

Senator Paul S. Sarbanes (D-MD)
Speech before the
Economic Club of New York
Joint Appearance with Congressman Michael Oxley
Sarbanes – Oxley Act of 2002
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It is a pleasure to be here this evening with my friend and House colleague Mike Oxley, the Chairman of the House Financial Services Committee.

We have Barbara Franklin, your able chair, to thank for arranging this dinner. Anyone who has received an invitation from Barbara knows how difficult it is to turn her down. "Just say no" simply does not work. The only option is to accept.

Barbara knows where the issues in corporate governance lie. Her experience as a director dates back a quarter-century – in 1979 she was one of the first generation of pioneering professional women to enter boardrooms not to serve coffee but to sit at the table. Since then she has sat on the boards of some dozen public companies, several private companies and numerous professional and non-profit organizations, and something like a dozen audit committees.

I also want to salute the Economic Club of New York as it approaches its centennial, and the distinguished members and guests who are gathered here. I am delighted to see a number of familiar faces. Many of you are deeply engaged in the effort to restore the integrity of the capital markets and the confidence of our investors.

Issues of accounting and corporate governance were long looked upon as dry, theoretical and abstract. No longer. They are today an urgent and practical concern.

- They affect every shareholder from the modest individual investor to the major institutional investor;
- They affect the efficiency and transparency of our capital markets, as well as the global perception of those markets;
- They affect the U.S. stature as a model and standard-setter for developing markets around the globe; and
- They have profound implications for the domestic economy. When the markets stumble, the economy suffers. Jobs, family security and community stability are put at risk.

The law that now carries my name and Mike's was developed, debated and enacted in response to the crisis in the markets that came to the surface – but did not begin – with the collapse of Enron Corporation in late 2001. It was a little more than two years ago, although it seems like an eternity.

When I became Chairman in the early summer of 2001 of the Senate Banking, Housing and Urban Affairs Committee – all hail to Jim Jeffords and Vermont – I set out a committee agenda. It did not include auditing, accounting or corporate governance.

In October Enron announced a third-quarter loss of \$1 billion, and shortly thereafter an additional loss of \$1.2 billion in shareholder equity. At the time, Enron was the nation's seventh-largest company. A fund manager who did not have Enron in his or her portfolio would have been regarded at best with skepticism.

And then on December 2 Enron announced the largest bankruptcy in the nation's history – until WorldCom surpassed it six months later.

Enron was not unique.

With increasing frequency major companies were resorting to convoluted and often fraudulent accounting devices to inflate earnings on their financial statements – statements that had been audited, approved by a major accounting firm, and duly filed with the SEC.

The markets faced not a ripple on the surface but a tidal wave.

Some argued that these were random events resulting from the malfeasance of a few “bad actors” or “bad apples.”

Others saw it differently:

According to the *Wall Street Journal*, “The scope and scale of the corporate transgressions of the late 1990s...exceed anything the U.S. has witnessed since the years preceding the Great Depression.”

Money magazine called it “a total breakdown by everyone, a complete breakdown in the system, in all the checks and balances.”

Just yesterday in an article in the *New York Times Magazine*, Roger Lowenstein observed that the problem was only partly personal greed on the part of those proverbial “bad actors.” Executives were – “helped along the way by lenders and investment bankers, auditors, lawyers, analysts – just about anyone whose job should have been to protect the public...(it was) not that a handful of executives got greedy but that the safeguards supposedly built into our financial culture stopped functioning.”

As the number of financial restatements continued to rise, there were indications of a worrying pattern of behavior. Concern grew in the Banking Committee, among members of both parties that a pattern of behavior had emerged that required a legislative response. That response was targeted to the issues within the committee's jurisdiction, which meant that issues like criminal liability and pension safeguards were to be dealt with by other committees.

The committee initiated a series of hearings to identify any systemic or structural weaknesses in the markets that had contributed to the crisis. Beginning in mid-February, 2002 and extending over a period of six weeks the committee held ten hearings with some three-dozen witnesses. John Biggs and John Whitehead made very significant contributions to the hearing record.

We began the hearings with a panel of five former chairmen of the Securities and Exchange Commission and concluded with the then-chairman of the SEC. In between our witnesses included experts with long and distinguished experience in accounting, corporate governance and regulatory matters. We heard from past and present government officials, self-regulators, investor and consumer groups, business and labor, the accounting profession, and leading scholars.

At one very technical hearing we heard from three former chief accountants at the SEC. About mid-way through the hearing one of my colleagues said, in a very audible whisper, "This is really boring." This brought forth a response from another colleague, Senator Mike Enzi of Wyoming.

Mike is a good friend. He is the only Certified Public Accountant in the United States Senate, and he played a pivotal role in drafting and moving the legislation. "It may be boring for you," Mike said, "but this is the most fun I've had since I was elected to the United States Senate.

There was remarkable consensus among our witnesses on the major structural and systemic problems.

They identified:

Inadequate oversight of accountants;

Lack of auditor independence;

(core auditing and accounting fees=70% of revenues in 1977, down to 34% in 1998;
"management advisory services"=12% of revenues in 1977, up to 50% in 1998);

Weak corporate governance procedures;

Egregious conflicts of interest for stock analysts;

Inadequate disclosure provisions; and

Grossly inadequate funding of the Securities and Exchange Commission, where the staff was overworked and underpaid and the annual turnover rate was one in three.

The law terminates accounting industry self-regulation and establishes the Public Company Accounting Oversight Board – the PCAOB.

It prohibits auditors from engaging in a specific list of consulting services to the companies they audit.

It requires audit committees to be independent of management. CEOs and CFOs must vouch personally for the accuracy of their companies' financial statements.

It requires disclosure of material off-balance sheet transactions. It requires prompt disclosure of trades in company stock by management and ten-percent shareholders.

It gives strong authorities to the SEC and the exchanges to adopt rules prohibiting conflict of interest on the part of stock analysts, and establishes safeguards against retaliation.

It authorizes a major increase in the SEC budget. We have seen that budget increase from about \$468 million at the beginning of the 2002 fiscal year to a request in the budget just submitted by the President of just over \$900 million – almost a doubling.

The legislation emerged over a period of months from a continuing give-and-take among committee members and continuing consultations involving committee members, staff, and the whole range of constituencies likely to be affected by it. Some described the process as “hasty.” I want to assure you there was nothing “hasty” about it. It was intensive, careful and deliberate.

The legislation had solid bipartisan support. It was approved by the Banking Committee on a 17-4 vote, in which Mike Enzi, my Republican colleague from Wyoming, and the committee’s resident CPA, played a pivotal role. It moved through the Senate and through the conference committee, which added strong criminal sanctions earlier approved by the House, and was sent to the President’s desk.

In signing the legislation on July 30, the President called the new law “the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt.”

Much has been accomplished in the eighteen months since enactment:

Under the leadership of Bill Donaldson the SEC has been reinvigorated and its professionalism restored. I cannot overstate the importance of this development. The Commission is now moving forward with a very crowded and complex agenda. It is being given the resources to do the job;

The PCAOB, too, is moving ahead on schedule. As you know, the PCAOB is fortunate to have Bill McDonough, this club’s former president, as its chairman, and four other highly qualified members;

Both the SEC and the PCAOB have taken a clear and strong position that issues of extraterritoriality are to be resolved within and not outside the framework of the law – in my view, a responsible and prudent position which the collapse of companies abroad has served to underscore. The law grants both the Commission and the Board significant flexibility to deal with these complex issues;

Meetings are well underway on the question of harmonizing the accounting standards set by the FASB and the IASB. This must be a high priority, as the EU is set to adopt the IASB standards by 2005. If globalization means anything, it seems to me, it should mean harmonizing those standards.

But more than strict implementation of the law is at stake. In the months and years ahead we need not just compliance, but a new way of looking at things – a rethinking of long-accepted practices.

Perspectives are shifting. For example:

The Conference Board Commission on Public Trust and Private Enterprise, co-chaired by Pete Peterson and John Snow when Secretary Snow was still in the private sector, has done a first-rate job of setting out best practices principles.

According to a recent story in the Washington Post, "New Ideas Take Hold on Corporate Boards, reports the Washington Post." "Tilt in the balance of boardroom power," reports the Financial Times. Stories like these appear with increasing frequency.

Speaking from his vantage point at Deloitte Touche, Jim Quigley told a National Press Club audience "Audit committees are more involved.... They now ask more probing questions of management and auditors...the number of audit committee meetings has doubled, and the time spent in the meetings has substantially increased.... a thorough review of internal control systems...is prompting remediation of weak systems."

At the same time we hear concerns that the costs of compliance are too high. But as Jim Quigley has pointed out, "The cost of lost public confidence is even higher...No one said that restoring our profession and the public's trust in it would be easy, immediate or without cost."

We should not forget that every solid market participant is hurt by the actions of the shady players. Regulation protects the legitimate from the under-handed. Good regulators are the supporters, not the adversaries, of healthy markets.

This is not a matter of costs that come with reform on the one hand and some kind of cost-free *status quo ante* on the other. We are talking about one set of costs versus another.

We also hear arguments that the law creates disincentives to risk-taking. On this point Bill Donaldson has made a crucial observation:

"Taking a regulatory risk is a big mistake. Taking a business risk is absolutely necessary."

He has spoken persuasively to this point:

"The success of a new era under the Act must involve a continued measure of the risk-taking and entrepreneurship that are the hallmarks of honest American business. There have been suggestions...that the recent crackdowns on corporations and executives by criminal and civil authorities, including the Commission, have discouraged honest risk-taking.

"I have a different perspective on recent developments. I believe the Act and the other steps that have accompanied it will lead to an environment where honest business and honest risk-taking will be encouraged and rewarded. What should be discouraged...are the activities that some have sought to disguise as honest business but that, in reality, are no such thing."

From the experience of the last few years I conclude that there are a few fundamental principles that can help guide us through this period of change and assure the integrity of our markets in the future. But we must hold to them.

Eliminate conflicts of interest. To do so, identify conflicts of interest. Then identify and eliminate conditions that give rise to or facilitate them;

Establish effective checks-and-balances mechanisms;

Insist on disclosure, transparency and openness;

Assure effective oversight, starting with the SEC and the PCAOB and including the self-regulatory agencies;

Mandate accountability; and

Be forward thinking. It is not enough to deal with a problem after the fact, when a lot of harm has been done to a lot of people. Nor is it enough to deal with problems as they arise. We must take further steps, and seek to assure the problems do not arise in the first place.

I regard the current time as an opportunity to restore honest, transparent, and ethical business practices, and look for your help in this endeavor.

Thank you.