U.S. Securities and Exchange Commission

Written Testimony Concerning Accounting and Investor Protection Issues Raised by Enron and Other Public Companies

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Chairman Sarbanes, Senator Gramm, Members of the Committee:

I am pleased to appear before the Senate Banking Committee on behalf of the Securities and Exchange Commission. As the final witness in the series of hearings you have held over the past two months, I have followed with great interest the many issues this Committee has explored surrounding high profile business failures in recent years, including, most recently, the collapse of Enron Corporation. At the outset, Mr. Chairman, I would like to express how much my fellow Commissioners, our Staff and I appreciate the thoughtful and deliberative approach you have taken in these hearings. The record these hearings have developed will help us all advance our thinking on improvements to our current regulatory system and surely will be a landmark example for future Congresses to follow. Undoubtedly, the record compiled will provide a thorough foundation for making our Nation's federal securities laws more responsive to the current-day needs of investors, whether by legislation, regulation, or some combination of the two.

On a related, note, we want to thank you, Mr. Chairman, Senator Gramm, and all the members of this Committee for your strong, bipartisan support of our agency. This Committee, of course, has had a long tradition of supporting the SEC; but over the last several months, as we have witnessed not one but three separate crises affecting our capital markets, you have provided leadership and strong support for our efforts, and I am personally grateful for your wisdom, support and encouragement. In addition, we deeply appreciate the support of the entire Committee for funding pay parity for our Staff and your concern for our agency's resources at this especially critical time. I will address resources later on in my testimony, but I wanted to begin a substantive discussion by both commending and thanking you, Mr. Chairman, Senator Gramm, and the members of the Committee, for your extraordinary support.

INTRODUCTION

The past seven months have tested the mettle and resiliency of our country, our markets, and the investing public's confidence. With the events of September 11th, the bankruptcy of Enron and, just last week, the indictment of Arthur Andersen, we have witnessed how critical our appropriately vaunted capital markets are to the strength, security and spirit of our Country and our economy. All Americans have felt, and continue to feel, the consequences of these events. These hearings appropriately address the crisis created by the implosion of Enron Corporation. But, before we turn to Enron's impact, it is important to keep in mind that, from the perspective of the federal securities laws, all three crises have much in common. In each, the continuity and integrity of our capital markets was, or is, put in play. The response to the tragic loss of lives, and the sudden shutdown of our capital markets after the terrorist attacks of September 11th, presented a model for all of us, and the rest of the world, on how to address and respond to a crisis. From the President's unstinting and fearless leadership, to bipartisan cooperation in Congress, we responded quickly and forcefully to an unthinkable crisis. With the implosion of Enron, and the indictment of Arthur Andersen, my hope is that we will follow the model set last September, and work constructively together to restore vital confidence in our capital markets.

With Enron's disintegration, innocent investors, employees and retirees, who made life-altering decisions based upon a stock's perceived value, found themselves locked-in to a rapidly sinking investment that ate up the fruits of years of their hard work. It is these Americans, whose faith fuels our markets, whose interests are, and must be, paramount. America's investors are entitled to the best regulatory system possible. The Commission as an institution, and I both as its Chairman and personally, are committed to doing everything in our power not only to prevent other abuses of our system, but also to improve and modernize our existing system.

In the aftermath of Enron's meltdown, our agency currently is conducting an enforcement investigation to identify violations of the federal securities laws that may have occurred, and those who perpetrated them. Until the investigation is complete, the Commission cannot address the specific conduct of Enron Corporation and those involved with it, or the activities currently under investigation. The public can have full confidence, however, that our Division of Enforcement is conducting a thorough investigation and that the Commission will redress any and all wrongdoing and wrongdoers swiftly and completely.

Nothing that has occurred in recent months should undermine, or be allowed to undermine, investor confidence that our markets, or the regulatory system governing them, are still the best in the world. Our capital markets are still the world's most honest and efficient. Our current disclosure, financial reporting and regulatory systems also are still the best developed, the most transparent, and the best monitored by market participants and regulators. No other system yet matches the depth, breadth and honesty of our markets, and it is important that we not lose sight of that critical fact. While some foreign regulators have publicly claimed that Enron would not have collapsed under other systems, I tell you unequivocally that any such claim is unsupportable.

But, even though our system is the best at present, we can, and must, do better. As more and more individuals become direct participants in our markets, and face increasingly difficult investment decisions that affect their lives, savings goals and retirement security, we need to maximize the utility of our existing system for individual investors. At the same time, we must find a way to facilitate and promote the ability of American businesses to raise capital efficiently and expeditiously.

At my confirmation hearing before this Committee last July, I noted that our core securities laws are nearly 70 years old and reflect a time and state of technology long past. I promised to lead a review of the requirements the SEC administers to be certain they are sound, reasonable, cost-effective and promote competition. At that hearing, many members of this Committee, including Chairman Sarbanes and Senator Gramm, discussed with me the need for reform in the areas of corporate disclosure, accounting, analysts, and even crisis management. The events that have occurred since then have focused national attention and scrutiny on these needs. But, as you are all well aware, the need for comprehensive reform in these areas did not arise overnight. In fact, this Committee had identified many of the issues with which we are now grappling even before I was confirmed. It is important to keep in focus the fact that our system has long needed regulatory attention, especially as we evaluate competing claims for solutions to currently perceived problems.

At my confirmation hearing, Senator Dodd gave me wonderful and sage advice. He said,

> [Y]our job isn't to become the most popular guy in town. It's to be the guy that actually will look at us and tell us, when we may be calling on behalf of constituent interests, no matter how popular it may be, that you've got an obligation to do what's really right on behalf of investors in this country, the consuming public that depends upon the integrity of these markets. . . . [A]t the end of the day, you've got to decide - the Commission does - what's really in the best interest of maintaining those basic pillars and standards that have . . . sustained this country and its markets and their integrity for so long.

I am reasonably confident that I have already satisfied and surpassed Senator Dodd's first standard - clearly, I am not "the most popular guy in town"! Today, I address Senator Dodd's second guiding principle - I will tell you what we think in unvarnished fashion.

OPERATIVE PRINCIPLES

In dissecting the weaknesses Enron has highlighted, and exploring appropriate solutions, we should start by recognizing the substantial agreement and consensus that exists. We all know there are problems. Enron will stand in history as the symbol of the excesses of the 90's, when our markets lived on a culture of speculation, with too many market participants believing the market could only go up. Enron is the poster child for something that has been evident for a long time - our financial disclosure and reporting system has not kept pace with changes in our markets, and as a result, it does not work as well as it should. Enron is tragic, and we grieve for the losses investors and employees suffered. Enron also must be a catalyst for lasting reform.

In analyzing the aftermath of Enron, there are two discrete issues we must address, and concomitantly, two discrete attributes the solution to both issues must possess. First and foremost, it is no secret that the public's confidence in our capital markets and disclosure system has been shaken over the past seven months. Therefore, whatever it is that we do, we must do it quickly. Second, our system of financial disclosure and reporting, corporate governance and accounting regulation are in need of significant improvements and updating. Therefore, as we act quickly, we must also act wisely and comprehensively.

As we work together, we need to identify the problems requiring solution, discuss the range of proposed solutions, consider alternatives to, and criticisms of, those alternative solutions, and accept the timeless truth that, in matters of this nature, there are no perfect answers, there is no absolute truth. Indeed, to paraphrase both Voltaire and von Clausewitz, the worst enemy of a good solution is a perfect one.[1] Both Congress and the Commission must act - at the Commission, through regulation, which has the benefit of greater immediacy, pursuant to our existing and ample available authority; in the Congress, through legislation, which has the benefit of extending the reach of our available authority where necessary. The fact that we have ample authority to pursue most of our reform objectives does not lessen our obligation to consult and work with Congress. But, it does mean that Congress should be cautious in passing legislation unless it is clear that our authority simply cannot get us to the finish line. Together, I am confident that we can solve these problems in the best interest of the public.

Regardless of the reforms we discuss or adopt, one point must be absolutely clear. The Commission and our Division of Enforcement are vigorously engaged in enforcing the current securities laws. Make no mistake, the SEC is the markets' top cop and - with additional resources this Committee has sought for us - we will carry out our mission with even greater vigor.

OVERVIEW OF NEEDED REFORMS

Our system requires that corporate leaders be faithful to the interests of investors and to act with both ability and integrity. Complete and accurate disclosure and financial reporting to investors and markets are important parts of this duty. The most important challenge to corporate governance today is to restore the preeminence of this duty. This is as much a moral imperative as a legal one.

In recent years, corporate leaders have been under increasing pressure from the investment community, including individual investors, to meet elevated expectations. They also have been operating under a system that can misalign the incentives of investors and those of management. Our culture over the past decade has fostered a short-term perspective of corporate performance. Corporate leaders and directors have been rewarded for short-term performance, sometimes at the expense of long-term fundamental value. Investors have purchased stock not because they believed in the business or its strategy as an investment over the long-term, but simply under the assumption that stock prices would only go up.

But, after a most incredible bull market, we have had to witness the truth of the timeless axiom that whatever goes up can also come down, and not only because of a reversal in business outlook or fundamentals. Corporate leaders, under pressure to meet elevated expectations in the bull market, in too many instances were drawn to accounting devices whose principal effect was to obscure potentially adverse results. Moreover, the effectiveness of a number of the checks and balances intended to ensure that we achieve appropriate corporate governance and financial reporting and disclosure also declined. These include reviews of financial reporting by outside auditors and the activities of audit committees. The moral imperative on those intended to provide the checks and balances has eroded and must be restored. Out of the ashes of the Enron debacle, corporate reputation is reemerging as a significant economic value. Corporate governance appears to be improving as a result of this greater market discipline in the wake of the Enron debacle. But much more needs to be done.

Confidence in our capital markets begins with the quality of the financial information available to help investors decide whether, when and where to invest their hard-earned dollars. Comprehensible information is the lifeblood of strong and vibrant markets. Our system and the global markets supporting that system require accurate, complete and timely disclosure of financial and other information. The current system of federal securities regulation is premised on full and fair disclosure of this information. Companies choosing to access the public capital markets must provide material information about their financial results and condition, businesses, securities, and risks associated with investment in those securities.

This Committee and its distinguished predecessors wisely permeated the federal securities laws with the philosophy that full disclosure is the best way to permit markets to allocate capital. Congress rejected a "merit-based" system of regulation, which could have been construed as government's approval or guarantee of securities issued by public companies and that could unduly interfere with efficient market allocation of capital. Optimal capital allocation requires that there not be limits on entrepreneurship or companies failing, or on permitting people to invest in companies that will fail. There must, however, be complete, clear, and timely disclosure to support the market's allocation decisions. We believe it is important to maintain a disclosure-based regulatory system that relies on capital allocation decisions made by market participants.

The success of our markets has not been due just to their depth and breadth, but also to their quality and integrity. In the wake of the Great Depression, when world economic forces caused precipitous and calamitous declines in equity market values, this Country learned that investors are willing to commit their capital to markets *only* if they have confidence that those markets are fairly and honestly run, are fully transparent, and affirmatively minimize the risk of loss from fraud and manipulation. Existing statutory and regulatory provisions require that the public statements by or on behalf of publicly traded companies in the United States contain no misstatements of material fact and no omissions that make the statements that are made materially misleading. These protections are supported by a detailed structure of accounting and disclosure requirements intended to ensure that financial reporting and other disclosures meet the mandated standards of accuracy, completeness and comparability. Current law prohibits wrongful activity including, but very definitely not limited to, fraud in making materially defective or incomplete disclosure.

As the complexity of our financial markets continues to grow unabated, and the number of Americans who participate in them increases steadily, the Commission must ensure that our system's traditional high standards are not compromised. The goal of the SEC is to ensure that our financial markets are transparent and fair to all investors, and to do so, we must make certain that the public is adequately informed about investing and that corporate America provides the disclosure investors need to make fully informed decisions based on sound and reliable information. In addition to our extensive investor education programs, an integral part of our investor protection efforts is the SEC's aggressive law enforcement program, which protects investors from fraudulent and unfair practices.

Of course, no one should believe that we could create a foolproof system; those with intent and creativity can override any system of checks or restraints. Fraud aside, however, both the quality and timeliness of financial reporting and other disclosures can, and must, be enhanced. Financial reporting and disclosure standards can and should be amended to address the evident deficiencies, and the standard-setting process can and should be made more responsive to changing circumstances. As I discuss in more detail below, we believe we can achieve needed improvements by improving standards and our regulations in three principal areas.

- ***First, disclosure by public companies must be truly informative and timely.*** Companies must be subject to an affirmative obligation to provide reliable information that is informative, relevant, comprehensible, and timely. Investors should have all the information they need to make valuation and investment decisions. We want investors to have an accurate and current view of the posture of their company, as seen "through the eyes of management." This has long been the SEC's disclosure standard, but "through the eyes of management" must be viewed by all of us, and most importantly by companies' top officials, as a broad and fluid obligation, not merely an obligation to disclose specified categories of information at specified times. And, meaningful disclosure is more than a single number. There has been far too heavy an emphasis by all market participants on quarterly and year-end earnings per share, and too little emphasis on a concise, yet lucid, presentation of financial information. We recommend additional substantive disclosure requirements that permit fuller understanding of financial statements and thereby improve overall financial disclosure. We also recommend improving other disclosure requirements to provide disclosure of higher quality, while avoiding greater quantity for quantity's sake. Finally, we are seeking to modernize our disclosure system to seek more timely disclosure of the most significant information, while protecting companies from premature disclosure, disclosure of sensitive information and second-guessing over when and how disclosures were made.

- ***Second, oversight of accountants and the accounting profession must be strengthened and accounting principles that underlie financial disclosure must be made more relevant.*** Outside auditors have an important role in ensuring that the companies they audit present an accurate, complete and current picture of their financial condition. Critical regulatory functions, including quality control and discipline, should be moved from the profession to an independent regulatory body that is completely or substantially free from influence or funding by the profession, and is subject to comprehensive and vigorous SEC oversight. Standards of independence should be revisited and strengthened to prevent conflicts of interest that might cause auditors to compromise the performance of their auditing functions. The standard-setting process for accounting and financial disclosure must be more timely and responsive to market changes and independent from undue influence. Present-day accounting standards are cumbersome and offer far too detailed prescriptive requirements for companies and their accountants to follow. That approach encourages accountants to "check the boxes" - to ascertain whether there is technical compliance with applicable accounting principles. We seek to move toward a principles-based set of accounting standards, where mere compliance with technical prescriptions is neither sufficient nor the objective. We support the wisdom of having accounting standards set by the private sector, but subject to our vigorous oversight. That standard-setting authority today resides in the Financial Accounting Standards Board, whose pronouncements govern financial statements because, but only because, the Commission has chosen to accept those standards as authoritative. The SEC should exercise its authority to ensure that FASB's agenda is responsive to issues facing investors and accountants and is completed on a timely basis.

- ***Third, corporate governance needs to be improved.*** Recent events also underscore the need to craft responsible guidance for directors and senior officers to follow. There are a number of ways current corporate governance standards can be improved to strengthen the resolve of honest managers and the directors who oversee management's actions and make them more responsive to the public's expectations and interests. We think the best way to do that is a two-fold approach: first, make certain that officers and directors have a clear understanding of what their roles are, and second, apply serious consequences to those who do not live up to their fiduciary obligations. The role of audit committees and outside directors also must be strengthened.

In his State of the Union Address in January, the President appropriately demanded "stricter accounting standards and tougher disclosure requirements." He called for corporate America to "be made more accountable to employees and shareholders and held to the highest standard of conduct."[2] Just two weeks ago, the President outlined a substantive, serious and thoughtful program to move toward implementation of these goals.[3] The SEC shares and embraces these principles, and is firmly committed to making them a reality.

OUR WORKING PROPOSAL

Even before Enron Corporation failed, we had been working to improve and modernize our corporate disclosure and financial reporting system to make disclosures and financial reports more meaningful and intelligible to average investors. As I pointed out in an opinion piece in *The Wall Street Journal* last December, the public and private sectors must work hard, together, to produce sensible and workable solutions.[4] Effective and transparent private sector regulation of accounting and accountants, subject to both SEC oversight and rigorous review by Congress, is an essential component. In addition, it is critical to improve corporate disclosure with financial statements that are clear and informative, with a system of "current" disclosure of unquestionably significant information and with better identification and discussion of critical accounting principles and other financial information and their impact on a company's results.

The Commission has endeavored to move forward as quickly as it responsibly can on these issues. First, in cautionary advice on December 4, 2001, we gave guidance on the appropriate use of, and limits on, pro forma financials.[5] In further cautionary guidance issued on December 12, 2001, we set forth initial requirements and guidance on the obligation of public companies to disclose critical accounting principles.[6] On December 21, 2001, we announced that our Division of Corporation Finance would monitor the annual reports submitted by all Fortune 500 companies that file periodic reports with the Commission in 2002.[7] This new initiative significantly expands the Division's review of financial and non-financial disclosures made by public companies. On January 17, 2002, we announced our preliminary plan for a Public Accountability Board, a private sector regulatory body for the accounting profession.[8] On January 22, we identified issues in Management's Discussion & Analysis to be addressed in 2001 fiscal year reports regarding off-balance sheet financing arrangements.[9] On February 4, the securities industry and its self-regulators announced proposed rules to create more transparency for analyst recommendations - in response to a directive from the House Financial Services Committee and guidance from the SEC. We are in the process of obtaining public comments on these proposed rules and will proceed expeditiously to review and finalize them.[10] On February 13, we announced plans to propose rules to address aspects of corporate disclosure needing immediate improvement, and on the same day we called upon the New York Stock Exchange and Nasdaq to look at specific components of corporate governance.[11]

Just this Monday, we released orders and temporary rules in order to assure a continuing and orderly flow of information to investors and the U.S. capital markets in light of the indictment of Arthur Andersen LLP.[12] Immediately upon the announcement by the Department of Justice that Andersen had been indicted, we announced that we requested and received assurances from Andersen that it will continue to audit financial statements in accordance with generally accepted auditing standards and applicable professional and firm auditing standards, including quality control standards. Andersen has also told the Commission that if it becomes unable to continue to provide those assurances, it will advise the Commission immediately. The Commission will continue to accept financial statements audited by Andersen in filings as long as Andersen's assurances remain in full force and effect. The orders and rules we released also establish a framework for Andersen clients that are unable to obtain from Andersen, or that elect not to obtain from Andersen, a signed report on audits that are currently in process. As to those issuers, the Commission will require adherence to existing filing deadlines, but will accept filings that include unaudited financial statements from any issuer unable to provide audited financial statements in a timely manner. Issuers electing this alternative generally will be required to amend their filings within 60 days to include audited financial statements. This alternative framework is procedural in nature, is of finite duration, and is intended solely to address timing constraints and temporary disruptions that the affected issuers may face.[13]

Over the past several months, we have been seeking input broadly, from all concerned, on both corporate disclosure and auditor regulation. To that end, we held Roundtables, on March 4 in New York City and March 6 in Washington, D.C., with distinguished business executives, lawyers, accountants, academics, regulators, and public interest representatives, who discussed various proposals and helped advance our understanding and insight into these issues. We have scheduled our next Roundtable for April 4th, in Chicago, and plan to hold additional Roundtables in the next two months. This May, we will hold our first ever "Investor Summit" to solicit additional investor input.

This Committee has acted in a similar manner, seeking input from a wide variety of experts, and today both the Commission and this Committee are much better informed as a result of our respective information-gathering processes. For example, the "Investor Confidence in Public Accounting Act" recently introduced by Senators Dodd and Corzine has substantially advanced the discussion of issues in the area of regulation of public accounting in this country. Other related initiatives contain a number of suggestions that would be beneficial to the overall improvement of our system and its controls in the wake of Enron.

In testimony today, we seek to offer this Committee the most detail we can on our thoughts and plans for reform. But we do not yet have final answers. We are still soliciting and gathering additional broad input. We are receiving e-mails, phone calls and letters daily from a wide variety of our constituents. We are continuing to work with this Committee, Congress, the Justice Department, the Labor Department, and the President's Working Group on Financial Markets. Of course, we will invite additional public comments in the formal rulemaking process. Therefore, I respectfully submit this testimony today as our informed commentary on a number of important and complex subjects, but caution that it is truly a work in progress - we are ready to learn more, to explore further, and we will not foreclose any valuable alternatives and suggestions. The SEC does not have a monopoly on wisdom. What we do have is an undeniable obligation to think about the issues, search for answers, lead constructive debate, and move quickly on behalf of investors.

1. Corporate Governance and Disclosure Reforms

One of the most important challenges facing our capital markets today is to improve the quality of available corporate information. While technology enables investors to acquire information more rapidly than ever, our capital markets cannot reach a higher level of efficiency and investor confidence unless companies provide higher-quality, more insightful information as well.

As we engage in rulemaking efforts to strengthen the corporate disclosure system, the Commission also is assessing how our Staff can further protect investors through our review of that disclosure. In recognition of the limits of our resources, we are working to further the application of risk management techniques to our review process. For example, in the screening of periodic reports by the Fortune 500 companies that we have begun, we are using revised criteria which focus on areas we believe require in-depth scrutiny. Some of our additional personnel resource requests are intended to enable us to build an improved risk management competence for many facets of our agency's activities, not the least of which is corporate disclosure.

1.1 Improved Quality of Financial Disclosure

1.1.1. Management's Discussion and Analysis

Among other reforms, we believe it is necessary to improve the Management's Discussion and Analysis section of disclosure documents. MD&A has three related objectives:

- to provide a narrative explanation of companies' financial statements to enable investors to see the company "through the eyes of management";
- to improve overall financial disclosure and provide the context within which financial statements should be analyzed; and
- to provide information about the quality of, and risks to, a company's earnings and cash flow.

As such, MD&A is the backbone of a company's disclosures. Its goal is to wrap GAAP financial statements in a clear, understandable discussion of their context. Recognizing the importance of MD&A information to investors, the Commission is working to improve the quality of that disclosure in three key ways.

- **Critical Accounting Policies**

First, we intend to propose that companies be required to identify critical accounting policies - that is, the accounting policies of a company that are most important to the presentation of its financial condition and financial results and that require the most subjective or complex accounting estimates. Investors need a greater awareness of the sensitivity of financial statements to the methods, assumptions and estimates underlying their preparation. In our December 12, 2001 release, we have asked companies to begin addressing that need.[14] We intend to adopt new rules to elicit more uniform and precise disclosures about critical accounting policies in the MD&A section of annual reports, registration statements and proxy and information statements, with quarterly updates of that disclosure.

Although we are still formulating our precise critical accounting policies rules, it is already manifest they should include, at a minimum, basic disclosures investors need to understand how a company identifies those policies, and a discussion of those policies in the context of the company's financial results, explaining which accounting estimates and assumptions relate to them. Investors will benefit from knowing what uncertainties could affect those estimates and assumptions. Simple quantitative analysis could show investors the sensitivity of a company's estimates, and the impact on a company's financial statements of possible changes - both positive and negative - of those estimates. Past changes a company has made in estimates may be relevant, as well as disclosure of any trends or uncertainties that may cause a company to change the accounting method it uses. Investors also should know whether management discussed the selection, application and disclosure of the critical accounting policies with the audit committee of the board of directors. Finally, to be truly useful, any new disclosure about critical accounting policies must be clear, concise and understandable - not legalese or "accountingese."

- **SPEs and Related Party Transactions**

Investors have become increasingly interested in the sufficiency of disclosure regarding off-balance sheet obligations and contingencies, including use of special purpose entities. A company's relationships with unconsolidated entities facilitate its transfer of, or access to, assets. Investors need to know more about liquidity risk, market price risks, and effects of "off-balance sheet" transaction structures. MD&A should mandate specific disclosures by companies concerning transactions, arrangements and other relationships with these unconsolidated entities, or other persons, when they are reasonably likely to have a material effect on a company's liquidity, its capital resources or its requirements for capital. If a company's liquidity is dependent on the use of off-balance sheet financing arrangements, such as securitization of receivables or obtaining access to assets through special purpose entities, investors also need to know the factors that are reasonably likely to affect its ability to continue using those off-balance sheet-financing arrangements. Such matters could affect the extent of funds required within management's short and long-term planning horizons. The Commission will clarify the need for this type of information in MD&A.[15] As indicated in our February 13 press release, we also intend to propose rules requiring current disclosure of transactions that increase a company's obligations, including contingent obligations, whether or not reflected on its balance sheet.[16]

Many readers of financial statements also have cited a lack of transparent disclosure about transactions where that information appeared necessary to understand how significant aspects of the business were conducted. Investors would better understand financial statements in many circumstances if companies' MD&A disclosures included descriptions of the terms of broader categories of material transactions that differ from those that likely would be negotiated with clearly independent parties, whether or not they involve "related parties" as traditionally defined. Investors need to understand a transaction's business purpose and economic substance, its effects on the financial statements, and the special risks or contingencies arising from it. More specific MD&A requirements relating to the effects of these kinds of transactions would aid investors.

- **Trend Information**

The third phase of our MD&A rulemaking will improve MD&A disclosures relating to trend information. We believe investors will be better able to see a company through management's eyes if MD&A includes information about the trends that a company's management follows and evaluates in making decisions about how to guide the company's business. This disclosure would in many cases entail certain forward-looking information. Thus, with the envisioned improvements in companies' financial trend disclosure, we will need to address lingering issues relating to when a company needs to update disclosure that is forward-looking and viable in the marketplace. With expanded disclosure obligations, we also are mindful of liability issues and the liability standards associated with new disclosures. Our goal is to assist investors by providing more meaningful and understandable information, but not to convert our disclosure system into an attractive nuisance for increased litigation.

1.1.2. Clarity and Accountability

In addition to these planned MD&A disclosure reforms, we have in mind two very different initiatives, both of which would improve the quality and utility of the corporate disclosure system. These are still in the conceptual planning stage.

First, we believe investors would benefit if companies could produce clear and concise financial statements. This would *not* be an initiative to "dumb down" or omit the complete picture that current financial statements are intended to provide. Rather, it would be an effort to give companies the flexibility to produce and disclose financial information in "layers" ranging from those with a general "big picture" focus to those that encompass the minutest detail, all of which would be readily accessible to investors electronically. This would permit investors to "drill down" to whatever layer they wish. The layers would allow companies to explain financial statement disclosure to investors in ways that are more clear, concise and understandable.

The second initiative is to improve the corporate disclosure system by increasing the CEO's individual accountability for his or her company's disclosure. As the President noted in his March 7th speech on corporate ethics and disclosure,[17] it is unacceptable for the CEO of a company to disclaim responsibility for, or deny awareness or understanding of, the financial disclosures that his or her company makes. We are committed to addressing and reinforcing that responsibility. Our vision is a rule that would require CEOs to certify to shareholders that any significant information of which the CEO is aware has been disclosed to shareholders, and that the disclosures made are not misleading, inaccurate or false. We believe this "sign on the dotted line" approach will focus CEOs' attention very acutely on responsibilities that already exist under current law. We are also considering rulemaking that would call for the establishment of procedures designed to bring significant information to the attention of top management.

1.2. More Timely Disclosure

In addition to improving MD&A and other initiatives to improve the quality of the corporate disclosure system, we also intend to take other steps to modernize and improve the timeliness of corporate disclosures. We are working on three sets of proposed rules that would do this.

1.2.1. Accelerated Annual and Quarterly Reports

We are considering proposing rules that would shorten the filing deadlines for annual reports from 90 to 60 days after a company's fiscal year end and would shorten the filing deadlines for quarterly reports from 45 to 30 days after a quarter's end. The current secondary market disclosure system under the Exchange Act requires companies to provide updated information to investors at annual and quarterly intervals, with a small number of specified significant events reported somewhat more timely. The SEC has not changed its annual and quarterly report deadlines for more than 30 years. Thirty years ago, companies still were dependent on paper and pencil, adding machines, carbon paper and the U.S. mails to prepare and file their reports with us. Significant technological advances in the intervening decades, including computers, remarkably quick and sophisticated financial and other software, speed-of-light communications, e-mail, video conferencing and the like, have enabled companies to capture, communicate and evaluate information and prepare their reports more rapidly.

The revolution in information technology and communications that allows companies to disseminate and collect information broadly and swiftly also has both increased investors' demand for, and provided the means for companies to supply, corporate disclosures on a more "real time" basis. Many public companies have adopted the practice of routinely issuing press releases to announce their annual and quarterly results *significantly in advance* of the due dates for their Exchange Act reports.[18] This is concrete empirical evidence that a more rapid time line for corporate disclosures is feasible and achievable. For all of these reasons, it is long overdue for us to modernize our periodic reporting system by significantly shortening report deadlines. The Commission for years has recognized the critical need for such reform.[19] We are committed to implementing those reforms.

1.2.2. More Accessible Filings

Today, the first and most obvious resource for many investors trying to find information about a company is through that company's website. We want to assure that investors can find companies' reports there. We therefore intend to move toward a system where public companies with Internet websites will post their periodic reports there no later than the same day they are obligated to file reports with the Commission.

1.2.3. Accelerated Disclosure of Corporate Insiders' Trading Activities

Under current law, corporate insiders are not required to file reports of their trading activities with the Commission until ten days after the end of the month in which the trading occurred.[20] Six years ago the Commission adopted a rule that allows insiders who sell their holdings back to their companies to postpone disclosure of those transactions for up to an additional year.[21] Under current law, we cannot accelerate statutory reporting requirements applicable to insiders. But, we can and intend to impose obligations on *companies* to report immediately any transactions by corporate insiders, including those with the company. Legislation is currently pending that would amend Section 16 of the Exchange Act to require the reporting (by electronic media) of securities transactions by officers, directors or other affiliated persons of the issuer within a much shorter time frame (a business day or two). While there are practical issues to work through regarding electronic filing, the concept of requiring insiders to report their trades more expeditiously is unassailable. Legislation of this nature is worth consideration, but we do not think it is critical. We intend to act by rule in order to expedite the flow of this important information to the market.

1.2.4. More Current Disclosure

We also intend to solicit public comments soon on a significantly expanded list of items to be disclosed by companies between their current periodic reporting periods. In addition, we intend to accelerate the filing deadline for these disclosures. At present, only five corporate events trigger mandated intra-period disclosure on Form 8-K. These include a change in the company's independent auditor; resignation of a director; a change in control; the acquisition or disposition of a significant amount of assets not in the ordinary course of business; and bankruptcy or receivership.

The proposals being drafted would add approximately a dozen new significant events requiring companies to make expeditious Form 8-K filings. In addition to transactions by insiders in company securities, described above, companies would be required to report the following events on a current basis:

- changes in rating agency decisions about a company;
- defaults and other events that could trigger acceleration of direct or contingent obligations;
- transactions that result in material direct or contingent obligations not included in a prospectus filed by the company with the Commission;
- offerings of equity securities not included in a prospectus filed by the company with the Commission;
- waivers of corporate ethics and conduct rules for officers, directors and other key employees;
- material modifications to rights of security holders;
- departure of the company's CEO, CFO, COO or president;
- notices that reliance on a prior audit is no longer permissible, or that the auditor will not consent to use of its report in a Securities Act filing;
- definitive agreements that are material to the company;
- losses or gains of material customers or contracts;
- material write-offs, restructurings or impairments;
- movement or de-listing of the company's securities from an exchange or quotation system; and
- any material events, including the beginning and end of lock-out periods, regarding the company's employee benefit, retirement and stock ownership plans.

Under existing Form 8-K requirements, companies must file a Form 8-K within five business or 15 calendar days after the triggering event, depending on the nature of the event. Given the significance of these disclosures to participants in the secondary markets, we intend to propose that companies be required to file their Form 8-K reports no later than the second business day following occurrence of the events. We also will consider whether some of the events should be disclosed by the opening of business on the day after the occurrence of the event. The need for more current disclosure of a broader range of significant corporate activities is something the Commission recognized several years ago.[22] We are committed to having companies provide better current information.

Over a longer term, we also will consider amendments to the basic framework of the reporting system to require public companies to disclose vital information on a "current" basis. We intend to formulate revisions to our rules that would impose a duty on companies quickly to disclose events that are unquestionably significant to investors. This would include, but not be limited to, the updating of the trend information that we envision adding to the MD&A disclosure requirements.

1.3. Corporate Governance Reforms

As discussed, there are a number of ways current corporate governance standards can be improved to strengthen the resolve of honest managers and the directors who oversee management's actions and make them more responsive to the public's expectations and interest. In considering these reforms, it is important to keep in mind that, traditionally, corporate governance issues and standards have been left to the states to develop and enforce. We do not recommend a change in that basic division of responsibilities between the states and the federal government. Nonetheless, because our markets are national and international, not solely intrastate, and because the consequences of a lack of meaningful and cohesive corporate governance reform are dramatic, we are devoting considerable attention to the ways in which our system can be improved. Other witnesses have raised similar concerns.[23] We support the "race to the top" of best practices on corporate governance.

To this end, last month we asked the New York Stock Exchange and Nasdaq to review their corporate governance and listing standards, including important issues of officer and director qualifications and codes of conduct of public companies. We also separately asked Financial Executives International to review its code of ethics in light of recent developments. Both the NYSE and Nasdaq responded quickly to our requests. Both have commenced reviews of existing requirements, and have appointed committees to assist that effort. We expect to receive results of their reviews shortly. And, this past Tuesday, FEI presented us with a series of recommendations, as well as revisions to its acclaimed code of ethics.[24]

We also intend to implement the President's directive to us to require CEOs to certify their company's annual and quarterly filings in a meaningful way. As we envision this, we believe that CEOs should be able to attest to the fact that anything *they* consider important in running their companies has been disclosed to investors. In addition, the President called upon us to seek disgorgement from corporate officers and directors of compensation and bonuses predicated on corporate performance that turns out to have been illusory or fraudulent. In fact, on March 13, we filed an action seeking exactly such disgorgement from the former president and chief operating officer of IGI Inc. for violations of the antifraud, periodic reporting, record keeping, internal controls and lying to auditors provisions of the federal securities laws.[25] We intend to proceed similarly in other appropriate situations where principal corporate officers and directors can disgorge to investors and their companies unearned or undeserved bonuses, stock options and compensations.

1.4. Capital Raising Reforms

Finally, contemporaneous with this renewed focus on the corporate disclosure system, we will pursue our plan to implement long-needed reform in the regulations governing capital raising. Our capital markets need to be strengthened by revising many of the communications restrictions imposed under the Securities Act and its regulations and by modernizing the delivery system for information, including prospectuses. In addition, once the Commission truly has put in place a current disclosure system, it will then be both possible and appropriate to provide accelerated access to the public markets for seasoned reporting companies with the largest market capitalization.

These offering initiatives remain a priority and the work on them is well underway; they should go hand-in-hand with some of the other initiatives I have already mentioned. In prior years, the Commission recognized the need for this kind of reform, but did not implement these improvements.[26]

1.5. Legislative Assistance

I have highlighted some of the items on the Commission's agenda for improving the quality and timeliness of corporate disclosures and modernizing the offering process. There are a few areas where we believe we need the assistance of Congress to implement fully some of the initiatives I have discussed, and to take other important steps in improving the integrity, quality and timeliness of the corporate disclosure system.

1.5.1. Additional Enforcement Tools

As noted, the President has called upon us to improve the system of personal accountability for corporate disclosures on the part of corporate officers and directors. The President also endorsed our need for administrative authority to bar officers and directors who seriously violate their duties to public shareholders. At present, the securities laws authorize us to seek officer and director bars in court in appropriate cases.[27] But some courts have taken an inhospitable approach to the plain legislative language, thwarting our ability to prevent some officers and directors who inflict serious harm on investors from repeating that kind of conduct.[28] We will continue to press for a more enlightened and hospitable reading of the statutory language, but we believe the Commission should have the ability, administratively, to effect such relief promptly, subject of course to subsequent judicial review of the Commission's action. We also think the Commission should have the authority to impose penalties in these instances. By removing existing judicial restraints, and by providing for judicial review of the Commission's imposition of such a sanction, you will be giving us a tool we need to address and deter corporate malfeasance and misfeasance - akin to our authority to do the same with brokerage firm personnel, stock exchange officers and directors and others, and akin to the authority of the banking regulators to bar future service by banking officers and directors. A recent edition of *BusinessWeek* reported that a significant majority of chief financial officers polled by *Business Week* and Financial Executives International favored harsher penalties for officers and directors who fail to discharge their duties properly.[29]

In addition, as I noted during my confirmation hearings, the amount of recidivism in the securities field is alarming. We believe that both the Commission and the courts should be under an *obligation* to impose officer and director bars in any case of repeat fraudulent misconduct by officers and directors.

Another tool we seek to enable us to deal with recidivists is statutory flexibility for the Commission to seek civil contempt penalties for those who violate prior judicial or administrative sanctions and restrictions. The Commission believes that the Department of Justice also should be given the ability and the resources to pursue instances of criminal contempt, on its own or at the Commission's urging, with a simplified statutory test that will not bog these cases down in endless proceedings.

Under existing law, the civil liability provisions for violation of disclosure requirements include disgorgement of all gains, but for those without gains the maximum civil liability is $120,000 or the "gross amount of pecuniary gain" for each violation, even for fraudulent disclosure violations. We seek legislation that increases the sanctions for defective disclosure. Legislation was passed in 1984 to address the previously insufficient sanctions under the securities laws for insider trading.[30]

A similar need exists today to increase the sanctions for violation of disclosure requirements without regard to trading. Investors can be harmed by disclosure that violates applicable requirements to the same degree, whether or not those responsible for the violations are trading. Since the purpose of these sanctions is to deter future misconduct, and redress past misconduct, looking at this problem from the vantage point of defrauded investors is the appropriate approach. While large monetary sanctions will not, by themselves, rid us of misconduct, they will give all those involved in our capital markets a greater incentive to abide by the statutes and rules administered by the SEC.

1.5.2. Increased Emergency Powers

On November 13, 2001, the House of Representatives passed H.R. 3060, the Emergency Securities Response Act of 2001, to augment the emergency authority of the SEC by revising Section 12(k) of the Exchange Act, to allow emergency powers for 30 business days. We had found, in the wake of the business repercussions from the significant damage and loss of life inflicted on lower Manhattan following the horrific events of September 11th, that the existing provision of 10 business days was not sufficient. I commend this legislation to the Committee's attention and ask for your support to present such legislation to the Senate.

1.5.3. Increased Shareholder Powers over Option Plans

To ensure that shareholders are both aware of, and have some right to evaluate, the proposed issuance of securities of a public company to its officers and directors, we believe all national securities exchanges and national securities associations should adopt listing rules in the next 6 months that require companies to seek shareholder approval for plans that allow corporate officers or directors to acquire company securities. We intend to ask the exchanges and associations to implement such proposals, and we believe, based upon our excellent working relationships with them, that they will do so, but we would like to make this a matter of law, rather than a matter of choice.

1.5.4. More Timely Access to Reports

To ensure the greatest degree of investor access to corporate disclosure, we seek clear authority to require public companies to maintain corporate websites, and to post corporate disclosures and other documents on their websites. While we believe that we can effect this result, clearer authority would move us quickly and easily to the desired result whereby all corporations recognize that the time has come for them to understand that constant and immediate communications with shareholders are essential.

Also, to ensure the ability of the Commission to modernize the delivery of corporate information, the Commission needs unambiguous authority to permit delivery of corporate disclosure through electronic means subject to such conditions as the Commission requires for the protection of investors.

1.5.5. Private Securities Litigation

Even though more must be done to minimize the likelihood that future Enrons can occur, it is also important to recognize that there is neither enough money, nor people, to prevent hucksters from defrauding innocent investors. The SEC has a critical role to play in protecting investors. But, private litigation, when properly formulated, is a very necessary supplement to the SEC's mission. To be effective, however, private litigation must be designed to help investors, not their lawyers. Though not a principal focus of concern, some have suggested that the Private Securities Litigation Reform Act of 1995 (P.L. 104-67) is somehow responsible for, or contributed to, the collapse of Enron, and that reforms, or even outright repeal of the Act, are warranted.[31] Because this Committee took the lead in promoting the PSLRA, we think it appropriate to express the Commission's position with respect to these issues surrounding the PSLRA.

The PSLRA was the subject of, literally, years of debate and consideration by the Congress. In 1995, after numerous hearings, exchanges with the Commission, and debate, the bill was initially approved by a vote of 320 to 102 (with one abstention) in the House of Representatives, and by a vote of 65 to 30 in the Senate. After President Clinton vetoed the bill, the Congress moved to override the President's veto message, voting 319 to 100 (with one abstention) in the House, and 68 to 30 in the Senate, after which the bill automatically became law.

Just prior to Congress' consideration of the bill, then-Commission Chairman Levitt wrote to then-Senate Banking Committee Chairman D'Amato on November 15, 1995, on behalf of the Commission:

> At the outset, let us express our appreciation for your willingness to heed the concerns of the Commission . . . [W]e believe the [current] draft . . . responds to our principal concerns. We understand the need for a greater flow of useful information to investors and the markets and we share your desire to protect companies and their shareholders from the costs of frivolous litigation.[32]

Since the enactment of the PSLRA, the dollar amount of class action awards and settlements have increased substantially, while the number of issuers sued has not changed significantly.[33] In addition, by requiring courts to consider who the plaintiffs should be in any class action, one intended beneficial result of the PSLRA is that larger, and more thoughtful, institutional plaintiffs have become more involved in the shareholder litigation process, rejecting cases that are frivolous, but pursuing vigorously those cases that reflect serious misconduct. We should all be alert to possible unintended consequences that may arise from any legislative enactment; but, in the absence of any empirical data suggesting a nexus between the PSLRA and situations like Enron, we strongly urge the Committee to refrain from making any changes in that legislation.

2. Accounting Reforms

2.1 The Public Accountability Board

The number of sudden and dramatic reversals of public companies' financial conditions has called into question the regulatory system currently used to oversee the quality of the audits of financial statements that are filed with the Commission and relied on by investors. In particular, it appears that the current system of firm-on-firm peer reviews, overseen by a Public Oversight Board that lacks the power to direct the conduct of those reviews or to discipline auditors for unethical or incompetent conduct, has not produced a credible result. The current system does not provide investors with sufficient confidence in the efficacy of the audit process.

We are proposing "private sector" regulation, not "self" regulation. Self-regulation implies that the accounting profession would regulate itself. We are suggesting regulation by the private sector, but <u>not</u> by the profession. Rather than a body that functions under the aegis of the American Institute of Certified Public Accountants, which represents the accounting profession, the Commission announced on January 17th our intention to create a new, private sector, independent body that can direct periodic reviews of accounting firms' quality controls for their accounting and auditing practices and discipline auditors for incompetent and unethical conduct. We believe there is substantial consensus on this approach.

This private sector body would supplement our enforcement efforts, by adding a layer, or tier, of new regulation. There should be no misunderstanding. In the first instance, we, and our Division of Enforcement, will continue vigorously to investigate and pursue instances of illegal conduct. The SEC has had a successful history with two-tier regulation that involves the private sector. Such two-tier regulation has been largely successful with the brokerage industry. Private regulation presents major advantages, in terms of available resources, quality control and discipline. The SEC is best suited to bring actions for civil violations of law - fraud and such. Private regulation can govern conduct that may not be unlawful, but reflects ethical lapses or deficiencies in competence. It allows quality control that is more flexible, but also more effective. And discipline can be applied more quickly and therefore more effectively. The accounting profession and the investing public both would benefit from such an approach.

In order to understand how the Commission's proposal regarding oversight of the accounting profession is a substantial improvement over the present system, it is important to understand what has been misunderstood by many who have commented on this issue - the structure of the AICPA's Public Oversight Board. The POB was created by the AICPA in 1977 and charged with overseeing and reporting on the programs of the AICPA's SEC Practice Section (SECPS), created that same year. The SECPS is comprised of accounting firms that audit the financial statements of public companies, and establishes quality control requirements for those firms. While intended to be autonomous (the POB could set its own budget, establish its own operating procedures, and appoint its own members, chairperson, and staff), the POB relied on voluntary dues paid by SECPS members for its funding. In addition, the POB lacked the ability to organize and implement its own quality control reviews. And, the POB was not given disciplinary authority. All of these deficiencies will be remedied in the private-sector regulatory regime we have proposed.

Another issue receiving a great deal of attention is whether legislation is needed to implement our proposed private sector regulatory body. First, it is critical to separate the regulatory model from the issue of whether there is a need for legislation. We think there is substantial agreement on the model we have proposed, and that is the first step in moving toward a more effective regulatory system. Legislation is not required to establish private sector regulation with SEC oversight. If Congress determines that legislation is appropriate, however, we are committed to assist that process. Whether or not Congress acts, it is incumbent for the SEC to move forward with the most responsible proposal it can.

The new body we suggest, which we refer to as the Public Accountability Board or PAB, must have certain attributes, and its mission must be based on certain immutable principles.

2.1.1 Private Sector Regulation

Today, we are even more convinced than we were when we initially proposed the PAB in January that there must be private sector, not self, regulation of the profession in the areas of discipline and quality control. The AICPA's Public Oversight Board has not been as effective as it could have been, and the disciplinary process has not been sufficiently swift or transparent. There is near total consensus on this point. Indeed, the AICPA and the major accounting firms have recognized this is a needed change to restore public confidence.

This new entity is a means to assure that accountants conform not merely to the law, but to the highest ethical and competence standards as well. In the details of our proposal that follow, such as an assured source of funding, and a required super-majority (at least) of public board members unaffiliated with the accounting profession, our guiding principle was to avoid the shortcomings of the current system, and to learn from those shortcomings. The POB was a good idea a quarter century ago, but it does not meet the needs of today.

2.1.2. Predominately Public Membership of the Board

For the same reason that we believe that public oversight, rather than self regulation, is needed to restore faith in the accounting profession, we believe that it must be clear that the PAB places the public interest and the interest of investors above all else. This means that representatives of the public must be in the position to make all significant calls on quality control and disciplinary issues. At its core, we believe the board should be composed predominantly of independent public members, unaffiliated with the accounting profession. This would help ensure oversight of the accounting profession that is free from undue influence from the accounting profession. In the Roundtables we have held so far, there has been general agreement that our proposed composition of the board - predominantly public members, not from accounting firms - was appropriate. During this Committee's recent hearings, virtually every witness endorsed the notion of a new regulatory structure of the kind we are proposing.

At the same time, we believe the public will benefit if the PAB also includes a small minority of members from the accounting profession. They bring necessary expertise and an understanding of current accounting issues. We think it ill advised to exclude them completely. As we consider reforms for oversight of the accounting profession, we need to take into account the likely effects of new initiatives - intended and unintended. If those with expertise are excluded from providing any oversight of their own profession, the PAB is likely to devolve into a board known more for its lack of understanding of issues than for its vigorous oversight. If we had to construct a board to oversee the structural integrity of a bridge, we would not exclude bridge builders or engineers. Having a small minority of members who are affiliated with the accounting profession will assure necessary expertise.

In order to obtain independence without sacrificing expertise, we believe that the PAB should be composed of public members and members associated with the accounting profession. Whether the board has a two-thirds majority of public members or three-quarters or some other super majority is an important detail, but should not detract from the underlying principle that the board must be independent, and must function independently.

To assure the quality and independence of the members, the selection of the initial group of PAB members, and the appointment of a chairperson (who should be a public member), should be made by the Commission. After the appointment of the initial members through a selection process directed by the SEC, the PAB itself should have the responsibility of choosing new members, and new chairpersons, to replace those who depart. Those selections should be subject to Commission approval. The PAB chairperson should always be selected from among the public members. The PAB should meet frequently, as distinguished from the current Public Oversight Board, and all of its members should be required to devote substantial time to the PAB and directly manage the entity.

The PAB appointment process should operate solely under the aegis of the SEC. The Commission has statutory authority to set accounting principles.[34] We have direct oversight responsibility for the quality of financial reporting, including enforcement powers. We recognize some witnesses and some legislative proposals would include other government officials, such as the Secretary of the Treasury, the Chairman of the Federal Reserve Board or the Comptroller General, in the selection process on an ongoing basis. We think this involvement by additional government officials with no direct responsibility for the governance of the accounting profession could dilute clear lines of oversight responsibility and unnecessarily complicate the selection process. In addition, we believe that the Commission, as an independent agency, should be protected from the appearance of pressure from other government sectors and agencies.

2.1.3. Diverse, Involuntary and Independent Funding

One of the most important steps to restore public confidence in the discipline and quality control of the accounting profession is to assure a funding source that is secure and independent. If all funding comes from the accounting profession, and voluntarily at that, as was the case with the POB, the PAB could operate under a cloud in the public's opinion. Well meaning legislative reform proposals that keep the funding source solely from the accounting profession are not as viable as those that spread the funding burden to all users of financial statements. We see funding coming from a variety of sources. First, membership in the PAB should be mandatory, in which case the PAB would be able to impose membership fees on accounting firms and their members. But, more importantly, additional funding should come from issuers whose financial statements are filed with the SEC and certified by independent public accountant members of the PAB. We believe, in contrast to a POB that is wholly dependent on voluntary funding from the accounting profession, the involuntary, broad-based funding from all users of audit services would protect the PAB from even the appearance of undue influence. We believe we have the authority under existing law to implement our funding concepts for the PAB.

2.1.4. Mandatory Membership

No matter how well conceived, the PAB will be effective only if all accountants, as well as all accounting firms, that audit public companies are required to abide by its directives. An auditor should not be able to circumvent the quality control and disciplinary mechanisms of the PAB simply by declining to register with the PAB. Therefore, we propose that membership in, and being subject to the PAB's processes, must be a prerequisite to an auditor's ability to supply audit opinions on which a registrant may rely to satisfy its filing obligations under the securities laws. We propose to implement this requirement by making membership in the PAB a condition for certifying financial statements, as required under our Regulation S-X.[35]

Remaining in good standing with the PAB must also be a prerequisite to the ability to continue to audit the financial statements of public companies. As discussed in more detail below, PAB discipline, and the possibility of that discipline, must be meaningful, and to be meaningful, the failure to be in good standing with the PAB (reflected in a PAB-imposed suspension or revocation of registration, or limitation of functions) must have significant consequences.

2.1.5. Improved Quality Control Reviews

While individuals within accounting firms generally take firm-on-firm peer reviews seriously, investors and critics of the program often consider it to be a "one hand washes the other" approach to regulation.

To avoid this perception, we believe that quality control reviews should be directed and principally conducted by PAB staff, and PAB staff should make all key decisions during the conduct of the reviews. The PAB should be sufficiently staffed to carry out this responsibility, although it should be feasible for the PAB to draw upon professional personnel from the profession to assist in the reviews, as long as any such personnel are subject exclusively to PAB direction.

The PAB should promulgate standards for its quality control review process. It should publish those standards for public comment, and the standards ultimately adopted must be subject to Commission approval. The current system provides for reviews only every three years, which we believe is insufficient. Therefore, along with promulgating review standards, the PAB should determine how frequently to conduct routine reviews and should determine what events or circumstances will trigger non-routine reviews. The firms that audit the vast majority of public companies should be reviewed annually.

While we believe that the Auditing Standards Board (ASB), the entity tasked with promulgating quality control standards for audits, has performed that task well, we expect that the PAB, through its work in conducting quality control reviews, will be well positioned to make very useful recommendations about those standards. We therefore believe that the PAB's mission must include the expectation that it will, as it deems appropriate, influence the agenda of the ASB and make public recommendations about quality control standards. We also believe that the ASB should have a formal mechanism for considering, and obtaining public comment on, those agenda items and recommendations.

Many commentators, and prior witnesses before this Committee, have offered suggestions on the structure of the accounting firms themselves, and how these firms could change their internal governance structure to better reflect the public interest needs. Improving risk management, improving internal controls over audit quality, enhancing the supervision of the audit process are all laudable goals. We believe many of these issues, as they reflect competency and ethical standards, could be addressed more quickly and effectively by the PAB.

Similarly, calls for a statutory imposition of an affirmative duty of supervision of audit personnel, similar to the supervisory duties that arise from the defense available under the Federal securities laws to broker dealers, may overshoot the mark.[36] The Commission already looks up the chain of command on any defective audit, when seeking to enforce the law, and we are concerned that a statutory provision may limit, rather than expand, the potential reach of the existing proscriptions.

Finally, ideas concerning the restructuring of the governance of the audit firm, requiring public members, or a majority of public members, or an independent oversight board, such as that adopted by the Andersen firm and chaired by Paul Volcker, are interesting and productive suggestions, but may be best left to individual firm consideration. The market has a large appetite for improved audit governance, and enhancements in this area should be supported by the SEC, but not mandated. We should encourage a "race to the top" in the adoption of best practices, but should be careful not to impose a one-size-fits-all solution.

2.1.6. Disciplinary Powers

The SEC has long had power to discipline accountants for failing to meet their professional standards of conduct. Rule 102(e) currently embodies that authority. The PAB should have parallel authority, such that the SEC could refer cases to it, and could take back investigations from it, at any time. This is similar to the current enforcement relationship the Commission has with NASDR and the NYSE.

Principal criticisms of the current system are that it takes too long to discipline an errant accountant, and that the sanction is not sufficient. Through mandatory membership of both firms and individual accountants in the PAB, the PAB could remove the accountant or the firm from practice before the SEC. If individual and firm membership in the PAB is a prerequisite to conducting audits of public companies, the temporary or permanent removal of an accountant or firm from the PAB's membership would operate to prevent the accountant or firm from practicing before the Commission. Additional remedies, such as limitations on the firm taking on new business, or specific quality control changes and other undertakings, should also be the subjects of PAB authority. The PAB would be required to take immediate action on any matter referred to it from the SEC. The public members of the PAB would oversee that immediate inquiry, and the public members would determine the sanctions. A further sanction would allow the PAB to require the rotation of auditors, that is, to force a public company to obtain a new firm, in light of the misconduct found on the part of the present auditor. This sanction we view as more meaningful than the wholesale call of some for automatic rotation of auditors, without any showing that there was misconduct, or a need for such rotation.

A further concern about private sector regulation is the lack of authority to compel production of documents and testimony. Due to the required membership in the PAB for both firms and individuals, and supplemented through contractual requirements with any issuer using financial statements prepared by a PAB member, we believe the PAB could conduct rapid inquiries, with the right to revoke or suspend for a time the registration of any member firm or individual, thus providing the clout necessary to get discovery of the facts in any investigation. This could work as effectively as if the PAB had subpoena power. In fact, the SROs regulating the brokerage community do not possess subpoena power, but through the available sanction of throwing the broker out of the business can nonetheless effectively compel cooperation in investigations. Moreover, we believe that, in cases in which the PAB was denied certain information, the Commission could assume responsibility for a particular accounting enforcement matter, and use its own subpoena enforcement authority to make sure that a full record is developed.

Persons subject to PAB disciplinary decisions should be able to obtain meaningful review of those decisions. The PAB should routinely and promptly transmit its disciplinary decisions to the Commission, and those decisions should be reviewable by the Commission either at the request of the disciplined person or on the Commission's own initiative. That review process would, of course, be public. These procedures could all be implemented under the Commission's existing statutory authority.

2.1.7. Commission Oversight

Although the Commission's relationship with the POB was based on the desire to assure Congress and the public that the peer review process and related programs were working well, the Commission had limited ability to affect the work of the POB or the peer review program.

For the PAB to be credible, the Commission must have a direct role in the operation of the PAB's regulatory programs by exercising effective and rigorous oversight of its membership, rules and activities. In addition, in order to promote an understanding of its processes and to inform the public of the results of its programs and proceedings, the PAB should be required to issue periodic reports.

2.1.8. Method of Formation

We believe we must act quickly to restore faith in the accounting profession and our markets that rely on it. The Commission can, through its existing authority, effectively establish a PAB with all of the attributes described above quickly. In our Roundtables regarding the proposed PAB structure, all panelists seemed to agree that integrity and competence of auditors was crucial, and that these characteristics likely cannot be legislated into existence.

We view authority for the PAB to flow from our authority to determine the nature of financial statements filed with the Commission, and the nature of the certification required on those financial statements. Just as the independence requirements of the SEC flow from its ability to define the term "independent" as used in the securities laws, so, too, do the competency and ethics requirements of Rule 102(e), and indirectly of the PAB, flow from the Commission's authority to determine the nature of the filings made to it. The Commission's authority to create an administrative disciplinary system, presently embodied in Rule 102(e) has already been judicially recognized.[37]

2.2. Auditor Independence Requirements

There has been considerable debate concerning what, if any, changes to the Commission's auditor independence rules are necessary to restore investors' confidence in the integrity of the audit process. The Commission's current rules on auditor independence were adopted less than 18 months ago, and were targeted to address problems about which there had been considerable study, discussion and debate. The Commission's approach at that time should be tested by practical application, over a reasonable period of time. If problems are empirically shown to exist in this area, any needed reforms can be tailored to address the precise problems uncovered. Some of the restrictions on non-audit services adopted in those auditor independence rules have not yet even taken effect, due to the rules' phase-in provisions. With this in mind, we are considering these matters carefully, in light of the rules adopted previously by the Commission, the additional evidence before us, and legislative proposals that have already been made.

Most Roundtable panelists expressed the view that critical independence issues occur in the relationship between engagement personnel and the audit client. Audit firms must play an important role by ensuring that audit teams adhere to the highest standards of auditing, including their independence. By focusing independence concerns on those who perform the audit, in the first instance, we can resolve the real issues confronting the profession. An individual audit partner whose income increases even by relatively modest sums of money from cross-selling consulting services may lose proper perspective in resolving difficult accounting issues. To be effective, independence restrictions must deal with both levels of concern - first, the engagement auditors should be precluded from receiving any compensation for cross-selling *any* non-audit related services to an audit client. Second, firms must be incentivized to ensure that every audit meets the highest standards of the profession, and must be subject to meaningful sanctions where audits are not performed at those levels.

This is the analysis reflected in an AICPA policy paper I helped prepare in 1997 for submission to the then newly-created Independence Standards Board, a body formed in by the SEC and AICPA to address independence issues in the profession.[38] In recent years, independence reforms have primarily focused on the independence of the firm. Narrow rules focused mainly on this area can give investors and members of Congress the false sense that the problems that gave rise to Enron's collapse effectively have been eliminated. The Commission's responsibilities do not permit us to accept simple solutions for complicated issues. In the area of independence, we must move to a system that recognizes that true independence lies not only with the firm, but also with the engagement team, and any conflict, external or internal, that might impair the team's independence, must be addressed.

Some have suggested firewalls as a means to separate the financial and personal aspects of the consulting engagement from those who perform the audit. In its recent rulemaking the Commission did not require that auditors and their audit clients forsake all non-audit service arrangements; those of us currently on the Commission do not believe that it is necessary to propose such a ban at this time. Information gained through consulting engagements may be useful in performing an audit. In fact, auditing literature requires auditors to ask firm personnel who have provided consulting or other services to the client if they have any information that would be relevant or useful during the audit.[39]

The Commission's existing independence requirements provide a conceptual framework to be applied to any proposed non-audit service to determine whether that service is inconsistent with independence. We believe this framework, adopted in late 2000, will, over time, serve investors better than would a blanket ban on the receipt of non-audit services from the auditor that certifies the financial statement. Indeed, that was the precise reason that former Chairman Levitt, in endorsing the existing rules as they had been revised, claimed that they were *better* than an absolute ban.[40]

It is useful to recall that there were large audit failures before accounting firms had any significant consulting business.[41] It should be apparent, therefore, that merely mandating the separation of consulting from auditing - to create an "audit only" firm - does not guarantee an "audit failure free" future. And, there are costs to be weighed. An "audit only" firm might lack certain expertise, especially if tax consulting were eliminated, necessary to perform high quality audits. An "audit only" firm would be *more dependent*, not less, on their audit clients, and a single, large audit client could exert far more influence on such a firm than is the case with firms that have multiple sources of revenues.

We believe that limiting those services that create an inherent conflict with auditing, barring inappropriate compensation mechanisms (such as compensation for cross-selling services) and penalizing firms whose aggregate and individual audit performance is substandard (most likely by limiting the ability to take on new clients for significant periods of time and compelling termination of client relationships) are more likely to prevent audit failures than the suggestion that we increase the reliance of all audit firms on their audit clients. We believe it is appropriate to pursue, and we intend to pursue, the following changes in this area.

2.2.1. Change of Auditors

As discussed above, allowing the PAB to exercise judgment, subject to prompt Commission review, to direct auditors to step down from an engagement could address risks that auditors that have worked with a client for a number of years may become either complacent or too dependent on the audit client.

Some have suggested the possibility of requiring that public companies replace their auditors after a specified number of years. The Commission believes that this approach, often referred to as "mandatory rotation," would be unwise. Studies over the last three decades suggest that the number of financial frauds in the first years of a new auditor's engagement is unacceptably high.[42] Mandatory periodic rotation of firms also could lead to "opinion shopping" in the decision on which new firm to select. Another concern is the unique strengths particular audit firms bring to clients in certain industries. Large accounting firms are not fungible; one firm is not identical to another, and there can be valid market-driven reasons, such as expertise in a certain industry, for selecting and retaining one firm over others. This freedom of choice should lie with the corporation; it should not be a government-imposed mandate or a decision delegated to the stock exchanges.

Required rotation of the lead audit engagement partner (every seven years) could be reviewed by the PAB to determine whether a deeper rotational requirement, affecting more members of the audit team, would be advantageous. This is an area where it may be useful for the PAB, over time, to evaluate different quality control approaches to the issue and eventually make appropriate recommendations.

2.2.2. Compensation for Cross-Selling

Because the engagement partner learns a great deal about a company during the audit process, he or she might be in the best position to suggest services that a company needs and help the company find credible people to provide those services. Some firms provide additional compensation to audit engagement partners who sell non-audit services to audit clients. The Commission believes that such compensation practices could cause serious conflicts and should be stopped.

2.2.3. Undue Influence by Clients

As discussed above, conflicts can occur if an auditor becomes overly dependent on a client, even if there is no cross-selling of services. For example, over the years the argument has been made that, since the company hires the auditor and pays the auditor's fee, the auditor can never be really independent from management. But the proposals that attempt to address this issue offer a cure that is worse than the disease. For example, there have been suggestions that the exchanges select the auditors of listed companies' financial statements. Significant practical difficulties would impede implementation of this suggestion. As discussed above, there may be very legitimate business reasons for management to prefer one auditor to others. It may be beyond the exchanges' current expertise to chose auditors, negotiate a reasonable fee, evaluate the auditor's performance, or determine if a complaint by the company about an auditor was legitimate or was made because the auditor was taking tough positions on accounting and auditing issues.

There has also been a concern that engagement partners would subordinate their judgment to that of the client merely to retain the business. Firms uniformly have required consultation and review procedures to assure that engagement partners are not compromised. We would strengthen these protections by calling on audit committees to provide the necessary counter-weight to management to avoid inappropriate pressure of the accounting firm.

Finally, some have suggested that there should be either a ban on auditors going to work for audit clients or a "cooling off" period ranging from one to five years between the time the individual provided any services for the audit client and the time that he or she becomes an employee of that client. As a general matter, especially for smaller companies that have more limited options for hiring seasoned accounting personnel, this could work a serious hardship. The Commission rule adopted in 2000 provides that if a person takes on "an accounting role or financial reporting oversight role" at an audit client, then independence is impaired unless he or she does not influence the accounting firm's operations or financial policies, has no capital account at the firm, and has no financial arrangements with the firm other than a fully funded retirement plan that pays a fixed dollar amount (which is not dependent on the firm's revenues or earnings). Again, this is a rule that we believe should be evaluated after it has been given time to work. The first place we would look is to provide additional comfort against risks to independence is the audit committee. Certainly audit committees should closely examine and approve any decision to employ individuals that have provided audit services to the company.

2.3. Accounting Standard-Setting

While the SEC has statutory authority to establish financial accounting and reporting standards for publicly-held companies, for over 60 years the Commission historically has looked to the private sector to provide the initiative in establishing and improving accounting principles.[43] The high quality of our accounting standards and our capital markets can be attributed in large part to the private sector standards-setting process, as overseen by the SEC.

Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards of financial accounting and reporting. The FASB was designed to be an independent body, insulated from political pressure, to provide it with the opportunity to focus on creating neutral accounting standards that are transparent to the underlying economics. An oversight body appoints the members of FASB. This oversight body, the Financial Accounting Foundation (FAF), is composed of investors, business people, and accountants. The FASB's standards are designated as the primary level of generally accepted accounting principles (GAAP), which is the framework for accounting. The interpretative body of FASB, the Emerging Issues Task Force (EITF), meets every other month to provide interpretative guidance, or develop new guidance, on narrow, new or emerging issues that arise under existing GAAP and when GAAP does not exist.

The secondary standard setter is the Accounting Standards Executive Committee (AcSEC), which provides guidance in the form of Statements of Position (SOPs), subject to the affirmative concurrence by FASB at every step in the process. The principal purpose of AcSEC, which is a committee of the AICPA, is to develop standards for specialized industries.

Some have opined that the public interest at stake in establishing accounting standards is too important for that function to be left to a nonpublic body not responsible to Congress. Those who make this suggestion apparently have lost confidence in FASB's processes. However, we believe that the accounting standard-setting function should remain in the private sector. When done properly, standard setting in the private sector is the best option for our capital markets as it provides a number of advantages over federalized standard setting. Private sector standard setting has greater flexibility to complete rules more quickly than accounting standards set by the government.

Federalization of the FASB not only would require substantial increases to the federal budget, but also might disenfranchise those who are best qualified to address the highly complex business and accounting issues that must be resolved. The FASB is composed almost entirely of accounting experts and has a greater ability to attract and retain qualified personnel. Similarly, AcSEC and the EITF are composed of members with accounting expertise.

Moreover, Government agencies may be more susceptible to political pressure than private bodies. This political pressure could result in the development of accounting standards that are not solely designed to meet the needs of those who use financial statements in economic decisions. For example, many question whether the FASB's proposal to expense stock compensation would have been better for investors. This concept was set forth in 1994, when it was the sense of the Senate that FASB's private sector nature should be respected and safeguarded and that Congress should not impair the objectivity or integrity of FASB's decision making process by legislating accounting rules. We believe the concept remains sound today.

We do believe, however, that FASB's processes can and must be improved. In fact, even before Enron's collapse, we recognized that FASB needed to address concerns about timeliness, transparency, and complexity, and we asked FASB to address these concerns. The markets and investors simply cannot wait a decade or more for standards regarding such important matters as revenue recognition and consolidation of special purpose entities. Moreover, the work of the standard setters must result in standards that ensure illumination and not obfuscation in financial reporting.

From the beginning of my tenure as Chairman, I have recognized that the SEC historically had abdicated too much of its obligation to ensure that accounting standards meet the objectives of the federal securities laws. The SEC consequently plans to take a more active role than it has in the last decade to ensure that standards are implemented and benefit our markets and investors. I believe that with strengthened Commission leadership and cooperation by FASB, FASB can be effective, and confidence in the process can be restored. Private-sector standard setting can work in our current business environment, even as financial transactions become more complex.

As discussed in more detail below, we plan to use our existing statutory authority to oversee the standard-setting process to ensure that it functions in the best interest of investors, including by: (i) broadening funding sources to decrease FASB's dependence on revenues from the accounting profession; (ii) providing SEC input to the selection of projects on FASB's agenda; and (iii) ensuring that FASB's standards evolve to become general principle-based standards instead of overly complex, rule-based standards.

2.3.1. Involuntary funding for the private-sector standard setter

Currently, the Financial Accounting Foundation (FAF) is responsible for selecting the members of FASB and its Advisory Council, funding their activities, and exercising general oversight. FAF receives contributions to fund FASB and approves FASB's budget. To enhance FASB's independence, we believe that its funding source should be more secure and should strengthen both the reality and the appearance of independence. Funding should be made involuntary. This funding change will help to ensure that FASB continues to be independent so that it can continue to be objective in its decision-making and to ensure the neutrality of information resulting from its standards. We also believe that the Commission must have a direct role in the selection and approval of the members of FASB.

2.3.2. FASB's Agenda

FASB at times has operated too slowly to be responsive to changes in the market place. For example, while FASB's Emerging Issues Task Force (EITF) has provided limited guidance on unique issues related to special purpose entities, FASB has been working on its overall consolidation project, which includes the consolidation of special purpose entities, for many years.

In addition, FASB has not always added critical or significant projects to its agenda on a timely basis. For example, revenue recognition is usually the largest single item in financial statements; studies indicate that it is the single largest category of financial statement restatements, and our recent experience with actions brought by our Division of Enforcement involving financial statements indicate this is the core issue in over 50% of our actions. While certain narrow industry specific guidance exists, it was only on January 28, 2002, twenty-seven years after its inception, that FASB issued for public comment a proposal to broadly address revenue recognition. Because there is no general standard on revenue recognition, issues involving revenue recognition are among the most important and the most difficult that accountants face. A final revenue recognition accounting standard could take several years to complete without a fundamental change to FASB's current processes.

The SEC plans to work with FASB to develop a mechanism that will ensure that each project on its agenda is completed on a timely basis. Moreover, FASB must ensure that its agenda is responsive to those issues facing investors and accountants. To help achieve that goal, the SEC will provide more input to the selection of projects to FASB's agenda, and direct FASB to address promptly priority items.

In addition, we will actively oversee the standard-setting process to ensure that it functions in the best interest of investors. The SEC has exercised, and should exercise, its authority over the accounting standards it will accept for filings made with the agency. We should not use this power indiscriminately; it should be reserved for those exceptional situations where the public interest demands it. The reason for this approach by the SEC is clear: FASB has acted in the public interest and has brought a level of sophistication and professionalism to the accounting standard setting process that we should not heedlessly shunt aside.

2.3.3. Principle-Based Standards

Much of FASB's recent guidance has become rule-driven and complex. The areas of derivatives and securitizations are examples. This emphasis on detailed rules instead of broad principles has contributed to delays in issuing timely guidance. Additionally, because the standards are developed based on rules, and not on broad principles, they are insufficiently flexible to accommodate future developments in the marketplace. This has resulted in accounting for unanticipated transactions that is less transparent and less consistent with the basic underlying principles that should apply.[44] The development of rule-based accounting standards has resulted in the employment of financial engineering techniques designed solely to achieve accounting objectives rather than to achieve economic objectives.

The SEC believes that FASB's standards, at least going forward, should evolve to become general and principle-based, instead of encyclopedic and rule-based, standards. While principle-based standards can also be subject to abuse, and some level of standardization is necessary for comparability and verifiability, we believe that principle-based standards in general are better suited to the sort of rapidly changing financial landscape in which many companies operate. Moreover, the abuses should be minimized if our other suggestions are adopted, especially those regarding emphasis on overall accuracy and completeness of financial reporting and other disclosures, rather than disclosure based merely on compliance with specific rules. Of course, FASB and the SEC should continue to provide appropriate specification where the circumstances require and should use professional groups, like the EITF, to fill in the interstices of broad principles-based pronouncements.

SEC FUNDING NEEDS

Let me conclude with a point that may be last but is certainly not least. We need legislative assistance in increasing our funding for both this and subsequent fiscal years. The SEC regulates industries and markets that have grown enormously, in both size and complexity. The Commission currently oversees an estimated 8,000 brokerage firms employing nearly 700,000 brokers; 7,500 investment advisers with approximately $20 trillion in assets under management; 34,000 investment company portfolios; and over 17,000 reporting companies.

The President's budget for fiscal 2003 requested an appropriation of $466.9 million for the Commission, an appropriation that I supported when it was first formulated. But, since the time that appropriation was formulated, pay parity legislation has passed, and the Commission has had to respond to three crises. As a result of those recent events, we critically need additional funds to enable us to phase-in a modest pay parity plan. We also need authorization to add new staff to address pressing immediate needs. We have discussed our interim personnel and resource needs with OMB, and they have indicated their receptivity to our request for an additional $15 million to fund 100 new lawyers and accountants.

1. Pay Parity

The Commission has been subject to extremely high attrition, principally because our employees earn substantially less than their counterparts in the other financial service regulatory agencies. The "Investor and Capital Markets Fee Relief Act" (P.L. 107-123), enacted this January, authorized pay parity, but the Administration's proposed fiscal 2003 SEC budget provides no new money to implement this vitally important program. Once pay parity was a reality, however, the failure to provide funding was a disappointment to our most valued employees. We estimate that an *additional* $76 million is needed to provide a modest implementation of pay parity for the agency in fiscal 2003.[45] At this critical time for the Nation's financial markets, we must rely on our most experienced, talented, valuable and productive employees. The only way to do that is for us to be able to provide our staff with pay parity at levels comparable to those with whom they regularly work at the other federal financial regulatory agencies. If we receive funding for pay parity, I assure you that the SEC intends to make responsible increases in staff salaries and benefits, with a significant component of the increases subject to true merit pay.

The failure to fund pay parity now would only exacerbate the problems that the legislation passed by Congress last December was intended to cure. By raising expectations and hopes in anticipation of finally achieving pay parity, we will face even greater employee losses and suffer greater irreparable harm to morale if pay parity is not funded in fiscal 2003, and thereafter. Even if we can cobble together a pay parity program for the remainder of this fiscal year, which OMB has said it supports, the threat of either terminating the program in fiscal 2003 or terminating approximately 700 employees - the number we estimate would have to be cut from the agency to continue the program - would cripple many of the projects we have underway, which are important for the protection of investors and Americans whose retirement accounts are invested in the securities of public companies.

As I mentioned before, we are extremely grateful to have bipartisan backing from this Committee. We especially appreciate Chairman Sarbanes' and Senator Gramm's calls for full funding of pay parity. The SEC cannot afford to continue suffering the staffing crisis it has endured for the past decade at such an important juncture. Pay parity provides benefits we truly need to meet the increasing regulatory challenges we face. We continue to work closely with OMB to persuade them of the need for these funds. In the interim, I am committed to proceeding with our implementation of the reforms the President has directed us to effect.

2. Additional Personnel

In addition to the absence of any funds to implement pay parity, we were also given a "no-growth" budget, which means that we cannot add any new personnel. Indeed, under current funding levels for 2002, we are effectively precluded from hiring any new personnel. The solution to every problem does not start and end with larger and more expensive government. I have started a thorough review of our deployment of personnel, to see whether we can effectuate some meaningful efficiencies.

But the tragedy of 9/11 and the very issues we are discussing here today made any contemplative review of our needs impossible. Given the enormous surge in our enforcement activities, the desire to do a better job than has been done previously at reviewing public company filings, and overseeing a restructured accounting profession, the SEC must seek a staffing increase of 100 positions in fiscal 2003 even before looking for efficiencies. This would allow us to add:

- 35 accountants and lawyers in the Division of Enforcement to deal with the increasing workload from financial fraud and reporting cases;

- 30 professional staff, including accountants and lawyers, in the Division of Corporation Finance to expand, improve and expedite our review of periodic filings; and

- 35 accountants, lawyers, and other professionals in the other divisions - including the Office of Chief Accountant - to deal with new programmatic needs and policy.

These are the minimum staffing levels required to deal with our *immediate* post-Enron needs. Under a pay parity system, this increased staffing level will require an additional $15 million. The Commission has not received a staffing increase in the last two years, despite the additional responsibilities we have received as a result of the Commodity Futures Modernization Act and the Gramm-Leach-Bliley financial services modernization act. A staffing increase is even more critical in light of recent events.

3. Additional Resources

In addition to the initiatives discussed in my testimony above, which will take substantial resources, there are other important initiatives we are undertaking in the areas of enforcement, investor education and technology that will require additional resources in the coming years.

- One of our major new initiatives - "real-time" enforcement - is an important component of our fiscal 2003 budget. Our goal is to provide quicker, and more effective, protection for investors, and better oversight of the markets with our limited enforcement resources. As recent experience has reinforced, the SEC must resolve cases and investigations *before* investors' funds vanish forever; that means we must act more quickly, both in identifying violations and taking prompt corrective action to protect investors. These efforts necessarily require resources, the most important of which is appropriate staffing.

- Even with our shift toward real-time enforcement and our current efforts to improve financial disclosure, the first line of defense against fraud is always an educated investor. The Commission works with numerous public and private organizations to foster investor educational programs. Our staff gives presentations to countless schools, religious organizations, and investor clubs, explaining basic investing concepts and answering questions. We also host "Investor Town Meetings" across the United States that bring together industry, federal, and local government officials to educate investors on basic financial concepts. And this spring we will host our first "Investor Summit," to discuss policies and proposals that impact them. We want to give all Americans an opportunity and an avenue to weigh in on the broad policy objectives that ultimately could impact their ability to send their children to college or retire comfortably. We plan to use the Internet to broadcast the summit so that anyone can participate. We also are asking people to write us and call us so that we can hear the broadest possible range of viewpoints. We want to hear the concerns and aspirations of America's investors.

- Like the rest of the government, our needs in the area of information technology continue to increase. Given the critical and increasing role of technology in the financial markets, the President's budget requests $4.0 million to fund the SEC's e-government initiatives. This is an area where the Commission needs to improve, both internally and externally. Technology is constantly altering the landscape of our markets, and SEC staff must have the necessary tools at their disposal to successfully meet the increasing demands that we face. In particular, funds proposed for fiscal 2003 will allow the SEC to get better and more timely enforcement information from the markets, enhance our intrusion detection capabilities, and meet the President's security requirements for information technology. These initiatives are a small, but important, first step toward meeting the Commission's technology needs.

- With the advent of alternative trading systems that have grown from only a handful to over 60 today, and as a result of the Internet, the

SEC also must consider what effect our regulatory actions and decisions have on the industry's use of technology. To respond to this need, I have created a new position of Chief Technology Officer to provide the Commission with the technical expertise and advice necessary to improve the Commission's oversight of the markets. Generally, this office will be responsible for ensuring that the SEC's regulatory, disclosure, examination, and law enforcement programs are implemented with the benefit of a state of the art understanding of technology. Through this process, the agency can be confident that what we implement or approve is technologically sound and cost effective to the private sector.

CONCLUSION

While it remains strong, our system has shown signs of strain over the last five to ten years, resulting in unacceptable and potentially avoidable losses to those who believed in the truth of what they were told and took comfort that what they did not know would not hurt them. The present financial reporting and disclosure system for public companies has not changed significantly in many decades. Investors should continue to have confidence in our present system, but there must be determination to make improvements.

I take quite seriously my stewardship responsibilities and the Oath of Office I took when I became Chairman of the Commission. I look forward to continuing to work with you to make sure that we discharge our obligations prudently, generously and in the spirit with which the federal securities laws were adopted: to protect investors and maintain the integrity of the securities markets.

Thank you for the opportunity to testify today. I am pleased to respond to any questions the Committee may have.

Footnotes

1 Francois Marie Arouet Voltaire, *Dictionnaire Philosophique*, "Le mieux est l'ennemi de bien" ("Perfection is the enemy of the good"). *Compare also* Carl von Clausewitz, *On War* ("The greatest enemy of a good plan is the dream of a perfect plan.").

2 President George W. Bush, State of the Union Address (Jan. 29, 2002).

3 President George W. Bush, Remarks During 2002 Malcolm Baldridge National Quality Awards Ceremony (Mar. 7, 2002); President's Plan to Improve Corporate Responsibility and Protect American Shareholders, available at www.WhiteHouse.gov/infocus/corporateresponsibility.

4 "How to Prevent Future Enrons" *Wall Street Journal*, A18 (Dec. 11, 2001), annexed as Attachment A.

5 Cautionary Advice Regarding the Use of "Pro Forma" Financial Information in Earnings Releases, Securities Act Release No. 8039 (Dec. 4, 2001).

6 Cautionary Advice Regarding Disclosure About Critical Accounting Policies, Exchange Act Release No. 45149 (Dec. 12, 2001).

7 "Program to Monitor Annual Reports of Fortune 500 Companies," *SEC News Digest*, Issue 2001-245 (Dec. 21, 2001).

8 Public Statement by SEC Chairman Harvey L. Pitt: Regulation of the

Public Statement by SEC Chairman Harvey L. Pitt: Regulation of the Accounting Profession (Jan. 17, 2002), available at www.sec.gov/news/speech.shtml.

9 Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations (Jan. 22, 2002), available at www.sec.gov/rules/other.shtml.

10 *See* Notice of Filing of Proposed Rule Changes by the National Association of Securities Dealers, Inc. and the New York Stock Exchange, Inc. Relating to Research Analyst Conflicts of Interest, Exchange Act Release No. 45526, File Nos. SR-NASD-2002-21; SR-NYSE-2002-09 (Mar. 8, 2002).

11 The Commission's Press Releases regarding these actions are annexed as Attachments B-H.

12 Requirement for Arthur Andersen LLP Auditing Clients, Securities Act Rel. No. 8070 (Mar. 18, 2002).

13 The Commission's Press Release regarding reporting requirements for companies audited by Andersen LLP is annexed as Attachment I.

14 This release is annexed as Attachment C.

15 *See* Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations (Jan. 22, 2002), available at www.sec.gov/rules/other.shtml.

16 The Commission's Press Release regarding these rules is annexed as Attachment G.

17 President George W. Bush, Remarks During 2002 Malcolm Baldridge National Quality Awards Ceremony (Mar. 7, 2002); President's Plan to Improve Corporate Responsibility and Protect American Shareholders, available at www.WhiteHouse.gov/infocus/corporateresponsibility.

18 Of course, there can be problems in such releases, especially in the presentation of "pro forma" earnings, which caused the Commission to issue its cautionary guidance on December 4, 2001. Cautionary Advice Regarding the Use of "Pro Forma" Financial Information in Earnings Releases, Securities Act Release No. 8039 (Dec. 4, 2001).

19 *See* The Regulation of Securities Offerings, Securities Act Rel. No. 7606A (Nov. 13, 1998), Sections XI.A - XI.B.

20 Section 16(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78p(a)).

21 *See* 17 C.F.R. 240.16a-3(f) and 16b-3(e), adopted by Exchange Act Rel. No. 37260 (May 31, 1996).

22 *See* Securities Act Rel. No. 7606A (Nov. 13, 1998), Section XI.B.

23 *See, e.g.,* Senate Banking Committee testimony of John Whitehead on March 19, 2002 ("The authority of the SEC should also be extended to create a new self-regulatory entity charged with drafting a voluntary code of best corporate governance practices linked to an SEC disclosure requirement. Companies would then disclose whether they comply with the voluntary code, and explain areas of non-compliance.").

24 The FEI's recommendations and revised code of ethics are annexed as Attachment J.

25 *See* SEC Files Financial Fraud Actions and Settled Administrative Proceedings Against Former Senior Officer and Managers of IGI, Inc. and Against IGI, Inc., Litigation Release No. 17410 (Mar. 13, 2002). The action is pending.

26 *See* Securities Act Rel. No. 7606A (Nov. 13, 1998). *See also* Report of the Advisory Committee on the Capital Formation and Regulatory Processes (July 1996).

27 Section 21(d)(2) of the Securities Exchange Act.

28 *SEC v. Patel*, 63 F.3d 137, 141 (2d Cir. 1995) (in reversing the lifetime injunction against an officer of a company who was found to have violated the federal securities laws, the court discussed a non-exclusive six factor test for considering fitness to serve as officer or director: (1) the egregiousness of the violation; (2) whether the defendant was a recidivist; (3) the defendant's position when he engaged in the fraud; (4) the degree of scienter; (5) the defendant's economic gain from the violation; and (6) the likelihood that the defendant would repeat the misconduct).

29 "The CFOs Weigh in on Reform," *Business Week* (Mar. 11, 2002).

30 *See* Insider Trading Sanctions Act of 1984, Pub. L. 98-376, 98 Stat. 1264.

31 *See, e.g.*, "Now Who, Exactly, Got Us Into This?" *The New York Times*, Sec. 3, p.1 (Feb. 3, 2002).

32 A copy of this letter is annexed at Attachment K.

33 According to the Stanford Law School Securities Class Action Clearinghouse (available at securities.stanford.edu):

- The absolute number of issuers sued does not appear to have changed dramatically since passage of the Act, once the effects of the IPO Allocation Litigation are excluded. Litigation activity declined in 1996, but that decline was likely a transition effect;
- Since passage of the Reform Act, a larger percentage of litigation activity centers on allegations of accounting fraud, with revenue recognition issues emerging as particularly significant causes of litigation;
- Since passage of the Reform Act, a larger percentage of litigation activity also alleges trading by corporate insiders during periods when frauds are allegedly "alive" in the market;
- The dollar magnitude of settlement has increased noticeably, particularly in the settlement of "mega-cases." There have been five post-Reform Act settlements in excess of $200 million. The Cendant litigation was settled for $3.525 billion ($3.185 billion in the common equity settlement and $340 million in the Prides settlement.); the Bank of America Litigation settled for $490 million; Waste Management settled two separate class actions for $457 million and $220 million; and 3Com settled a class action proceeding for $259 million.

34 *See, e.g.,* Section 19(a) of the Securities Act (15USC 77s(a)), and Section 13 (b)(1) of the Securities Exchange Act (15 USC 78m(b)(1)).

35 Form and Content of and Requirements for Financial Statements, Securities Act of 1993, Securities Act of 1934, Public Utilities Holding Company Act of 1935, Investment Company Act of 1940, and Energy Policy and Conservation Act of 1975 (Regulation S-X), 17 C.F.R. Part 210.

36 With respect to broker-dealer supervision, *see* Section 15(b)4(e) of the Securities Exchange Act of 1934.

37 *Touche Ross & Co. v. SEC*, 609 F.2d 570 (2d Cir. 1979).

38 David E. Birenbaum and Harvey L. Pitt on behalf of the AICPA, Serving the Public Interest: A New Conceptual Framework for Auditor Independence (Oct. 20, 1997).

39 AICPA, Planning and Supervision, AU §§ 311.04*b*, 9311.03.

40 "Accounting Firms, SEC Agree on Audit Rule; Compromise Expected To Avert Legal Face-Off," Washington Post, p. E01, November 15, 2000 ("Though the SEC dropped its proposed ban on information technology consulting, Levitt said, `We got something I think is better, with the requirement for audit committee approval and disclosure.' ").

41 *See, e.g., Dirks v. SEC*, 463 U.S. 646 (1983) (regarding trading prior to the failure of Equity Funding in 1973); *US v. Simon*, 425 F.2d 796 (2d Cir. 1969) (regarding the financial fraud on the books of Continental Vending Machine Corporation).

42 Mandatory rotation of auditing firms, on some multi-year cycle, was discussed at the time of the Moss/Metcalf hearings in the mid-1970's and has often been suggested since that time. The 1977 Metcalf report states, "Rotation of audit firms and personnel has been widely discussed as a means of strengthening the independence of auditors.... The subcommittee believes rotation needs more study by the Commission before a sound conclusion can be reached." The rationale in support of firm rotation is that it would result in a periodic "fresh" look at the financial statements, would result in an auditor knowing that another firm will be reviewing the positions it has taken, and would limit anticipation of a longer relationship.

The Cohen Commission Report recommended against rotation of audit firms based, in part, on its finding that most audit mistakes occurred in the first year or two of an audit engagement. The Cohen Commission found that most mistakes occur in the first year or two of an audit engagement, that rotation would limit firms' incentives to "learn the business" of their clients, and that firms might be inclined to have their personnel focus on new work and lessen the attention given to matters during the last year or two of an audit.

Subsequent studies have reported information that tends to support the case against rotation. For example, the 1987 National Commission on Fraudulent Financial Reporting (Treadway Commission) examined 42 cases brought by the Commission against independent accountants from July 1981 to August 1986 and stated that these cases "revealed that a significant number involved companies that had recently changed their independent public accountants...." Additional research commissioned by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 1999 examined 88 cases occurring between 1987 and 1997 where the Commission had alleged an audit failure and the name of the auditor could be determined. It found that 26% of the 88 companies changed auditors between the period in which the company issued its last "clean" set of financial statements and the period in which it issued the allegedly fraudulent financial statements. This study concluded that "most auditor switches occurred during the fraud period (versus before the fraud period)...."

43 *See* note 34, *supra*, and accompanying text.

44 On February 13, 2002, the SEC Chief Accountant wrote to the Auditing Standards Board calling on them to prohibit SAS 50 letters on "hypothetical transactions," thereby preventing the potential for these preference letters to help investment bankers market structures designed to get around particular FASB principles. A copy of this letter is annexed as Attachment L.

45 In fiscal 2001, the Commission received approval and funding to implement "special pay" to help begin addressing our recruitment and attrition problems. In fiscal 2002, we also received funding to continue special pay. The appropriation proposal for fiscal 2003 provides $19 million to fund special pay. We estimate that an additional $76 million is needed to fund pay parity for fiscal 2003.