Corporate Governance

By Joel Seligman

Weidenbaum Center on the Economy, Government, and Public Policy
Breakfast Presentation
September 19, 2002

About once a month during the course of the academic year we have a breakfast with a speaker. This morning we have with us Dean Joel Seligman, Dean of he School of Law, at Washington University.

As many of you know, the Dean has been at the Law School since 1999, and most importantly for our purposes this morning, he is perhaps the nation's premiere legal scholar of securities law, corporate governance and related subjects. He has authored 19 books and innumerable articles on securities regulation, corporate finance and other subjects. He served previously as the Dean of the University of Arizona's College of Law. He has consulted with several federal agencies including the FTC, and now chairs the Federal Advisory Committee on Market Information.

Now, you also all know by reading the *Wall Street Journal* and the *New York Times* every day, that the dean is prominently mentioned as a possible member of the new Public Company Accounting Oversight Board (PCAOB) that was created under this year's Sarbanes-Oxley Act.

The topic this morning is "Corporate Governance and Federal Regulation after Enron." Let me also add that the Weidenbaum Center, along with the School of Law, will be co-sponsoring a conference in February 2003. This conference will be held at the Law School. It is entitled, "After Enron: Wither the Mandatory Disclosure System," at which some of the country's most important figures on corporate governance will be speaking. It is my pleasure to introduce Joel Seligman.

It is a great honor to be here. I have long admired the work of Murray, and it's just a pleasure to have him associated with Washington University and to see him so frequently, here. Steve has done a wonderful job as Director and it has been a joy the last two years, actually, to have jointly sponsored our annual F. Hodge O'Neal Conference. It's always a pleasure to see Dick Mahoney, who keeps me honest, and tries to regulate my excessive impulses towards Washington whenever we get a chance to chat.

Let me introduce my junior colleague Troy Paredes, Professor of Corporate and Securities Law, who actually organized next year's F. Hodge O'Neal Conference. We will be giving roughly the same presentation at the Law School in a few days, and Troy will be speaking about the Board at that point.

When I look at the Sarbanes-Oxley Act, and the questions that it generates, I have a sense of history, which seems particularly striking at this point. In the 1920s we went through what was then described as the greatest bull market in the history of our country. It was a "period of irrational exuberance," to paraphrase quotes much in the news recently. It was a period in which investment bankers engaged in recommendations that were far removed sometimes from underlying factual realities. Where stocks were sold to "preferred lists of insiders," where disclosures about corporations were partial and often quite misleading, where enforcement of flawed laws and rules, which certainly existed at that point, was clearly inadequate.

In a certain sense, when you look at the underlying factual background of Sarbanes-Oxley, you see a recurrence of several of these themes. Between 1980 and March 2000 we did, in fact, go through the greatest bull market in the history of our country. We saw practices by which accounting reports, which we had come to believe, or at least it was generally believed, fully disclosed material information were partial and quite misleading, at least in some instances. We've seen evidence recently of the

equivalent of preferred lists or insiders receiving special access to hot issues. When you read about a Securities and Exchange Commission division of corporate finance, which at least has the theoretical goal of reviewing 1 in 3 annual reports, the so-called form 10K's each year, reviewing at most 17% in the year 2000 and at most 8% of overall filings in 2000 and 2001, you realize that enforcement efforts have deteriorated badly. The factual basis for Sarbanes-Oxley, in spite of the fact that in one week, I believe in March of this year, there were 13 separate congressional hearings going on, nonetheless was somewhat thin.

We had a somewhat detailed report about Enron that was produced by Dean William Powers of the University of Texas, then an Enron Director, and published in February. We had a great deal of opinion testimony, if you will. There were hearings, for example, with five former SEC chairs, opined, and they were from both political parties and they were very, very consistent in the type of critiques they made. But when you focus on actual identification of factual problems, the jury is still out in a number of respects. There are serious concerns that have been expressed about investment analysts; there haven't been full investigations. There have not been full court opinions. There have not been systematic studies. There have been serious concerns expressed about the apparent deterioration of the quality of corporate financial reporting. There is some exogenous evidence. We've seen the numbers of earnings restatements among the 12,000 to 13,000 corporations that report to the SEC, increased from 116 in 1997 to 305 in 2001. And that is a staggering rate of increase. But what we saw more than anything else, I would submit, driving the legislation, was a sense of crisis or panic.

On July 10th, I remember telephoning Steve Harris, who is the General Counsel to the Senate Banking, Housing and Urban Affairs Committee, and saying in effect: "So, Steve, are we going to have a law this year?" And he said, "I don't think so." He, in effect, said, "Enron has spent itself"; he said, in effect, "We may get a successful vote of

a Sarbanes bill in Sarbanes' Committee. We will then deadlock in conference." Two days later, WorldCom announced its $3.8 billion earnings restatement. And it was as if fuel or rather a match had been supplied to tinder. You went from a Congress, which seemed to be deadlocked to one, which would within 16 days, by a unanimous vote in the Senate and a vote of 423 to 3 in the House, passed a very far-reaching bill.

It was a law, which in its last days had aspects that were somewhat akin to a feeding frenzy. There were a number of new provisions, particularly what are called articles 8 through 11 of the Act, which were added at the last moment. They were added in some instances so hurriedly that the vocabulary is not well harmonized with articles 1 through 7. They were added sometimes so that they were duplicative or contradictory. It was a sense that Congress shifted gears from "we are probably not going to do anything" to "something must be done." And the something that must be done is a law of great length — it's 130 pages. I want to submit to you, when you look at it sort of bit by bit, some of it actually is quite thoughtful, some of it gravitated or was reflected upon over months, some of it was quite hurried, and it's important to disaggregate it.

Let me give you some headlines in five areas, and try to give you a sense of where I think there were very serious open questions, where I think the law is most constructive, and where it's perhaps most frustrating.

First, with respect to the Securities & Exchange Commission, I think the law actually makes some powerful contributions. The SEC was overwhelmed in terms of its ability to review corporate filings, to review accounting standard setting, clearly to review audit standard setting. It was beginning to lag seriously in terms of its technology. And most significantly, because of an issue that's popularly known as "pay parity," it found that it was able to hire very good people and it lost them very quickly to law firms and other employers because salaries weren't competitive with the banking agencies or with the law firms in town. Sarbanes-Oxley, very quietly, in a provisional way near the end of

the act, increases the SEC budget from $446 million to $766 million. It does so for three purposes. First, pay parity; second, to improve the technology of the commission; and third, to allow it to hire at least 200 new professionals. Where that number comes from, I don't know. But the key is these are very constructive and frankly long overdue steps.

Now there are other steps, with respect to the SEC, which are perhaps a little less commendable. One of my favorite provisions requires certain reporting to be regulated by SEC rule, "In real time plain English." And as a lawyer, my eyes reel when I see phraseology like this. At the risk of sounding quaint, neither "real time," nor "plain English" is a defined term. It is an aspect of the type of drafting which is clearly playing to the constituents back home. It will be domesticated when the SEC does adopt rules and tries to explain what they think Congress meant.

But there are number of provisions in the act, again somewhat hurriedly drafted often in the form of mandates or directives to the commission which partake of that flavor. The most serious overstatements, if you will, in a directive to the commissions, concern corporate loans and executive certification. The corporate loan provision was inspired by Bernie Ebbers, who received, as I understand it, something like $370 million in essentially unreported loans from WorldCom. Now everybody I assume agrees that's wrong, excessive, inappropriate. Nonetheless the language might reach as far as using a credit card. And that can't be what Congress really meant. It was clumsy. It will have to be worked out through either SEC No Action Letters or rulemaking. But again it was a hurried impulsive response.

With respect to executive certification, at one level one could argue this was a thoroughly unnecessary SEC order, SEC rule on congressional legislations. Executives should stand behind their financial statements and should be responsible for them and should be susceptible to criminal and civil enforcement. What you had here I would submit were confidence building efforts. There was a general sense that when a stock

market loses $7 trillion with the economic consequences of it, you needed to send a powerful signal that people were doing something. And one can look more benignly on executive certification in that sense.

Nonetheless, some of the phraseology in section 302 of Sarbanes-Oxley is clumsy. You have to certify, “that you helped design the internal accounting control system within the previous 90 days.” That is question begging. Surely you could have a good system in place designed by someone else. And again, that will be domesticated by SEC rules. But it’s the type of language you see throughout the act.

Second area where Congress perhaps had a little longer to cogitate on what it was doing, deals with the corporate board. The general impression created by the Powers report, created by a number of other, at least, indictments or newspaper stories, created by a lot of anecdotal evidence is there were a lot of boards that were quite quiescent, asleep at the wheel as Warren Buffet put it recently with respect to compensation committees, “There were too many cocker spaniels, not enough Dobermans” in the compensation committee. *The Economist*, which has a quite different take on things, explained that the problem was there were too many poodles. It’s been a rough year for dogs, I think it’s fair to say.

The major impetus for what Sarbanes-Oxley does at one level with respect to the corporate board came from a series of reports from a committee at the New York Stock Exchange. And in effect the essence of these reports was to state we wanted to empower the audit committee, we wanted it to have power to select the auditor, to set levels of compensation, to separately and without permission from the CEO receive outside legal advice or what have you. We wanted the CEO not to be in control of who would be on the audit committee. We wanted that to be controlled by a separate corporate governance or nomination committee. And it’s in that spirit that Sarbanes-Oxley proceeds.

I know — I am separately on an ABA task force on corporate responsibility — when we look at what New York had done, in effect we realize we had a very short report. There was general support for their approach in that group of largely very sophisticated corporate lawyers. The language in Sarbanes-Oxley with respect to the board is much shorter than in the New York Stock Exchange rule proposals that will be adopted by the SEC. The big question there is again separate from Sarbanes-Oxley, which is, will you ultimately harmonize the standards of New York with those applicable in other stock exchanges.

Now, on the other side with respect to corporate governance, there was a fair amount of playing to the galleries. I have never seen so many criminal provisions in a law. I have been doing a poll with corporate executives. Whenever I met them I said, "Hypothesize you were seriously considering a major and willful misstatement of your financial statements. How many of you would be dissuaded from engaging in this because the maximum criminal penalty would now be 25 years rather than 5?" Curiously enough, not one executive has said yes to this point. In effect what you see to be less facetious is just as with drug dealers and terrorists it makes Congress feel good to adopt more sweeping criminal penalties. That's the wrong issue. The right issue is how you deter fraud in the first place and how you enforce violations. From the perspective of a corporate executive, I would submit, I am quite skeptical that whether you get a one-year sentence, or a 5-year sentence, or a 25-year sentence makes any difference at all, it's the fact that you are punished in the first place. From the perspective of wise public policy, the issue is how do we avoid fraud, less, I would submit, than how you punish it after it's occurred. Nonetheless there are an extraordinarily large number of these provisions. I don't think they do much harm, and some of them are rather thoughtful, they basically say the Federal Criminal Sentencing Commission should study whether to change guidelines, that kind of thing.

Third area, and one which was almost late-breaking news as we move towards Sarbanes-Oxley, involves investment analysts. With respect to investment analysts, there were a number of addresses by former SEC chair Arthur Levitt, I believe one also by former SEC commissioner Laura Unger, expressing concern about the fact that we had gone from a period where there was a significant number of sell side recommendations to one where according to various samples there was as much as 99% buy side recommendations. These concerns took on a much graver hue, when someone in Eliot Spitzer's office in February leaked to the *New York Times* copies of e-mails at Merrill Lynch to the effect that they believed they should downgrade their recommendations, but were unwilling to do so because it might hurt their investment banking business. This suggests a corruption of a process that I at least am skeptical is limited to Merrill Lynch. It expresses a sense that the conflicts of interest in investment analysis had become quite severe and quite serious. Now, to date the New York Stock Exchange and the NASDAQ have adopted rules, have tried to create better disclosures to whether or not this conflict exists.

The Sarbanes-Oxley Act goes a little bit further on the disclosure front. The structural question here is to be studied, and the structural question is: Should you try to separate firms that do investment analysis from firms that do investment banking? That type of question, in a different context, was examined by the SEC during the 1930s, and they ultimately decided they could not separate because of the economics of the securities industry. I think, once we have a better sense of how common this type of practice was, whether or not disclosures will work, whether or not they will inspire independent investment analysis firms to come into existence, would be in a more thoughtful position to address this. But I will say in some respects when I look at all the things that have occurred, since Enron broke, if you will, in November 2001, the degree of corruption suggested by the investment analysts community is among the most

shocking. And my sense is, only one shoe has dropped so far. There will be more developments on this front.

A fourth issue, and one that was treated relatively lightly in Sarbanes-Oxley, deals with accounting standard setting. I thought it was among the more intriguing aspects of the Powers report, that when it looked at the special purpose limited partnerships or special purpose entities used by Enron to avoid reporting in essence losses and shifting them to off-book transactions of various types, that Arthur Andersen initially took the position that in fact Enron was in compliance with the general accepted accounting principle then in effect. In retrospect Arthur Andersen changed its view. The Powers report was quite emphatic — it was not in compliance.

But nonetheless, the story behind special purpose entities and their accounting standards is an intriguing one. As long ago as 1985 the SEC had raised questions about the relevant accounting principles board statement that controls here. And nothing happened. In effect the FASB (Financial Accounting Standards Board) never quite got it to the top of their priorities list, the SEC's office of Chief Accountant, the SEC's commissioners or Chair never really pushed on the subject. You've seen in a number of areas, with respect to the FASB, a very slow process of accounting standard setting, often waffling on reversals. Perhaps in the 1990s this was most evident with respect to topics like stock options and derivatives. It is intriguing, for those with long memories, to recall that among those placing great pressure on the FASB not to go forward, were some of the leaders in seeking the adoption of the Sarbanes-Oxley Act early in 2002. But all I can say is that foolish consistency is the hobgoblin of little minds. Times have changed.

Nonetheless, there is a structural issue with respect to the FASB that I am unpersuaded that the Sarbanes-Oxley Act addressed as well as it might. The question really is: Is the FASB sufficiently independent so that they can adopt what they think are

wise standards and not be subject to the type of political pressures that there were in the 1990s? There are really two dimensions to this. One is their funding basis. And in the Sarbanes-Oxley there is a shift, from in effect a kind of series of discretionary allocations or appropriations for FASB, which admit that when various institutions, either in the corporate or accounting profession disagreed with the FASB, there was a capacity to withhold or threat to withhold funds. That was addressed. There will be more the equivalent of automatic taxation mechanism.

The part that was not addressed was who appoints the members of the FASB. I am uncertain and I think the jury will be out as to whether or not the funding mechanism alone will lead to more independent behavior on the part of the five accountants who will be at the FASB, appointed by in effect a foundation called a financial accounting foundation. There is a very different approach taken with respect to the public company accounting oversight board, which is the new board to address auditing standards. The appointments are made by the full SEC with consultation with the Chair of the Federal Reserve System and the Secretary Treasurer. And it is a system, which among other things, requires "a minority of the membership on this board to actually be accountants," and more a sense that you want to have users of financial statements, and persons "of stature and independence" on the board. Whether or not that is a better model, the jury is also out.

But the question that is most fundamental with the accounting standard setting has been in effect the inability of the FASB to wrestle on a timely basis with the most difficult accounting issues of the day. Now, at the moment, we know they've been given some help. We know that the SEC is directed to look at critical accounting policies, and to look at special purpose entities. We know in any event the FASB has a new proposal with respect to special purpose entities. We know that they will undoubtedly look at stock option expensing within the next year, and probably will do something and will have to

wrestle how do you expense stock options. But whether the FASB under the current constellation will remain as vigilant two years, five years, ten years down the line I think is an open question.

The core of Sarbanes-Oxley, its major contribution, is with respect to the Public Company Accounting Oversight Board. And this is a board which, to focus on its basic responsibilities, has three functions. One, it is to preside over independent standards. That is to say, the debate during the late 1990s-early 2000 periods as to whether or not the same accounting firm could both provide auditing services and certain forms of management consulting for now has been largely resolved by Sarbanes-Oxley, which expressly prohibits nine types of conflict, directs other potential conflicts to go to the audit committee as long as they involve 5% or more of the fees to be received by the outside auditor. This is a resolution, which is more thoughtful than it might have been. Not all conflicts are prohibited. More significantly the little discussed is the fact that there in fact is no prohibition on an auditing firm both providing consulting services and providing auditing services. The prohibition is merely on providing them to the same client at the same time. This aspect of the law will probably not require major activity on the part of the PCAOB for the foreseeable future, but over time no doubt there will be questions.

Second there is the co-responsibility of in effect auditing the auditors. The law states that the PCAOB on an annual basis is to review the audits of any firm with 100 or more SEC clients, fairly small number of very significant accounting firms clearly the final four and a few others. It also states that for smaller firms you do this on the basis of one in three years. This is a very crucial ambiguity in the law, there's a series of crucial ambiguities which are going to have to be fleshed out, and it's an incredible significance for the PCAOB. First, what does it mean to review an auditing firm? Does it mean you review every audit? With what level of intensity? Does it mean you selectively review

audits? Does it mean you review audits for the same firms whose 10Ks are being reviewed by the division of corporate finance and the SEC? Does it mean you're wiser to review other 10Ks? That issue, or series of issues more than anything else is going to determine the size of the PCAOB. The size of the late Public Oversight Board, I believe was about $27 million. It did not directly perform less functionally; it had a peer review system that was universally critiqued before various congressional hearings. Clearly the PCAOB is going to do a direct inspection kind of system. But the degree of review is one of the crucial ambiguities.

A related crucial ambiguity is, will the PCAOB take over the promulgation of generally accepted auditing standards. Currently there is a board, relatively small one, within the AICPA that addresses such things. I know I testified, I know John Biggs testified, I know a number of others testified that the structure of oversight of the auditing profession was Byzantine, too complex, too lacking in accountability. I think there is a strong case for the PCAOB to directly take over auditing standards. I think that is a less complex kind of issue than generally accepted accounting principles. But it is an open issue. It is one that the PCAOB would have to address within the new term. There is a third function for the PCAOB with respect to enforcement. It is a complex function as is, by the way, auditing auditors. There will have to be some formal coordination with the SEC and in some instances the Justice Department. It is a very hard area to try to figure out how to budget in that you don't yet know the dimensions of frequency of enforcement cases. While it is easy to imagine three separate aspects, conceivably three separate branches of division of the PCAOB and to imagine how many people you might need in an office of general council or the auditor's function, the enforcement is one that will have to be developed over time.

What we do know about the PCAOB in the political context that we are currently in is, it will have a significant budget. There have been discussions with certainly Paul

Volcker and others where figures up to a hundred million dollars and perhaps more have been intimated. That is quite a good deal more in resources than, for example, the FASB or the former POB had. It is likely but not certain the PCAOB will be located in Washington, DC. It is certain that the membership of it would be named by October 28, 2002, it is certain because it is required also by statute that the board will be “certified by the SEC for operation no later than April 30, 2003 and conceivably sooner than that.” And it is certain that an awful lot of people are going to be working very long hours between October 28 and April 30, hiring a number of other individuals, drafting everything from ethics standards to operational rules to address the functions of the PCAOB. It is an agency, which to some degree partakes of the spirit potentially of the SEC in the 1934-1939 period under the New Deal where there was excitement and vigor at creating a new regulatory structure, but it also has the same challenge that the SEC did. And that challenge more than anything else was, is it possible to design regulation that will improve the integrity of the mandatory disclosure system without being so burdensome or onerous that it would make much more difficult legitimate business activity. It is going to require some subtlety and balance and wisdom, and that is in effect the great challenge of the PCAOB. It is an agency like the SEC — born in crisis. The question is how well it does not in the first three months, or three years, but over time in balancing the challenges both of avoiding fraud with not being too bureaucratic.

I’d be glad to take in any questions that you have.

Questions & Answers Session:

Is there any discussion of the practice of having two sets of books for taxes and not, and the appropriateness of having that?

Oh, I think that wasn’t addressed to the best of my knowledge in the hearings and the notion that tax accounting standards are different than financial reporting

standards seems as if it will persist. The question is, can you have two sets of books and, more, do you disclose the differences in the financial reports and that, I assume, will also continue.

When the current distinguished board passes on and the next board comes in, and becomes probably as politicized as the SEC, do you think this is going to be an improvement over the FASB, which was influenced by preparations and therefore politicians, but still had a degree of sovereignty as compared to what probably will be a larger, perhaps unwieldy, and in ten years, perhaps not distinguished group of overseers?

And that's a great question. I mean, there are some steps taken to try to create a persistent level of quality, if you will. The statutory language —

And lack of politics.

Well, lack of politics is pretty hard to totally vanish.

Are they?

The language, "people of integrity and stature," I don't quite know what that means. There is the setting of salary levels of FASB rather than government levels that at least means you can attract people like John Biggs, whom I don't think you could attract on SEC salary, although I don't know. There is the notion of the appointment is not made by the chair of the SEC, who will be from one party or the other, but by the full commission. At least two of them have to be from the other party. So there is a consensus approach. But when you look at the four SEC Commissioners other than the Chair in recent years, there have been a rather small number of truly outstanding non-share commissioners. Right now we have Harvey Goldschmid as a second

Commissioner who is extraordinary and could be chair, that kind of thing. But we have had periods when it has been like Snow White and the four dwarfs, if you will. And that's the kind of risk you will have at one level. And to the extent you go from having former CEOs of accounting firms, to former Associate General Counsel of accounting firms, whether or not they will have the same integrity and political independence we will see if it will happen.

About the oversight board, in my hasty reading of Sarbanes-Oxley, I haven't come across what standards the Board will use to determine that a firm is in violation.

To some degree, the best way to look at the PCAOB is the moon that revolves around the SEC sun. And the standards, in effect, are the standards of federal securities laws. And the notion of material misrepresentations or omissions, the notions of our friends' Rule 10b-5 and other fraud provisions will be directly applicable to that type of question. Standards for rule adoption are in the act as well and they don't sound terribly sophisticated when you refer to things like public interest, protecting investors but they are there and they are kind of typical of legislation. What's intriguing to me is not so much the standards, but the delineation of detail with respect to the way in which the PCAOB is to review auditing firms. I don't honestly know where that detail came from. I presume there was a good deal of exchange between the office of chief accountant of the SEC and the Senate Banking, Housing and Urban Affairs Committee that led to it. That detail may be more important than the standards.

Maybe a question for the political scientists in the room, but you will I think have some information on it as well. You mentioned the increase in restatement of

earnings from a 100 something to 300 something, roughly a 100%, maybe a little bigger rate of increase, but of course measured as a percentage of the public companies that is from 1 to 2% increase. We saw this enormously large number – 3.8 billion – and Bernie Ebbers doing the atrociously inappropriate thing. This company is now bankrupt. I assume he is going to jail. Arthur Anderson is dead. So the question is, these events, which did create a crisis of confidence perhaps, and certainly a huge amount of media attention, spun this rather wide-ranging bell. Given your interest in deterring fraud and misconduct rather than punishing it, is it that those highly public acts are the tip of the iceberg, and that, therefore, this type of reaction is justified? Or do you see it more as a political feeding frenzy issue as you called it, at the end?

Well, let me put it this way. If not a single billion dollar plus fraud is revealed for the foreseeable future, we have still seen the iceberg. The iceberg was a $7 trillion decline in the aggregate value of publicly held securities in this country. It was a reflection of a serious deterioration of investor confidence in firms that distribute information. One can argue that investors were not as sophisticated as you are in terms of your statistical analysis of the percentage of earnings restatements, and one can argue the investors started from a very different premise. They believed the SEC, with 3000 employees and a number of AICPA Committees and the FASB, that they had the right to assume when they got financial statements they were going to more or less be accurate. To see an increasing number of billion dollar plus frauds, a sense of uncertainty — where is the next one coming, who will it involve — maybe it is not just IPOs or funny companies in Houston but more mature and larger companies like WorldCom, was unnerving. And to some degree I think that was the key basis for Sarbanes-Oxley.

In 20 or 25 years, when political scientist graduate students are writing their dissertations about Sarbanes-Oxley, how are they going to know whether or not the bill created any value?

In which sense?

In the sense that I guess corporate governance or corporate control is a good. It is obviously something that people want. And right now the new regulatory apparatus being proposed attempts to provide this good or at a price that effectively equals zero. So how are we supposed to know whether or not we are doing anything of value here?

Well, I think there are a variety of metrics that political scientists can employ, but they range from everything, from hopefully a decline in the number of enforcement cases and earnings restatements over time, hopefully some adjustment in stock market prices. The key, though, a good deal of "the value" is not going to be that easily quantifiable. When I suggest that some and certainly not all of the $7 trillion decline in stock prices was related to a reduction of confidence, integrity and financial reporting. It is very difficult to measure confidence. You will see it reflected in editorials and opinion pieces in popular press. You will see it reflected in speeches and statements from opinion makers. And that's part of the analysis I would submit as well.

Is it really possible for the audit committee on a board of directors to operate effectively when you have collusion between the accounting practices of the firm and the public accounting auditor that is auditing the books. My experience is that an audit committee is dependent upon the information that it receives from those two sources and that that really is the sole source it has for its information. In that

largely it becomes a ratification of the work that has already been done. There isn't really any appreciable previous work done by an audit committee. And it strikes me that if the Dean of the Business School of Stanford is incapable of chairing an audit committee effectively, then there is something wrong with the concept.

Let me start by being unequivocal. Deans can be fallible. What we are doing in Sarbanes-Oxley and the New York Stock Exchange proposals and proposals that will come from a number of other directions is trying to change the concept. We are in effect stating to audit committees: you are going to have potential personal liability that you perhaps didn't experience before. You are going to be expected to ask tough questions. You are going to be expected to choose auditors, not to save money for your firm but to ensure the integrity of the financial reporting system. You are expected to follow up when you receive troublesome answers. You are expected to be vigilant in avoiding conflicts of interest. At some level the most significant change if you will that may be portended in Sarbanes-Oxley is an effort to shift the balance of power between the CEO and the audit committee. Now it is an odd way, at least in my view, to try to achieve the business goals of a corporation, but it reflects a recognition that the cost of (recording interrupted)

But it seems you have to have a degree of expertise on the audit committee that you know isn't normally contemplated.

Actually one is contemplated. In Sarbanes-Oxley there is a requirement for a financial expert, and if you don't have one, an explanation as to why not. Enron was a study in dysfunction. It was a study in quiescence and passivity, it was a study of sort of a simultaneous breakdown in every accountability mechanism. The behavior, whether it is of the former Dean of the Business School of Stanford or the others on that audit

committee, it not likely to be replicated in the near term by audit committees that are already engaged in a great deal of self-correction. They are already in effect asking probably as they come to each other committee: How can we avoid being the next Enron? We have seen a dramatic expansion in the size of filings with the SEC. I don't think you are going to see as many special purpose entities, unless they can be easily defended. How long will this persist is a fair question, but I envision at least for the short term quite different behavior on the part of all the audit committees.

How will a new system be perceived by foreign corporations? Will they be more or less inclined to want their shares traded in New York?

There are some provisions in this Act, which require kind of an elevation of reporting standards, and there's going to have to be some sort of wrestling through SEC rule making with them. Before Enron, there seemed to be a gravitation towards trying to move the United States closer to international accounting standards. And, for example, Paul Volcker, who was the chair of the International Accounting Standards Board and for all I know still is, was a figure from the United States who commanded great respect who might have been able to nudge the SEC closer to that. The reaction on the part of Congress in Sarbanes-Oxley was in effect to say lets put that on hold. Let's demand higher standards for firms that want to sell either ADRs or directly list in this country. Whether or not that reaction can persist for long, I am skeptical. I think we are going to move, like it or not, inevitably towards a different kind of financial reporting system, for blue chip securities that will be simultaneously traded in leading securities markets throughout the world with standards that will be some sort of homogenization or harmonization of the United States and other standards. I think we see some elevation of standards through the European Union. I think the question is how do we modulate

the United States standards so that we can attract these securities as well. Sarbanes-Oxley is slowing that down a little bit. How long we will see.

I am wondering about in studies for board members to really represent the shareholders, the shareholders are probably the largest additional shareholder. The simplest thing is just to sell the stock rather than to try to raise an issue. And I am wondering if this act provided incentives for board members to represent the shareholders more effectively.

Well, in crisis now the normal response of Congress, and we see it here as well, is to focus on the liabilities side, to focus on exposure — board members. There is, second, a series of provisions, which at least for the audit committee reduce the possibility of audit committee members having certain types of financial conflicts. My sense is that, believe it or not, the biggest winners from this act are not going to be the lawyers who are very busy now sending statements to their clients, but they are going to be the audit firms and board members. They are going to be board members because there is more financial exposure and their responsibilities are increased, they will not benefit through stock options but they would benefit through direct salary, and auditors, outside auditors, because the requirements for effective auditing are going to be elevated. Now will this mean that board members will better represent shareholders, and will this mean that persistently over time? That's a great question. That's the kind of question that Troy is going to try to educate us on on September 25 at the Law School. It is very hard as the prior question suggested to change behavior. And whether or not what we are seeing is short-term reactions that don't persist is a significant open question.

You and I are lawyers, Dean, and we consider ourselves members of a learned profession. And up until these incidents with accounting, which is sort of a learned profession too, in fact the accountants were to take over our business, while aspiring lawyers are doing their thing. Does this Act breathe a new life into the concept of accounting as another one of the learned professions, and if not, what do you think needs to be done to do that?

I think when you listen to the music of the act and not just read the words, that ultimately is a message of Sarbanes-Oxley, that accounting at least in the view of Congress went badly askew over the last twenty and thirty years when leading firms tried to be businesses in a series of consulting activities which in some instances generated the majority of their incoming profits and became less involved with auditing which does have characteristics of the type of profession law and medicine have been. I think the moral lesson, if I can use a kind of unusual term of Sarbanes-Oxley, is Congress and the SEC are going to demand that the audit business become the audit profession again.