feeling very shaky right now.

Also, ironically, as we are beginning to expense them, as Coca Cola and Bank One and a number of companies have announced that they're going to expense stock options the formulas are based, in part, on past performance of the stock. We may be getting overvaluations of these options, because it's unlikely that the market will continue to perform as well as it has been.

Senator FITZGERALD. I have a follow-up question on that. Some companies, particularly in Silicon Valley, pay ordinary expenses—like they have a bill from their law firm, they'll pay it in stock options. Do they—does anybody know whether they're expensing those bills when they pay them in stock? And my understanding is that they do, they have to expense it when they're paying anybody but their own employees. What is the public policy rationale if you pay an expense to your own employees in options for not expensing it, but if you pay it to a law firm or pay some ordinary bill in stock options, that you do expense it?

Ms. MINOW. Yes. In the go-go years, even landlords were asking to have their rents paid in stock options.

[Laughter.]

Senator FITZGERALD. That is an expense, right? They do have to report that as an expense on their earnings report?

Ms. MINOW. It's an operating expense, absolutely, and you've pointed out exactly the logical flaw, the fallacy, and the corruption at the heart of this one exemption. Everything else that the company pays out in the form of compensation does have to be expensed. And this one great big loophole has created a very perverse incentive and a distortion of the balance sheet.

Senator FITZGERALD. Now, let me ask you this. When a manager has millions of stock options and they could make millions of dollars—Ken Lay cashed out, I think, $250 million worth of his stock options in Enron. There are many examples of corporate executives who just feasted on options and can make a lot of money by keeping the stock price of their corporation high, and that often depended on keeping the earnings per share high. At a certain point, when there's so many options in the hands of senior management, doesn't that become somewhat of an incentive to goose the earnings to keep the stock price high so that the management can profit from their own stock options?

Ms. MINOW. There is no question about it, and there have been academic studies documenting corporate announcements and developements and relating them to the exercise of options. That's why I believe that it's very important that we rescind this SEC rule that permits cashless exercise of options and require those

who exercise options to put the money down and hold onto the stock, because that will truly align their interests with the interests of the shareholders.

I want to really emphasize one point here. Seventy percent of option gains are attributable to the overall market and have nothing to do with the performance of the individual company. And the fact that our tax system makes it impossible to give out indexed options has also contributed to that same——

Senator FITZGERALD. Are you saying that's like rewarding the weatherman because the weather turns out good?

Ms. MINOW. Except that the weather turns good less often than the market does well, so, in fact, it's a better bet.

Furthermore, just a few years ago, 100,000 options was considered to be a very generous grant. They literally redefined the term "mega-grant" of options, because everybody was getting them. And if you have a million options, the stock doesn't have to do that well for you to make a million dollars.

Senator FITZGERALD. There's one famous company, and I won't mention its name, but it's my understanding they earned $5 billion last year; but if they had recorded an expense for their stock options, they would have reported zero earnings. Now, there are two ways of looking at that. They earned nothing—one way of looking at it is they earned nothing, but figured out a way to tell the public they earned $5 billion.

Ms. MINOW. Right.

Senator FITZGERALD. Or another way of looking at it is that they earned $5 billion, but they transferred the $5 billion in profits to their employees and, to a lesser extent, their management, and, to a lesser extent, their rank and file employees. My question is, would not an investor be irrational to want to hold stock in a corporation where 100 percent of the profits are transferred to the employees? Why would someone want to hold stock in a company like that?

Ms. MINOW. You're completely right. And they're transferred to the employees in a way that's very dilutive to the shareholder value, not only to the shares themselves, but to the voting rights that go with them. And the answer is, that's why companies don't want to expense their options, because if they told the truth about it, nobody would want to buy stock.

Ms. CLAYBROOK. Mr. Chairman, I think it's also the point that it's very hard for the investors to figure out how many options are being given. This is not an easy type of information to find. The calculation you just made, it may be irrational, but——

Senator FITZGERALD. Since it's not reported. But the institutions have figured this out. I mean, they're coming into my office begging to require expensing of stock options. But, unfortunately——

Ms. CLAYBROOK. It's certainly not something that's readily available to the average citizen, and I was just going to say that Mr. Moore was talking earlier about transparency and availability of information, and certainly we've done a lot of research through the SEC files. It's not easy. Most consumers could never do this. Most investors could never do this.

Senator FITZGERALD. So won't they just stay away from the market? Figure this is a fool's game?

Ms. CLAYBROOK. No, no——

Senator FITZGERALD. You think they'll—you don't—I mean, aren't they doing that, to some extent, now?

Ms. CLAYBROOK. They are now, because there's this huge corporate crime wave going on, but, by and large——

Senator FITZGERALD. What's the motive for goosing the earnings, though, if it isn't to cash in on the options?

Ms. CLAYBROOK. Well, I completely agree that it is. I mean, that is absolutely what it is.

Senator FITZGERALD. So isn't that the root cause, then?

Ms. CLAYBROOK. Oh, I believe it is one of the root causes of it, but when they goosed the earnings, they engaged in a lot of illegal acts, and if there's no——

Senator FITZGERALD. But why goose the earnings unless it's to pocket the money that, individually, you can make from your own options and then leave the company?

Ms. CLAYBROOK. That's the incentive, but if there's no enforcement for doing it, then they're going to keep on doing it.

Senator FITZGERALD. Well, why don't we remove the incentive to goose the earnings. I guess that—Mr. Moore?

Mr. MOORE. And you're hitting on a couple of points, Senator First of all, the reason that it's done to begin with, the reason that people look at using options, is the tax policy in place. You know, if you want to peel that back to root cause, and both of you, Senator Boxer and Senator Fitzgerald, have both made equally compelling points on this. Instead of getting caught up on whether options are good or bad or not, examine whether the taxing policy that encourages the use of them is something you want to do.

And I would urge you to look back at another thing. We're one of the few nations in the world that double-taxes dividends. You know, maybe it wasn't such a bad thing for the quality of corporate earnings to pay out dividends. And I've been working with a group, with Warren Buffett, who, you know how strong his opinions are that the quality of corporate earnings are the worst they have ever been. Let's maybe take a step backwards in that way.

Now, I agree with you, Senator Fitzgerald. I think it is the root cause. As someone who spent several years of their life prosecuting smart, white-collar criminals, there are two types of people in the world that do these things—one, the people who are criminals the day they enter the business, and we're never going to stop them. I mean, the only thing is we can prosecute them to the full extent of the law.

But there is the type of person that, if there is an incentive—and I believe you're right; it's tied back to options—that if they tell the truth or they lie, next year they make $500,000, no matter what. If they tell the truth or they lie. Well, which one are they going to do? They're going to tell the truth.

Now, if you change the scenario, and if they lie, they make $10 million next year, instead of a half million. Well, that's a decision many people don't want to be faced with, and that's what options do.

Senator FITZGERALD. So they're——

Mr. MOORE. But it goes back——

Senator FITZGERALD.—giving incentives for good people to do bad things.

Mr. MOORE. But you didn't, you weren't here during my testimony. And I think an appropriate middle ground on this is do as you've done in food labeling, do as you've done in so many things. If this is a contentious area, make them put it in the proxy statements, in the annual reports, in a clear and open place——

Senator FITZGERALD. How about in the earnings statement?

Mr. MOORE.—and the market——

Senator FITZGERALD. How about the earnings statement?

Mr. MOORE.—will take care of the options that do not align management and ownership.

Senator FITZGERALD. But are you——

Mr. MOORE. Because those are the——

Senator FITZGERALD. You're in favor of putting it in the proxy statement and the annual report. It's already in a footnote in the annual report. What I'm suggesting is they should expense the expense in their earnings report. Are you in favor of expensing stock option compensation on the earnings report?

Mr. MOORE. I am in favor of that, but if you, as a body, get caught up between the two, what I'm saying, at a minimum, please put it in boldface, not in a footnote somewhere, so we can value these overhang and run rates. We can do this. The institutional investor can do this. And if we kill the stock price, then we look after the small investor.

Senator FITZGERALD. Well, thank you.

Senator BOXER [presiding]. Let me just disagree. I don't think good people do what these people did. So I will disagree. Good people don't hide losses and show them as profit. Good people don't do that. And so I do believe there are good people who don't do that, but I don't believe the people who have done this——

Senator FITZGERALD. Do you believe that it's a temptation at all?

Senator BOXER. I'll be happy to yield to my friend.

Senator FITZGERALD. Do you believe it's a temptation at all?

Senator BOXER. You know, I guess I'm a person that's kind of right and wrong, black and white. It's the kind of family I grew up in, it's the way I am. And I was taught, you know, you don't take a two-cent lollipop out of that candy store even, if it's right out there. Even when I was a little kid, and, boy, if I ever did it, that would have been it.

So I would like to tell you that we need to do something about changing the law here, because just note, this scandal, the illegalities were not the exercising of the stock options, as we've all pointed out; this is the law. So we need to do something to change it. Some think if you expense it, you solve the problem. I do not. Because I believe what will happen then is the little guy gets squeezed out, the big guy will still get it and will still be able to manipulate.

But I want to just put in the record what I think the roots of the scandal are. Accountants acting as consultants, OK? Analysts making false recommendations because of conflicts of interest, Enron and others hiding losses in special-purpose entities, executives encouraging their workers to put their retirement savings, 100 percent of it, in employer's stock as they were unloading—

that's wrong—claiming false earnings. And the rules of the game allowed them to do this.

But yet and still there's a lot of illegalities. Insider trading, I would add, which I hope we're going to get to later today.

So I just want to thank the panel from my perspective, because I think you've given me some great ideas. And, Ms. Minow, I want to talk to you a little further about the ideas you've put on the table, as far as how we should treat these options, because FASB can meet today and do whatever they want.

And my fear is, you know, it will have unintended consequences. We will take these away from the—out of the 11 million people, 10 or 11 million, we'll take it away from the hardworking middle class, lower class folks, and the upper class will still get their options and they'll still be able to do all these things, these bad people will. And I want to make sure that we have a fix here that's much broader than an accounting fix, and that's what I'm working on. And I heard you talk about that, holding periods and so on and so forth.

And so I want to thank you all. Mr. Chairman, we've had a series of rolling chairs, and we're back to you.

[Laughter.]

Senator DORGAN [presiding]. Let us thank the witnesses and excuse them. Thank you for your contribution.

[Whereupon, at 11:15 a.m., the hearing was adjourned.]

A P P E N D I X

PREPARED STATEMENT OF HON. GORDON SMITH, U.S. SENATOR FROM OREGON

Mr. Chairman, thank you for holding this hearing today on the perspective of improving corporate responsibility. So many investors in this country have lost hope. They have lost hope that honesty and integrity guide the businesses of America. A sad state of affairs has led us to create a system of increased checks and regulation. I am committed to preventing further corruption and dishonesty from entering into corporate America. I am proud of the legislation passed unanimously by the Senate last week, S. 2673, the Public Company Accounting Reform and Investor Protection Act of 2002, and I will continue to fight for needed reform.

In the weeks before this bill was passed, I proposed an Investors' Bill of Rights. I worked with colleagues on both sides of the aisle to come up with bipartisan goals to prevent corporate abuse and protect investors. I feel that there are changes that investors should be able to count on coming out of the United State Congress. Many changes will be made as a result of this bill . . . and in other areas we may have to work further.

I believe that investors must have access to information about a company. We should ensure that every investor has access to clear and understandable information needed to judge a firm's financial performance, condition and risks. The SEC will have the power to make sure companies provide investors a true and fair picture of themselves. A company should disclose information in its control that a reasonable investor would find necessary to assess the company's value, without compromising competitive secrets.

I believe that investors should be able to trust the auditors. Investors rely on strong, fair and transparent auditory procedures and the concept of the Oversight Board in the Sarbanes bill is a sound one.

I believe investors should be able to trust corporate CEOs. Unlike shareholders or even directors, corporate officers work full-time to promote and protect the well-being of the firm. A CEO bears responsibility for informing the firm's shareholders of its financial health. I support the concept of withholding CEO bonuses and other incentive-based forms of compensation in cases of illegal and unethical accounting . . . further I do believe that CEOs must vouch for the veracity of public disclosures including financial statements.

I believe that investors should be able to trust stock analysts. Investors should be able to trust that recommendations made by analysts are not biased by promises of profit dependent on ratings. It is only common sense that there should be rules of conduct for stock analysts and that there must be disclosure requirements that might illuminate conflicts of interest.

Finally I believe that we should be able to rely on the Securities and Exchange Commission to protect investors and maintain the integrity of the securities market. Current funding is inadequate and should be increased to allow for greater oversight—ensuring investors' trust in good government.

During the debate on this bill my attention has been called to the plight of public pension systems, such as Oregon's Public Employment Retirement System—known by the acronym PERS. PERS was invested in both Enron and WorldCom stock and has been hit hard by the debacles that occurred in each company. The PERS system lost about $46 million after Enron self-destructed and another $63 million following the WorldCom scandal.

These losses occurred because false profits were inflated and corporate books were doctored. Under the PERS system, an 8 percent rate of return is guaranteed for the 290,000 Oregon active and retired members of PERS. Oregon taxpayers have to make up the difference following an ENRON debacle or WorldCom scandal—and my state's budget is not prepared for this kind of loss.

Further, I am interested in finding out if there is more we can do. I am asking the General Accounting Office, in consultation with the Securities and Exchange Commission and the Department of Labor, to report to Congress on the extent to

which federal securities laws have led to declines in the value of stock in publicly traded companies and in public and private pension plans.

I believe that a study of this nature is necessary because many public and private pension plans continue to rely on the continued stock growth in publicly traded companies—much like the PERS system. I believe that such a study would provide the needed information so public and private pension plans can reevaluate future investments in publicly traded companies.

We cannot stand by and watch our hard working Americans' pension systems ruined while corrupt corporate executives take advantage of investors. I am proud of the work the Senate has done in the last week in creating accountability and responsibility in corporate America and look forward to working on this issue in a way that will help the investors and pensioners in the PERS system in Oregon.

Thank you Mr. Chairman.

○