House
Committee on Financial Services
Michael G. Oxley (OH), Chairman

Rebuilding Investor Confidence, Protecting U.S. Capital Markets

The Sarbanes-Oxley Act: The First Year

Sarbanes-Oxley—One Year Later

About one year ago, there was a perception that American capitalism was in crisis.

We faced numerous problems in corporate America ranging from bankruptcy to failures of investor protection to fraud. Shareholders were losing money fast, and that general trend was punctured by the news of Enron, WorldCom, and Global Crossing. In addition to the hardships of these bankruptcies on employees and retirees, the energy and telecommunications sectors bore losses as the ripple effects continued.

With losses of trillions of dollars in market capitalization, it's no wonder investors lost their nerve. Clearly this disparate set of problems was far outside the bounds of any normal economic trough or recession.

The President, Congress, regulators, law enforcement, and all of corporate America responded well, all tending to their own roles. The President deserves commendation, as do the superb efforts of the people at the Securities and Exchange Commission and the Public Company Accounting Oversight Board.

Bill authors Sen. Paul Sarbanes (MD) and Rep. Michael G. Oxley (OH).

It is a tribute to our financial and government systems, as well as to the spirit of our people, that we are able to face adversity and deal with it. Now, one year later, our markets are coming back at a more measured pace, and economic conditions are favorable for the next period of expansion. Individual Americans are getting back into the capital markets, and our entrepreneurial spirit is returning.

While I have listened to complaints about compliance with Sarbanes-Oxley, I also have been heartened by the executives and employees who embraced the new law with enthusiasm. Many publicly traded companies undertook attic-to-basement reviews and accepted the law as an opportunity to make sure their companies were sound. I've given scores of speeches about the law, and everywhere I go, corporate officers and employees tell me about their experiences. I've appreciated their progress reports along the way, and overall, my impression is that it's going well.

In the end, we found that the vast majority of American companies are run by ethical people seeking to provide value to their customers, good working environments for their employees, and honest returns for their shareholders.

Just as there was no one cause for the problem, there is no one solution. But I hope that the law helps in the process of bringing America back to prosperity. So, on this first and on future anniversaries, it is my hope that Sarbanes-Oxley will be viewed as making a positive contribution to the nation's financial and economic future.

-House Financial Services Committee Chairman Michael G. Oxley (OH)

Chairman Oxley — On the Record

The following statements were made by House Financial Services Committee Chairman Michael G. Oxley (OH):

- "We have more transparency, more investor confidence now. We have a changed outlook in the boardrooms across America, and we have a lot more due diligence in the decision-making process in corporate America."
- "It wasn't just the Congress and the President, it was the whole system that really cleansed itself and reformed itself. It was pretty remarkable, really."
- "One of the things that I always feared is that executives and board members would be extra cautious about taking risk. Capitalism is about taking risk, and that is what makes our system so productive. I think there will be a natural pulling back in the short term, but I think we will work our way through that as everybody gets a feel for the new world order of corporate governance. So I'm confident that it's a short-term phenomenon, but it's not to be ignored."
- "Paul Sarbanes deserves a great deal of credit. He was under enormous pressure to blame Republicans and to blame the Bush Administration, but he chose to take the high road. He chose to work with me, and I think he was a real statesman."
- "Sarbanes-Oxley has had the effect of focusing people's attention on real results and the fundamentals of investing as opposed to the speculative bubble that we found ourselves in in the 90s."
- "WorldCom took all the oxygen out of the room because it was so huge — four or five times larger in bankruptcy terms than Enron. It really did change the debate, particularly in the Senate."

Congressman Michael G. Oxley has chaired the Financial Services Committee since its creation in the 107th Congress.

- "The Securities and Exchange Commission has done a superb job of meeting its deadlines on the regulatory issues and assiduously complying with congressional intent of the law. This allowed us to set a foundation for this law to really work in the best interests of the American investor and the American economy."
- "It's incumbent upon the regulators to steer through some of the tough stuff. We tried to make it as flexible as possible for the regulators."
- "I have a great deal of faith in the PCAOB and its leadership, so I'm not going to sit in the stands and second-guess what they're doing."
- "We have this incredible ability and political will to make necessary changes in our system, and every time we do that we become more efficient and better for it."

Transparent and Rapid Financial Disclosure

During hearings on corporate accounting failures, the Committee found that accounting principles governing the reporting of billions of dollars in debt and potential losses were not followed by the accounting profession, were insufficiently reviewed and enforced by the Securities and Exchange Commission (SEC), and were abused at some of America's biggest companies. Deadlines for reporting financial results and pertinent company news were not updated to require more immediate disclosure, even though the Internet enables companies to instantaneously announce important information. Since the passage of the Sarbanes-Oxley Act, the SEC and the Financial Accounting Standards Board (FASB), the standard-setting body for the profession, have responded in exemplary fashion. Chief executive officers (CEOs) and chief financial officers (CFOs) are now personally responsible for their companies' financial results and controls through Sarbanes-Oxley's certification requirements. Corporate America is responding positively to the changes, with better and more accurate information reported to investors.

Companies Misled While Regulators Failed to Lead

Enron Corporation's bankruptcy led to revelations that, beginning in 1997, senior company officials had engaged in numerous off-balance-sheet transactions with complex special-purpose entities to hide billions of dollars in debt. During the initial congressional hearings on Enron, the Committee introduced evidence that these transactions at best adhered to vague accounting principles informally announced in 1990 and 1991 by the SEC and FASB. Enron officials also hid economic losses, inflated operating cash flows relating to certain guarantees and derivative contracts, and disguised certain debt instruments as equity. Despite the increasing abuse of these corporate financing mechanisms during the mid- and late-1990s, SEC officials did not force full disclosure of the impacts of such arrangements.

Additionally, the Committee reviewed the bankruptcy of Global Crossing and its reporting of pro forma revenue (that is, revenue not based upon Generally Accepted Accounting Principles, GAAP). Three firms represented at the hearing disclosed pro forma revenue earned from swaps of fiber-optic capacity in different ways. Each firm reported massive differences between pro forma revenue and GAAP-based revenue, and the firms failed to consistently reconcile the two as measures of revenue.

In spite of the growing trend in the 1990s to report revenue on a non-GAAP basis, the SEC did not issue or enforce clear guidance requiring reconciliation between GAAP and non-GAAP financial measures in disclosures. This left investors and analysts in the dark when comparing financial reports of competing firms in the same industry.

SEC Steps Up Reviews

As a result of these failures, Sarbanes-Oxley includes requirements to report all material financial results, commitments, transactions, relationships with entities, and uncertainties. Significant components of revenues or expenses, as well as matters that will have an impact on future operations, must also be reported. Non-GAAP and GAAP-based financial results must be clearly reconciled. Companies must disclose the accounting policies with the most critical impact on financial statements, along with estimates of the impacts under certain circumstances.

Concurrent with the hearings and the passage of Sarbanes-Oxley, the SEC and FASB began to redress the accounting principles for disclosing special-purpose entities and other off-balance-sheet transactions, pro forma revenue estimates, and other financing mechanisms. As a result, in November 2002, the SEC and FASB mandated greater disclosure of the impacts, risks, and trends inherent in certain corporate loan guarantees not previously disclosed in any way. In January 2003, the SEC and FASB eliminated off-balance-sheet treatment for many transactions, including those with special-purpose entities, which were previously not consolidated on financial statements. FASB followed in June with a draft statement to clarify the reporting of certain special-purpose entities involving financial assets. In April and May 2003, FASB issued new requirements to improve the accounting for derivatives and to prohibit companies from reporting certain debt instruments as equity.

Even before the passage of Sarbanes-Oxley, the SEC began to study the potential to modernize the periodic reporting system and to improve the usefulness of periodic reports to investors. In September 2002, the SEC released its final rule, which will, by 2004, require companies to release annual reports in one-third less time than is now required. Quarterly reports will be released in 35 days by 2005, compared to 45 days now. The SEC is still studying options for releases of current news in as little as two business days, as opposed to six business days currently.

The primary mission of the SEC is to protect investors and maintain the integrity of the securities markets. As more and more first-time investors turn to the markets to help secure their futures, pay for homes, and send children to college, these goals are more compelling than ever.

The SEC and FASB are also meeting mandates in Sarbanes-Oxley for structural improvements in the accounting industry. In April 2003, after studying the regime for establishing accounting standards, the SEC affirmed FASB as the designated private-sector body for setting such standards. The two organizations also collaborated to study the change from a rules-based to a principles-based approach to accounting standards in the U.S., as mandated in Sarbanes-Oxley. This mandate was added to Sarbanes-Oxley in response to concerns that the current rules-based approach results in unwieldy official statements that attempt to address each conceivable situation, when a clear set of principles would suffice.

The SEC released the study on July 25. The staff recommended that FASB and the profession develop principles-based or objectives-oriented standards with the following characteristics:

- An improved and consistently applied conceptual framework;
- A clear statement of the accounting objective of the standard;
- Sufficient detail and structure to enable users to consistently apply the standard, without too much detail that "obscures or overrides the objective underlying the standard;"
- Minimal exceptions to the standard; and
- Avoidance of percentage tests (bright-lines) that allow financial managers to technically comply with the standard while evading its intent.

In the opinion of the SEC staff, GAAP is still "the most complete and well developed set of accounting standards in the world," but "neither U.S. GAAP nor international accounting standards, as currently comprised, are representative of the optimum type of principles-based standards." The study outlines steps involved in moving to a more objectives-oriented basis.

Under Sarbanes-Oxley, CEOs and CFOs (or persons performing similar functions) must certify their companies' financial reports and disclosure controls and procedures, with a potential $5 million fine and up to 20 years in prison as penalties for violations. The SEC issued rules mandating that outside auditors attest to these reports.

The rapid issuance of new regulations and standards for disclosing the impacts of all material transactions was led by the Chairmen of the SEC during the past year, and the Chairman of FASB.

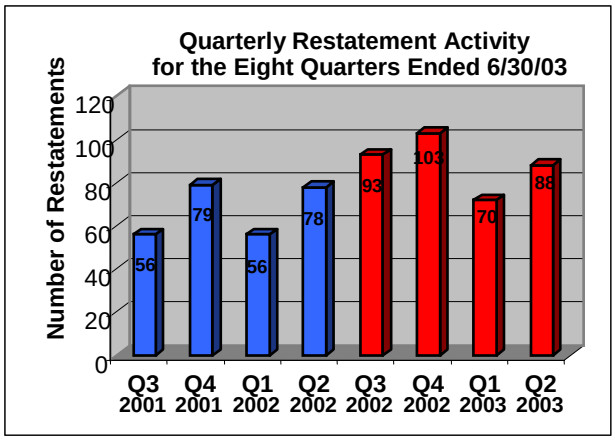
Corporate America Responds

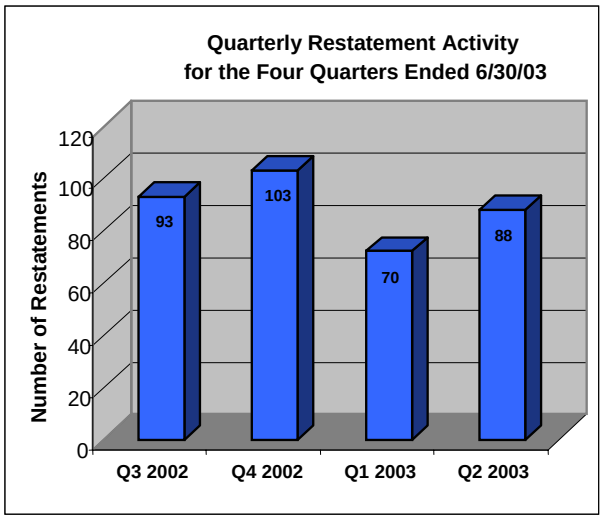
Sarbanes-Oxley has resulted in positive changes in corporate auditing control and compliance procedures. Writing in the May 2003 edition of *Chief Executive* magazine, Edward Nusbaum (CEO of Grant Thornton, the fifth largest accounting firm in the U.S.) wrote that a "hidden benefit in Sarbanes-Oxley is that CEOs may find that the new requirements provide them with useful tools for running their companies more confidently." A survey released in March 2003 by PricewaterhouseCoopers of senior executives at large U.S. multinationals found that Sarbanes-Oxley had resulted in changes in auditing controls and compliance procedures at 84 percent of the companies. Of the executives interviewed, 82 percent expressed confidence their companies are in full compliance with the law.

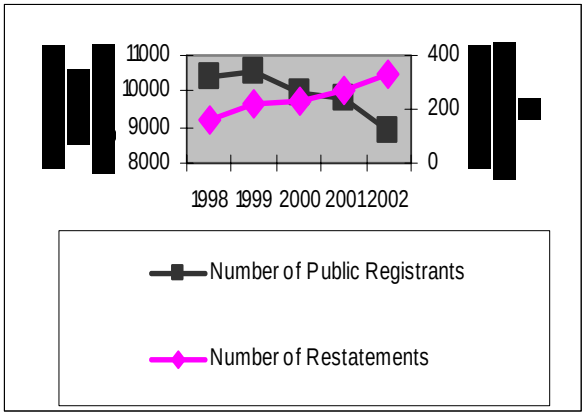
Companies are now reporting their critical accounting policies in annual reports as required under Sarbanes-Oxley. A survey conducted by Shearman and Sterling LLP of recent annual reports of 95 of the Fortune 100 companies found that accounting policies affecting contingent liabilities, goodwill, pension benefits, and income taxes, are among the most critical in many industries.

Companies are also now less likely to release pro forma results because they do not provide a sound basis for comparison. The National Investor Relations Institute (NIRI), the association of investor relations professionals, released a poll stating that more than 40 percent of 600 companies polled report financial results based only on generally accepted accounting principles, with 16 percent of the companies still releasing pro forma results. Nearly half of those companies releasing only GAAP-based information cited the new SEC rules as the reason for no longer issuing pro forma results.

Even with these drastic changes, there is no evidence to suggest that companies are restricting the flow of information to key audiences in any significant way or moving away from traditional communications with shareholders and analysts. According to NIRI, "Participation rates of companies in one-on-one and small group analyst/investor meetings and in breakout sessions following presentations at analysts/investor conferences continue to track those preceding the adoption of Regulation FD and the enactment of Sarbanes-Oxley."







Companies are filing restatements of financial statements at a record rate to ensure that errors are carefully excised and that statements fairly present all required and needed information. The Huron Consulting Group performed a search of all quarterly and annual reports filed from 1997 through June 30 of this year. Huron included only those restatements as a result of official, accounting errors and excluded changes in accounting principles and non-financial related causes. Huron reported that, "The number of restatements filed in the five months after the enactment of Sarbanes-Oxley was significantly higher than the restatements during the first seven months of the year, and likewise as compared to the same five-month period in 2000 and 2001." Additionally, the number of restatements filed during the latter two quarters of 2002 is the highest of any consecutive quarters during the past five years. The number of restatements announced during the first two quarters of this year is significantly higher than during the first two quarters of last year.

The number of restatements has climbed by 53 percent since 1999, while the number of publicly held companies has actually decreased by 14 percent. According to Huron, the three primary causes of accounting errors are problems applying accounting rules, human errors, and fraud.

Three underlying causes to restatements

Cause	Examples
Rules	Revenue measurement and timing
	Fitting complex business arrangements into slow to change rules
	New accounting guidance
Errors	Lack of communication within the company
	Flawed foundation for accounting judgments and estimates
	Calculation and posting mistakes
	Accounting personnel without proper experience and training
	Poor systems changes
	Deficiencies in internal controls—magnified by growth
Ethics	Earnings mismanagement
	"Disconnected operations"—lack of proper oversight
	Collusion by employees to override controls

Compliance Costs

Charles L. Hill, Director of Research at Thomson FirstCall and one of the nation's most respected independent analysts, credits Sarbanes-Oxley for improvements in the quality of financial statements:

"One of the main abuses in the stock market bubble of the late 1990s was that the earnings numbers were being inflated (or the losses diminished) by many companies, abetted in some cases by their auditors or by the sell-side analysts covering their company.

"But the good news is that the quality of earnings has been improving over the past year. The main driver has been Sarbanes-Oxley. Earnings quality is not yet at the level it should be, but improvement has already been considerable and more will follow as additional provisions are implemented and as the SEC gets geared up to enforce them.

"In general, Sarbanes-Oxley has been a very good piece of legislation. There is always the risk that regulations hastily drawn up in the heat of scandal announcements may overreach or may generate unplanned consequences. That does not seem to be the case with this law."

Although some critics have considered the compliance costs of Sarbanes-Oxley to be substantial, a Congressional Research Service (CRS) review conducted for the Committee found evidence to the contrary in a survey done by PricewaterhouseCoopers. "A significant number of corporate executives characterize the startup costs of implementing Sarbanes-Oxley as unsubstantial. Sixty-one percent of the senior executives who responded to the Management Barometer survey characterized the initial expense of implementing Sarbanes-Oxley as either not all costly (15 percent) or not particularly costly (46 percent)." The survey also found that 70 percent of the executives who indicated that Sarbanes-Oxley would not have any future cost impact gave a positive assessment about Sarbanes-Oxley. CRS also reported, "some academics observed that: 'Because of companies' initial uncertainty about how to comply with the Act, we expect the effects of Sarbanes-Oxley to be somewhat negative in the short run with compliance costs declining over time."

According to survey results by the American Society of Corporate Secretaries, which has over 4,000 members representing approximately 2,800 companies, compliance costs appear to parallel the size of the company. Forty percent of the respondent companies have under $1 billion in revenues, and 45 percent of the respondents estimated their costs at under $1 million. Another 34 percent have revenues between $1-5 billion, and 31 percent estimated costs at between $1-5 million.

Given the substantial loss of investor wealth, estimated at over $7 trillion, the benefits of preventing future losses and restoring investor confidence greatly outweigh the costs of compliance.

Best Practices in Corporate Governance

The news in 2002 was filled with revelations that long-time directors of huge companies failed to diligently oversee financial reporting matters and rubber-stamped proposals of corporate officers without sufficient review. These caused Congress and the SEC to call for more independence of directors and for more detailed reviews of financial matters. Corporate leaders are responding not only to its mandates, but also to the movement toward transparency in corporate management that underlies Sarbanes-Oxley. Numerous recent surveys show that Sarbanes-Oxley is leading to a culture change in corporate boardrooms.

Concurrent with the passage of Sarbanes-Oxley, the SEC, the New York Stock Exchange (NYSE), and NASDAQ embarked on a complete rewriting of corporate governance standards for publicly traded companies. The NYSE and NASDAQ submitted differing proposals, which the SEC is reconciling prior to release of a final rule. Together, they would increase board independence by mandating that boards be composed of a majority of independent directors; convene executive sessions outside the presence of management; have powerful audit, compensation, and nominating/governance committees composed of independent directors; and have continuing director education programs.

"The Sarbanes-Oxley Act of 2002 has proven an effective catalyst for boardroom reform. Compliance with the Act and related SEC rules and listing rule reforms has explicitly placed greater responsibility and accountability on the Board of Directors, and its important committees, particularly the Audit Committee."

Ira Millstein, Esq., Senior Partner
Weil, Gotshal & Manges LLP

The corporate scandals also revealed that audit committees allowed management to dominate the corporate relationship with auditors, thereby compromising the independence and integrity of the audit process and all parties involved. Sarbanes-Oxley required the SEC to direct the exchanges to establish national standards to reinvigorate the role of audit committees in financial matters. Sarbanes-Oxley also required that audit committee members have no affiliation with the company and receive no compensation from the company, except for fees received for service as a director.

The SEC first addressed the independence of audit committee members in January 2003 by requiring each public company to attest to the qualifications of key audit committee members. By rule, the SEC announced that a company must annually disclose whether it has at least one financial expert serving on its audit committee, and if so, the name of the expert and whether the expert is independent of management. A company that does not have an audit committee financial expert must disclose this fact and explain why.

In April 2003, the SEC mandated that the exchanges submit new rules for listed companies' audit committees by July 15, 2003, with specific requirements:

- Audit committee members must be independent according to specified criteria;
- The audit committee must be responsible for the appointment, compensation, oversight, and dismissal of the auditors and must review financial statements;
- The audit committee must pre-approve all audit and non-audit services not specifically prohibited in Sarbanes-Oxley; and
- The company must establish funding for the audit committee, including, when necessary, the means to retain independent counsel.

Culture Change in Corporate Boardrooms

Corporate boards are changing in advance of the listing requirements of the exchanges. Many have already adopted the NYSE guidelines and changed board and audit committee structure accordingly. But the new requirements do not appear to be stifling innovation or creativity among corporate management.

The first impact of the scandals and Sarbanes-Oxley was to focus attention on reforms in the boardroom. Leading organizations in business and academia are studying corporate governance guidelines and practices that can meet or exceed the requirements in Sarbanes-Oxley. For instance, the Conference Board, a global research and analysis organization serving 2,500 businesses, conducted a series of conferences in the U.S. during 2002 to gather information on leading governance practices for board members and management. In May, the Board released *Corporate Governance Best Practices: A Blueprint for the Post-Enron Era*, in which it suggested numerous best practices in corporate governance, audit practices, and disclosure/compliance/ethics practices and controls.

In June, the Business Roundtable, an association of CEOs of 150 leading U.S. corporations, surveyed corporate governance practices among its members. John J. Castellani, president of The Business Roundtable, commented that, "America's corporations are demonstrating their dedication to shareholder and investor confidence." The important findings from the survey are as follows:

- 80 percent of Roundtable companies report that their boards are at least 75 percent independent, and 90 percent report that at least two-thirds of their boards are independent;
- 55 percent of Roundtable companies have (or will have by the end of 2003) an independent chairman, independent lead director or presiding outside director;
- Outside directors at 97 percent of Roundtable companies are meeting in executive session at least once each year, and 55 percent expect to do so at least five times this year; and
- 90 percent of Roundtable companies now encourage, require, or conduct education programs for new (54 percent), and in some cases all (36 percent), directors.

The American Society of Corporate Secretaries conducted a survey in July to gauge the changes underway in the past year in corporate governance, even before the listing rules are finalized. According to survey results, respondent companies have already made significant changes in director independence and involvement, without excessive compliance costs, as follows:

- One year ago, only 26 percent of respondent corporate secretaries had an independent chairman, an independent lead director, or a presiding outside director. Today, 62 percent of the respondents report one of those three as a corporate leader.
- During 2002, the outside directors of 156 companies, or just over 56 percent of respondents, met in executive session more than twice per year. During 2003, that number will rise to 257 companies, almost 82 percent of the respondents.
- 75 percent of the respondent secretaries said they have seen more involvement by directors in board meetings in the past year, while 89 percent said the number or length of audit committee meetings has increased.

The law firm of Shearman and Sterling examined the corporate governance policies of the Fortune 100 companies, based on annual reports and corporate information available as of May 2003. Of these 100 companies, 96 were listed on the NYSE, and four on the NASDAQ. The survey found early and growing compliance with the proposed guidelines, as follows:

- 56 companies have publicly available governance guidelines;
- 53 companies require at least a majority of independent directors;
- 38 companies have defined director independence;
- 58 companies have already adopted new audit committee charters that generally comply with the proposed NYSE rules, and 37 of these held more than 6 audit committee meetings in 2002;
- 65 companies have reported stock ownership guidelines for directors, executives or both; and
- 82 companies have publicly disclosed how board compensation is determined. At 45 companies, compensation is recommended by the corporate governance and/or the nominating committee and approved by the board, and at 26 companies, compensation is recommended by the compensation committee and approved by the board.

In April, the American Corporate Counsel Association (ACCA) and the National Association of Corporate Directors (NACD) joined forces to interview their respective members on corporate governance trends. According to a joint survey, corporate counsels and directors have placed the highest degrees of responsibility for the corporate scandals in CEOs and senior management (over 93 percent), followed by accounting firms. The survey also found that directors appear satisfied with the independence standard set for them in Sarbanes-Oxley; 74 percent of the directors described themselves as comfortable with the definition.

It appears that directors are already reviewing financial reporting matters in more detail. The Investor Responsibility Research Center reviewed recent SEC filings for 1,250 companies in the S&P 500, MidCap, and SmallCap Indexes and found that the number of audit committee meetings in 2003 has increased, on average, 39 percent from 2002 among the companies.

Perceptions that Sarbanes-Oxley might stifle corporate risk-taking are not shared by respondents in the ACCA-NACD survey. A majority of directors and corporate counsels think that the recent scandals will not restrict risk-taking or entrepreneurial ventures by senior management and directors.

A survey released in May by PricewaterhouseCoopers of CEOs of the 403 fastest-growing U.S. companies found that only 15 percent are publicly held and thus immediately subject to Sarbanes-Oxley. However, 30 percent of the private fast-growth CEOs said they understand the requirements in Sarbanes-Oxley "very well," thus indicating that they expect to comply with Sarbanes-Oxley at some point. A near majority of all fast-growth CEOs (46 percent) is positive in an overall evaluation of Sarbanes-Oxley, including more private companies (58 percent) than public companies (26 percent). The public CEOs are more positive about the impact on company value; 68 percent expect it will have a positive or neutral impact on their ability to create value for shareholders, while among private businesses, 42 percent foresee a positive or neutral impact.

New Trends in Corporate Governance Review

As awareness of the legal necessity for good governance spreads, an increasing number of companies and stakeholders are turning to various compliance vehicles and independent ratings of corporate governance practices. For instance, major financial institutions formed Regulatory DataCorp, Int'l. LLC (RDC), to aggregate public information and to enable companies to comply with Sarbanes-Oxley and other legal requirements. RDC searches publicly available data sources such as government lists, regulators' announcements, and sector-specific media for names of individuals and organizations of interest to corporate financial managers and public accountants. RDC is building a real-time capability to share its data with clients as they consider transactions and prepare SEC and PCAOB filings.

Groups issuing corporate governance ratings include Institutional Shareholder Services (ISS), GovernanceMetrics International (GMI), The Corporate Library (TCL), Moody's Investors Service, and Standard & Poors (S&P). As an example, ISS, which provides research and advice to institutional investors, launched its Corporate Governance Quotient (CGQ) in 2002 as a subscription service. ISS now expects to issue two percentile scores for 9,500 publicly traded companies during the 2003 proxy season. The first score shows how the company's corporate governance practices compare against all other companies in the relevant stock market index. The second score compares each company to its peers in S&P's 23 industry groups.

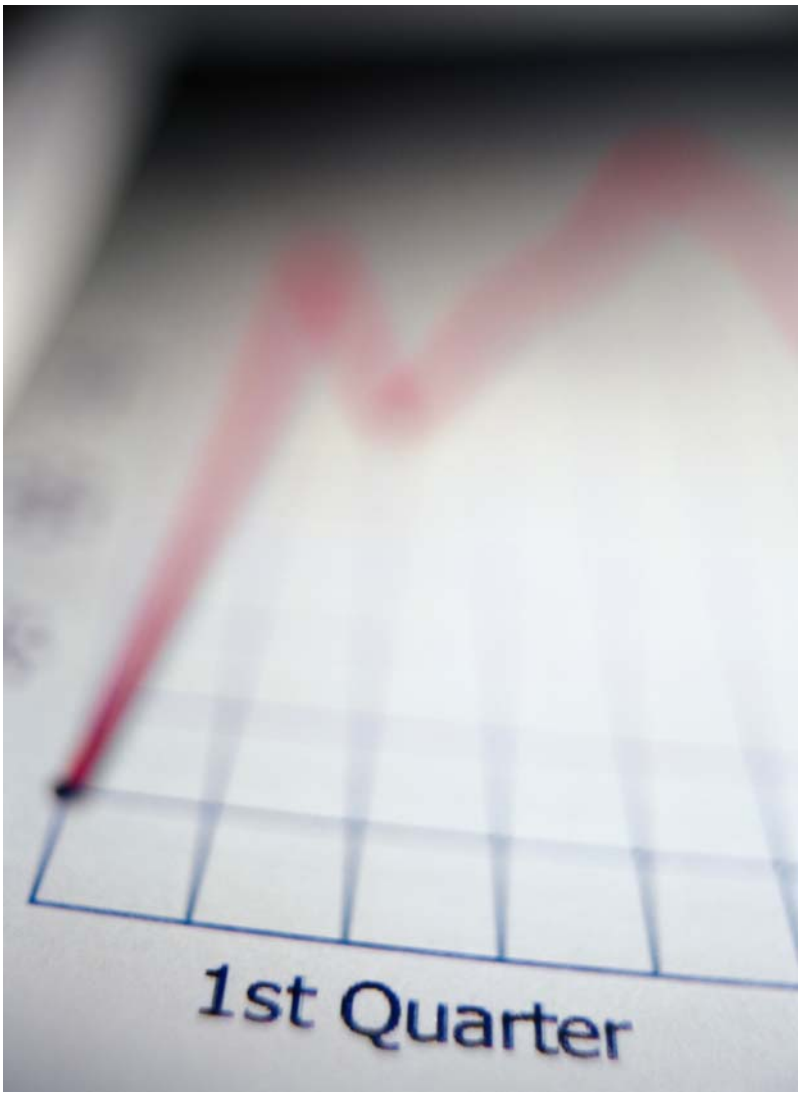
ISS ratings are based on eight core topics, with 61 sub-topics. The core topics are: auditor independence; board structure and composition; anti-takeover charter and bylaw provisions; laws in the company's state of incorporation; executive and director compensation; qualitative factors, including financial performance; directors' and officers' stock ownership; and director education. ISS conducts its own research, but also invites input by the companies through the ISS Web site.

"The voluntary acceptance of best practices, articulated by both investors and companies, has grown substantially over the past year. At many companies, I hear that the boardroom culture clearly has shifted as directors appear much more willing to ask hard questions and probe deeper into what is happening underneath the surface at companies. This cultural evolution should continue for a few years as the full impact of Sarbanes-Oxley creeps into the corporate governance backbones of these companies."

Terry Gallagher, CEO of Corporate Governance Associates, former Vice President-Corporate Governance of Pfizer Inc.

There is some evidence that the ratings correspond to market performance. S&P's October 2002 Transparency and Disclosure Study of its ratings found that "companies with higher transparency and disclosure rankings (on both an annual report-only and composite basis) have lower market risk" and, "Our preliminary empirical findings indicate that companies can lower the cost of equity capital by providing higher transparency and disclosure." A July 2002 survey of 200 institutional investors conducted by McKinsey & Co. found that, "Corporate governance is at the heart of investment decisions. Investors state that they still put corporate governance on par with financial indicators when evaluating investment decisions. An overwhelming majority of investors are prepared to pay a premium for companies exhibiting high governance standards. Premiums averaged 12-14 percent in North America and Western Europe; 20-25 percent in Asia and Latin America; and over 30 percent in Eastern Europe and Africa."

It also appears that Sarbanes-Oxley has resulted in corporate attorneys' advising their clients to take the ratings seriously. According to Matthew S. Brown of the law firm Katten Muchin Zavis Rosenman, "Management or the Board should consider the various criteria described that affect a governance rating positively or negatively, and may want to consider implementing or changing some practices to improve the company's rating."



Another major corporate governance development is the trend among the Delaware state judiciary, considered among the most experienced state judiciary in corporate law in the country.

"From mid-2002 to [February of 2003], the Delaware Supreme Court has issued a series of opinions in cases involving the performance by directors of their fiduciary duties. In every one of these recent cases, the Supreme Court held for the shareholders and against the directors…The recent decisions and comments by noted Delaware jurists indicate that if corporations do not themselves fix these problems, the courts may hold defendants, including directors, lawyers and accountants accountable for corporate greed out of control," said Ira Millstein.

Tough Enforcement by the SEC and Justice Department

As a result of the scandals, the SEC and the Justice Department dramatically increased the number of corporate fraud enforcement cases in 2002, aided by the forging of a new cooperative relationship between the Department of Justice and the SEC. Sarbanes-Oxley increased criminal penalties for securities fraud to up to 25 years in jail and $2 million in fines. Upon the passage of Sarbanes-Oxley, the Director of the SEC's Enforcement Division, Stephen M. Cutler, stated, "Now, rather than cajoling criminal authorities into taking securities cases, we're fending off competing phone calls from prosecutors vying to take the lead on any given case."

On July 9, 2002, President Bush established the Corporate Fraud Task Force, which is chaired by the deputy attorney general and includes the SEC, Treasury Department, and numerous agencies involved in labor, energy, and commodities regulation and enforcement. The efforts so far have led to prosecutions of Enron, WorldCom, Adelphia, Arthur Andersen, and others. As of May 31, 2003, the task force had:

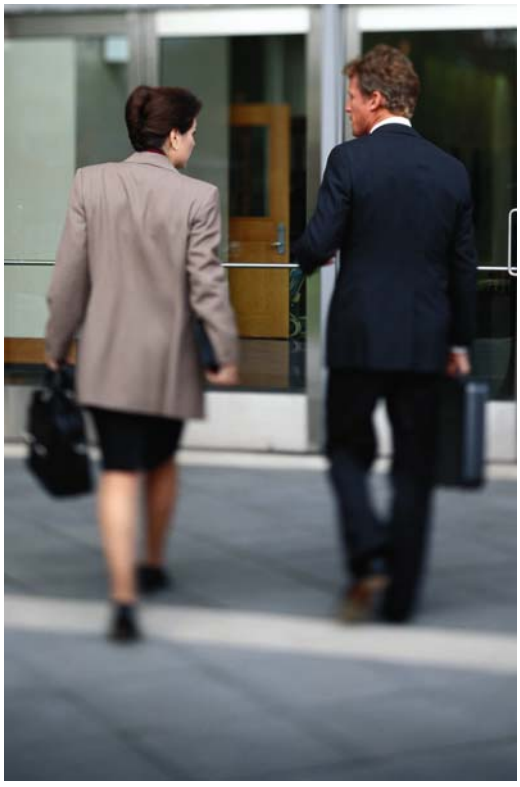
- Obtained over 250 corporate fraud convictions or guilty pleas, including at least 25 former chief executive officers;
- Charged 354 defendants with some type of corporate fraud crime in connection with 169 filed cases;
- Investigated over 320 potential corporate fraud matters, involving more than 500 individuals and companies; and
- Obtained restitution, fines, and forfeitures in excess of $85 million since inception of the task force, in connection with cases involving securities fraud, commodities fraud, investment fraud, and advanced fee schemes, conduct which is often part of corporate wrongdoing.

Members of the Corporate Fraud Task Force are especially enthusiastic about Sarbanes-Oxley's provision requiring CEOs and CFOs to certify their companies' financials, crediting this provision for quickly uncovering sophisticated accounting schemes. Three of the former HealthSouth CFOs entered guilty pleas to violations of Sarbanes-Oxley's certification provision. The charges brought against the CFOs were the first brought under Sarbanes-Oxley.

HealthSouth's senior executives appear to have ended their scheme when confronted with certifying pending SEC filings that they knew were false.

The cooperation was best summed up by SEC Atlanta District Administrator Richard Wessel in a recent press release, "The Commission's action against HealthSouth is another example of the excellent coordination and cooperation that has become the hallmark of efforts by the Commission and the Department of Justice to combat financial fraud."

The investigations and the passage of Sarbanes-Oxley induced tighter oversight by corporate directors, more independence, and the declaration of more restatements of financial results to avoid enforcement actions. Accordingly, the number of SEC actions has drifted lower in the past year, although they remain high when viewed long-term.



- The SEC's enforcement actions increased from 484 in 2001 to 598 in 2002. In 2003, the SEC filed 443 enforcement actions, 137 of which involved financial fraud or reporting.
- The number of temporary restraining orders filed increased 54 percent from 2001 to 2002, followed by a 41 percent decrease from 2002 to 2003.
- There was a 47 percent increase in the number of asset freezes from 2001 to 2002, followed by a 52 percent decrease in 2003.

The SEC's tough oversight has not decreased, as proven by the number of administrative actions:

- The number of officer and director bars sought in 2002 was 147 percent higher than in 2001. This vigorous SEC approach has continued on into 2003, with 124 bars being sought thus far.
- The SEC continues to seek justice from those responsible for any infractions. The number of individuals from whom disgorgement of compensation was sought has increased by 88 percent in the past three years.
- The number of trading suspensions ordered by the SEC was 450 percent greater in 2002 than 2001, and in 2003 to date, the number is currently equal to that of the total number in 2002.

Changing the Auditing Profession

After disclosures that audit firms provided additional client services and built client relationships in ways that compromised the auditors' independence and the integrity of financial statements, the President and Congress changed the structure of the auditing profession and the nature of services provided. At too many public companies, the curtain between independent, objective audit services and consulting services designed to maximize after-tax profits had been frayed or destroyed. The auditors and their consultants were seen as an arm of management, with the latter providing a greater percentage of revenue to the audit firms over time.

Determined to re-establish the independence of the auditing profession and provide more oversight over the quality of audit services, the President and Congress created the Public Company Accounting Oversight Board (PCAOB), a new non-profit corporation overseen by the SEC whose members are appointed by the SEC upon consultation with the Chairman of the Federal Reserve System and the Secretary of the Treasury. The PCAOB has the following authorities:

- Setting auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers;
- Overseeing the audit of public companies that are subject to the securities laws;
- Conducting inspections of registered public accounting firms;
- Conducting investigations and disciplinary proceedings; and
- Imposing appropriate sanctions on registered public accounting firms, and referring cases to the SEC for investigation or further referral to other enforcement bodies.

Sarbanes-Oxley limited the services that audit firms can offer to clients, changed the nature of client relationships, and mandated the maintenance of a trail of audit documentation for PCAOB examinations. Sarbanes-Oxley statutorily prohibits auditors from offering certain non-audit services to audit clients, including the types of consulting services at issue in many of the major corporate scandals. Certain non-audit services are allowed only upon approval by the audit committee. The lead audit partner, and the partner who reviews the lead partner's work, must change every five years. An accounting firm cannot provide audit services to a public company if one of the company's top officials (the CEO, Controller, CFO, Chief Accounting Officer, so on) was employed by the firm and worked on the company's audit during the previous year. Sarbanes-Oxley mandates audit firms to keep audit work papers for at least five years, with penalties of up to 10 years in jail for violations.

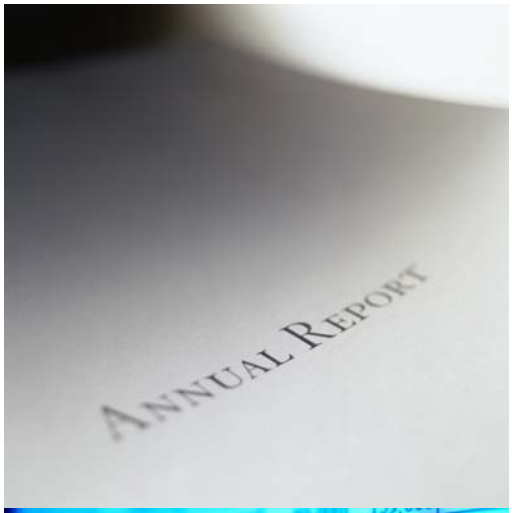
PCAOB

Public Company Accounting Oversight Board

The Public Company Accounting Oversight Board is a private, non-profit corporation, created by the Sarbanes-Oxley Act of 2002. Its mission is to protect investors in U.S. securities markets and to further the public interest by ensuring that public company financial statements are audited according to the highest standards of quality, independence, and ethics.

On July 16, 2003, the Board announced that its registration rules for public accounting firms became effective with the approval of the SEC. "This is a seminal event for the PCAOB," said Board Chairman William J. McDonough. "Registration is the underpinning of the Board's duties to oversee and inspect public accounting firms, as well as the Board's duty to enforce the auditing standards that will help restore public confidence in financial reporting." Under Sarbanes-Oxley and the PCAOB's rules, U.S. public accounting firms must be registered by Oct. 22, 2003, to continue preparing or issuing audit reports on U.S. public companies or to play a substantial role in such audits.

On July 17, the PCAOB launched its registration system for public accounting firms and set the application fee structure. Under Sarbanes-Oxley, the PCAOB is to "assess and collect a registration fee from each public accounting firm, in amounts that are sufficient to cover the cost of processing and reviewing applications." With this mandate, it devised a fee schedule based on the number of clients for which an accounting firm conducts audits in the preceding fiscal year. The tiered system is based on the costs to review and process a large audit firm's application compared to a small audit practice. The PCAOB is also discussing the program for inspecting audit firms, as well as for the investigation and disciplinary program.



The PCAOB is also rapidly adopting the standards as required under Sarbanes-Oxley. In April 2003, it announced the adoption of certain interim auditing, attestation, quality control, ethics, and independence standards to be used by registered public accounting firms in the preparation and issuance of audit reports. In June, it adopted a rule requiring registered accounting firms to comply with the auditing and related standards previously adopted. On July 28, it will propose rules governing investigations of registered public accounting firms, hearing procedures and sanctions. On that date, the PCAOB will also consider rules for regular inspections of registered public accounting firms on a regular basis and annual inspections for the largest firms, and consider proposing a rule governing the process by which a firm may seek to withdraw its registration.

The PCAOB has also exercised its authority to adopt bylaws, an ethics code, and a budget that supports its mission and decision-making process. The bylaws were adopted in January 2003 and amended in April 2003, and an ethics code was adopted in June. In April 2003, the Board approved a budget for the 2003 fiscal year and is aggressively recruiting qualified personnel to fill staff positions. These matters have been submitted to the SEC for approval.

A Level Playing Field for International Companies and Audit Firms

Many international firms and foreign governments sought exemptions from the legislation, but in the end, no accommodations were made for foreign entities in the bill. Prior to final SEC rulemaking, the European Union (EU) repeatedly voiced its concerns with the legislation, claiming that it conflicted with many European approaches to corporate governance and would be duplicative for European firms that are already required to comply with their home-country regulators. Sarbanes-Oxley and the SEC regulations, however, do not exempt foreign auditors from registration with the PCAOB.

Sarbanes-Oxley specifically requires foreign accounting firms to register with and to make their audit books available to the PCAOB. Additionally, domestic companies that rely on the services of foreign auditing firms must supply those documents to the SEC and reach agreements with its auditors that such production is a condition of their reliance on the auditor opinions.

The most strenuous objections to these provisions have come from the highest levels of the EU, with the EU Internal Markets Commissioner stating that empowering the SEC to oversee European auditing is unjustified. European auditors are regulated in their home countries, and EU officials contend that local regulations should be sufficient. However, the EU has yet to establish a single standard of registration for all auditors across its borders.

In April 2003, the PCAOB met the mandate of Sarbanes-Oxley to protect U.S. investors by proposing that foreign audit firms with significant activity in the U.S. and impact on the domestic markets register with the PCAOB. The PCAOB granted some flexibility by permitting foreign auditors an additional 180 days after U.S. auditors to register (until April 2004), and allowing them to request that proprietary or business information be kept confidential. Additionally, the PCAOB agreed to permit applicants making claims that the disclosure of particular information would violate laws outside the U.S. to withhold this information if they file claims with the PCAOB stating the relevant country law, a legal opinion interpreting the law, and documentation of the efforts made by the auditor to obtain consents and waivers. The PCAOB stated that it will work with foreign regulators to reduce the administrative burden and provide for coordination for areas "where there is common programmatic interest, such as annual reporting, inspection, and discipline." The SEC ratified the PCAOB's registration rules on July 16.

In May 2003, the European Commission announced its action plan for the improvement of corporate governance and audit services throughout the European Union. The plan is designed to help raise EU governance norms to meet new international expectations. EU officials continue to assert that the SEC and the PCAOB should accept the plan in lieu of the registration required under Sarbanes-Oxley. As described by the EU's legal advisors at Weil, Gotshal & Manges, some of the initiatives to be implemented soon include the following:

Disclosure Requirements The plan requires the disclosure of individual director compensation, an annual corporate governance statement for listed companies, and information about group and affiliate structures and relations. The liability of board members for key non-financial statements would also be confirmed.

Independent Directors The plan seeks to strengthen the independence and role of non-executive and supervisory directors by requiring enhanced disclosure of conflicts of interest and the setting of minimum standards of independence. Executive compensation decisions and audit supervision would be the exclusive responsibility of non-executive, preferably independent, directors.

Coordination Among Member States The EU would create a European Corporate Governance Forum to coordinate corporate governance efforts of member states.

The plan also foresees studies and long-term action on other topics such as board structure, director responsibility for insider trading violations, and company structures.

The plan also proposes a number of initiatives with respect to European auditors, including:

- Converging of EU auditing standards with U.S. standards;
- Coordinating national auditor oversight systems into a pan-European board;
- Defining auditor independence, in line with earlier EU recommendations to restrict the provision of non-audit services; and
- Considering the establishment of a pan-European auditor ethics.

Attorneys: Strengthening the Lines of Defense

The President and Congress also found that corporate attorneys and research analysts did not always fulfill their responsibilities to protect the public from the misdeeds of management. For instance, corporate attorneys at Enron did not object, in any material way, to the proliferation of the special-purpose entities concocted by the company's financial officials to avoid recognition of billions of dollars of debt. Moreover, Wall Street research analysts, who supposedly engaged in independent and objective analysis and in whom millions of investors placed their trust, developed close personal ties to company management and influenced, or were influenced by, investment banking officials within the same firm.

Attorneys' Duties to the Issuer, Not Management

The lack of due diligence and independence led Congress to set new requirements in Sarbanes-Oxley for attorneys who represent public companies before the SEC, marking the first federal regulation of securities attorneys. The SEC regulations, which take effect on August 5, expressly state that the attorney "owes his or her professional and ethical duties to the issuer as an organization," and not to individual managers, directors, or any such group. Sarbanes-Oxley and the SEC regulations require covered attorneys (reporting attorneys) who become aware of credible evidence of a material violation of securities law to report it to the company's chief counsel and CEO. The chief counsel must thereafter inquire into the alleged violation and respond to the reporting attorney. A reporting attorney who is not satisfied with the response must then report the evidence to the audit committee, another committee of the board of directors, or the entire board.

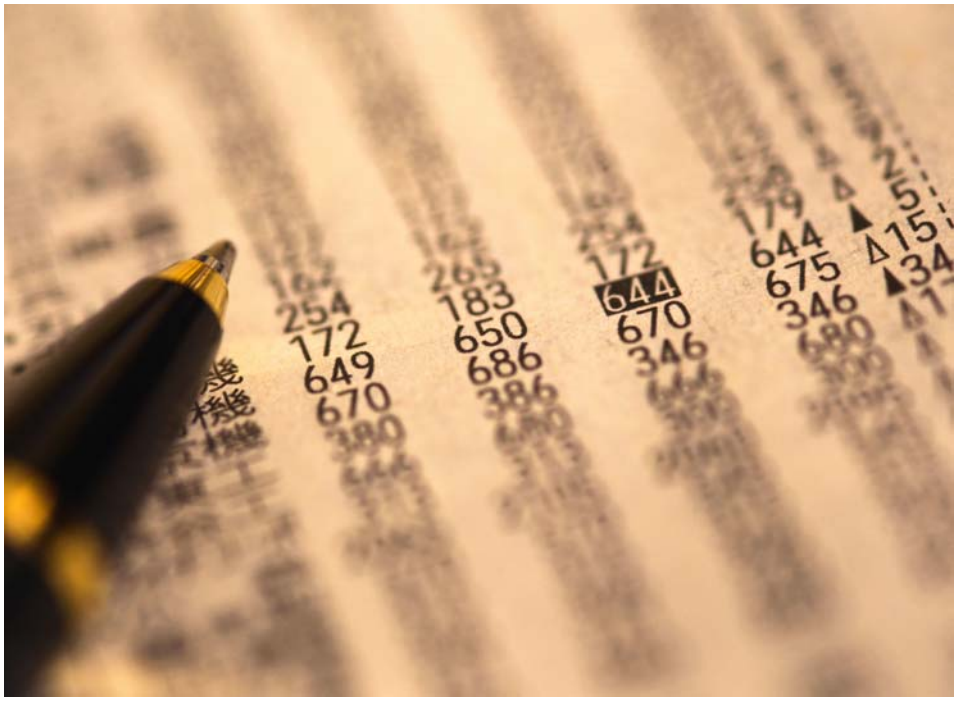
An attorney who complies in good faith with the rules will not be subject to disciplinary action or to civil liability. The SEC considered, but did not issue, a requirement that reporting attorneys must withdraw from representation and notify the SEC of the evidence if the attorney did not receive a satisfactory response.

The Legal Profession Responds

The American Bar Association established a task force on corporate responsibility in March 2002, in part, to "examine the framework of laws and regulations and ethical principles governing the roles of lawyers." In May, the task force recommended amending the model rules of professional conduct with respect to the lawyer's duty upon learning of a potential violation of law. The ABA will consider the recommendations at its annual meeting in August.

Analysts: Improving the Quality of Research

The Committee initiated oversight of analysts' conflicts of interest in 2001, leading to the first rulemaking against such conflicts by the SEC and securities industry. In May 2002, the SEC approved rules adopted by the NASD and NYSE to reduce securities analyst conflicts of interest. In connection with its investigation of the WorldCom accounting fraud, the Committee reviewed evidence of improper ties between Jack Grubman, influential stock analyst, and CEO Bernie Ebbers and CFO Scott Sullivan of WorldCom, and found a lack of independence. Grubman attended company board meetings, exclusive of other analysts.



The lack of analysts' independence and the distribution of biased research reports were a disservice to investors. In April 2003, after extensive investigations by the SEC, the New York Attorney General's Office, the NASD, the NYSE, and the North American Securities Administrators Association, the five bodies announced the settlement of charges of undue influence of investment banking interests on securities research at brokerage firms.

Sarbanes-Oxley directs the SEC, or at the SEC's direction the NASD or a national securities exchange, to adopt rules relating to analyst conflicts of interest by July 30. Sarbanes-Oxley establishes minimum criteria for these rules:

- Restrict pre-publication clearance of research reports by investment bankers;
- Limit the supervision and compensatory evaluation of analysts by bankers;
- Prohibit bankers from retaliating, directly or indirectly, against an analyst for an unfavorable research report;
- Define quiet period during which analysts are prohibited from issuing research;
- Establish structural safeguards to insulate analysts from investment banker pressure; and
- Require analysts – in public appearances and each research report – to disclose any conflicts.

Self-regulatory organization rules, adopted by the SEC in May 2002, already comply with many of Sarbanes-Oxley's requirements. Earlier this year, the SEC adopted Regulation AC, which requires analysts to certify that their recommendations reflect their actual views.

No Discernible Trend from Public to Private

Some commentators have expressed concern that Sarbanes-Oxley imposes costs that may drive public companies to opt out of the SEC disclosure regime and become privately held. Anecdotally, a handful of companies have reported that the costs associated with Sarbanes-Oxley's requirements of certification of financial statements, implementation of independent boards and audit committees, and accelerated company disclosures have forced them to go private. However, based on the number of pertinent SEC filings, there is little firm evidence that Sarbanes-Oxley is actually creating such a trend.

Corporations with low market capitalization, thin trading volume, low multiples, and limited analyst coverage now have ample reasons to consider going private. Many companies that rode the wave of initial public offerings have found that the public markets are no longer providing inexpensive capital and abundant liquidity. For many reasons, the costs of being a public company have increased, while the benefits have decreased.

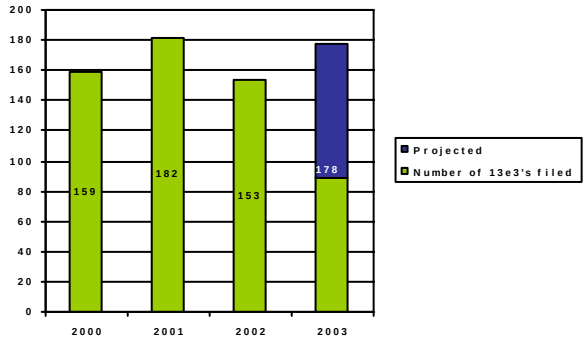
SEC Rule 13E-3 requires filing a schedule with the SEC to initiate the process of removing a company from a national securities exchange or an inter-dealer quotation system. A company becomes privately held when it reduces the number of its shareholders to fewer than 300 and is no longer required to file reports with the SEC. A number of transactions can result in a company opting out of the capital markets, including:

- Another company or individual makes a tender offer to buy all or most of the company's publicly held shares;
- The company merges with or sells the company's assets to another company; or
- The company declares a reverse stock split that not only reduces the number of shares but also reduces the number of shareholders.

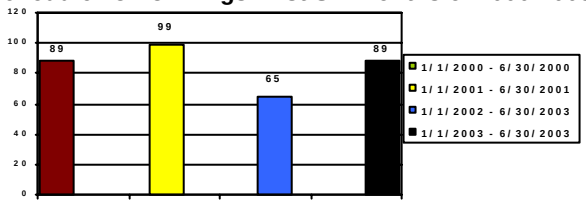
Based on the number of filed Schedule 13E-3s, there is no trend toward going private, as these graphs show. While the filings during the first six months of 2003 increased from the first six months of 2002, there were fewer filings than during the first six months of 2001, and equal to the filings during the first six months of 2000. If this year's trend continues, the level of filings for all of 2003 will be higher than 2002, but still not exceeding that of 2001. The trend would have to continue into 2004, with more analysis of the reasons for the filings, before Sarbanes-Oxley could be held as a reason.

A review by Thomson Financial of companies that completed transactions after filing the Schedule 13E-3 shows that only 83 went private in 2002, 63 percent more than in 2001 and slightly fewer than the 89 companies that went private in 2000.

Schedule 13E-3 Annual Filings 2000 through 2003 (projected)



Schedule 13E-3 Filings First Six Months of 2000-2003



House Committee on Financial Services Legislative Record

The House Financial Services Committee held the following meetings on the issues raised by large bankruptcies such as Enron and WorldCom. Among the subjects investigated were the impact on capital markets, the reasons behind overstated earnings, the mishandling of the employee 401(k) plans, potential securities fraud, and accounting irregularities.

June 14, 2001 and July 31, 2001
Analyzing the Analysts
Capital Markets Subcommittee

December 12, 2001
The Enron Collapse: Impact on Investors and Financial Markets
Capital Markets & Oversight and Investigation Subcommittees

February 4-5, 2002
The Enron Collapse: Implications to Investors and the Capital Markets
Capital Markets Subcommittee

March 13, 2002, March 20, 2002 and April 9, 2002
Hearing on H.R. 3763: The Corporate and Auditing Accountability, Responsibility and Transparency Act
Full Committee

March 21, 2002
The Effects of the Global Crossing Bankruptcy on Investors, Markets and Employees
Oversight and Investigations Subcommittee

April 11, 2002 and April 16, 2002
Markup and Passage of H.R. 3763: The Corporate and Auditing Accountability, Responsibility and Transparency Act
Approved by Full Committee, 49-12

April 24, 2002
Passage of H.R. 3763: The Corporate and Auditing Accountability, Responsibility and Transparency Act
Approved by House of Representatives, 334-90

May 1, 2002 and May 14, 2002
Corporate Accounting Practices: Is There a Credibility GAAP?
Capital Markets Subcommittee

July 8, 2002
Wrong Numbers: The Accounting Problems at WorldCom
Full Committee

July 25, 2002
Passage of Conference Report, H.R. 3763: The Corporate and Auditing Accountability, Responsibility and Transparency Act
Approved by House of Representatives, 423-3

July 30, 2002
Enactment of Sarbanes-Oxley Act, Public Law 107-204
White House

H. R. 3763

One Hundred Seventh Congress of the United States of America

AT THE SECOND SESSION

Begun and held at the City of Washington on Wednesday, the twenty-third day of January, two thousand and two

An Act

To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; TABLE OF CONTENTS.

(a) SHORT TITLE.—This Act may be cited as the "Sarbanes-Oxley Act of 2002".

(b) TABLE OF CONTENTS.—The table of contents for this Act is as follows: