An AEI-Brookings Joint Center for Regulatory Studies
Roundtable Discussion

THE FUTURE OF CORPORATE GOVERNANCE
Book Release for "Following the Money"

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THIS IS AN UNCORRECTED TRANSCRIPT.

MR. ROBERT HAHN: Good afternoon ladies and gentlemen. My name is Bob Hahn and together with my co-conspirators three feet to my right — Bob Litan and I co-direct something called the AEI-Brookings Joint Center, which is a joint venture that started about five years ago to study regulatory and related issues.

Before we get started I wanted to mention a couple of things. First of all, most of you will have a blue folder and in it you'll see a blue card. If you fill out that blue card you'll be kept abreast of the latest and greatest events that the Joint Center puts on and we'll let you know when we have articles put up on our web site. We also put all of our publications up on our web site and that includes potential best sellers to compete with Dan Yergin's like Bob's book that he's written with three co-authors that we're going to be discussing today called *Following the Money*.

If you actually want to get a hard copy of *Following the Money* and sit through the entire conference today I'm told you can get a 20 percent discount. Just a one-time discount by walking outside and going into the bookstore and saying that you know Bob Litan.

We have several other books and events in the works. Two other Joint Center Fellows, Cliff Winston and Bob Crandall, are about to release a paper that I think is going to turn conventional antitrust wisdom on its head. And Bob Litan, the prolific one over there, is about to release another monograph on the Fair Credit Reporting Act that promises to be even more exciting bedtime reading, and I'm not going to tell you the punch line. You'll have to read it.

The topic of today's discussion is "The Future of Corporate Governance", still a timely topic. Following the collapse of places like Enron and WorldCom there was a flurry of activity. Congress passed what they thought were comprehensive reforms, the New York Stock Exchange and NASDAQ made fundamental changes to their listing requirements.

Witnessing troubles faced by Arthur Andersen, members of our panel have written about this to some extent, accounting firms tightened their auditing practices. Many changes that were made relate to information quality and availability. Individual investors in markets generally need reliable information in order to price equities. I, for example, use that information. See how much I've lost in the last three months in my retirement account?

When that information is found to be unreliable, people lose confidence in equities and stock prices decline. If the loss in confidence is widespread, then the overall market may decline.

Are the reforms that we've had to date enough to ensure that we're getting the reliable information that we need that will restore confidence in the market? And what additional

measures, if any, are called for at this juncture?

Our roundtable today promises to address these questions and perhaps others.

Following our presentations, and Dan will go into this in more detail, we'll have questions and comments from the audience.

It's my pleasure now to turn things over to Dan Yergin who will be the moderator for today. Dan literally requires no introduction so I'll try to keep it brief.

As most of you know he's the winner of the Pulitzer Prize. He's also Chairman and Co-Founder of Cambridge Energy Research Associates, and I should say last but not least a trustee of that other institution for which the Joint Center shares its name, Brookings.

His best-selling book on *The Commanding Heights* has been translated into 13 languages at last count and was made into a six-hour documentary which was aired on PBS, but for those of you who missed it you'll have a chance to see it in May 2003.

My favorite quote about his book came from the *Washington Post*. In reviewing his book, the only thing bad the reviewer could find to say about the book was that Dan and his co-author wrote in short, declarative sentences. Now for an economist that would be a benefit and not a cost, but maybe for others that's a cost.

VOICE: I was the reviewer.

MR. HAHN: Oh, I see. I didn't know you were the reviewer. [Laughter]

However, talking about the documentary, you weren't the reviewer on the documentary were you?

VOICE: No, no. Just the book.

MR. HAHN: The *Washington Post* called it "stunningly ambitious, brilliantly successful. No more important program for making sense of our life and times has been seen on the air in at least a decade and just possibly a good deal longer."

Ladies and gentlemen, I now leave you in the capable hands of Dan Yergin.

[Laughter]

MR. DANIEL YERGIN: I'll try to do what I have to do here as Chairman in short declarative sentences. Thank you very much, Bob.

One other thing to say about *The Commanding Heights* is of course Paul Volcker is one of the very distinguished presences in that series.

I do want to add my welcome to all of you to this AEI-Brookings Joint Center for Regulatory Studies seminar on corporate government. We have a really excellent session and it's an honor to be part of such a distinguished panel that we have today.

The occasion, of course, is the publication of *Following the Money: The Enron Failure and the State of Corporate Disclosure* by Bob Litan and three of his accounting expert colleagues, and it raises absolutely essential questions for the workings of a market economy about corporate governance and the role of disclosure.

Of course this all takes place within a larger framework which may well be the biggest wave of reform and regulation of corporate governance since the Great Depression. I think we've seen quite a responsiveness of the system, the recognition of the absolute essentuality of rebuilding foundations of confidence. And some might say that within the last 15 months we've seen within companies an almost universal refocus on getting corporate governance right in current terms, in terms of the role of directors and boards, how things are done, procedures.

With so much happening there's clearly a critical need for assessment and a highly appropriate subject for the Joint Center to take up as it does today in its work, and will continue to do so. The focus on accounting, of course, is part of the issues of larger governance.

I was thinking we might have had another title to the session today, "The Momentous Consequences of the Failure of Accounting Footnotes" because a lot is really about disclosure and the confidence that goes with them.

But I think today we'll talk about accounting and then we'll go beyond it to broader issues, and there are some big questions that hover over this entire discussion which is, a lot has been done. Is it enough? Is it too much? Is it the right thing? What about the law of unintended consequences? How are boards going to operate in the future? What really will be the role of directors as we were talking at lunch? Five years from now how will that be assessed? What has been learned so far, and looking out, what will be learned? I think we are, by bringing together this panel we have the opportunity to have that discussion and indeed see what's been learned and get some sense of what we may learn in the future.

So the way we'll proceed today is first we'll lead off with Robert Litan who is the Vice President and Director of Economic Studies here at Brookings who is also with Bob Hahn the co-director of the Joint Center. He will be summarizing the key points that come from this new study *Following the Money*.

After that we have three really extraordinary and excellent panelists and very thoughtful leaders on these questions. We'll be able to, as I say, widen the discussion from the book to the current state of corporate governance.

This panel and these individuals are so well known that I'll only briefly tell you who they are. Of course the Honorable Paul Volcker, the former Chairman of the Federal Reserve and currently Chairman of the International Accounting Standards Board, and I think we all recognize a very wise man who gets to the heart of things.

Laura Unger, the former member and acting chair of the Securities and Exchange Commission.

And Bob Glauber, the Chairman and CEO of the National Association of Securities Dealers and a former Under Secretary of the Treasury.

So we'll hear for a few minutes from Bob and then we will turn to our panelists and then we'll open it up for discussion. Bob Litan?

MR. ROBERT E. LITAN: Thank you very much.

First I want to thank all of you for showing up and saying whatever you're going to say about the book. I know some of you are going to criticize, but that's what you're here for. It's part of the game.

I'm now about to do something dangerous which is to give you a Cliff Note version of the book which will immediately destroy all sales, but what the hell. Let me go ahead and just give you a few brief points.

This book did not start out about Enron. I have three co-authors who are accounting professors from different places around the world and we started with the thought that we're going to address the long-run issues that confront corporate disclosure, namely the increased importance of intangible assets in corporations; the role of the Internet and how it can be used to facilitate corporate disclosure; and finally, should we have one world accounting standard or should we have a competition of standards? These were the big picture issues at least on our radar screen about 18 months ago. Then Enron happened, and then MCI,

and Adelphia, Tyco, blah, blah, blah. Before you knew it we said to ourselves we've got to change this book. So as a result, 60 or 70 percent of this book is about the current accounting scandals, or the recent scandals, what was done, whether it was enough of the right thing, and so forth. So let me start with that and then I'll conclude with the long-run issues that we started when we initiated the project.

The first big question, what went wrong? Grand summary statement: despite what you read in the media, or at least initial reports in the media that it was U.S. accounting standards that were somehow at fault that contributed to all these wave of earnings restatements, our conclusion in the book is that the standards basically are fine, U.S. GAAP is okay, but that we had a massive failure in enforcement. By enforcement I mean all the gatekeeping institutions that were set up to ensure that the numbers were honest. Whether it be auditors, the regulators, boards of directors, analysts, rating agencies, you name it, we had a massive collective failure in the enforcement mechanism, with one exception.

There is one standard that we did not like in U.S. GAAP that we think contributed to the atmosphere of earnings misstatements and it will not be a surprise to you. That is the failure to expense stock options at the time they're granted.

It is our belief, although without a lot of hard proof, nonetheless our belief that stock options got out of hand. There was an atmosphere certainly among the unscrupulous that with a lot of options in hand if you could cook the books, sell your stock before everybody else, get out and make a lot of money, that was to your advantage and that's what happened in some of these egregious cases. So we are very much for the expensing of stock options.

But with the exception of that, the violations of accounting standards that you saw in virtually all of these cases were either things you could have learned in Accounting 101 or maybe 102. Enron was a little more complicated case because it involved off-balancing entities, but even there there was evidence that Enron lied to its own auditors; that Enron did not disclose things it was supposed to disclose; and again, we do not fault U.S. GAAP necessarily as the major villain in Enron. That's the first point.

The second point, as I said, is stock options. Stock options leads to the second major focus of the book and that is what is wrong, if anything, with the setting of accounting standards? While we're not critical of the standards, the particular ones that were at issue in all these cases, nonetheless we're uncomfortable with the way standards are set. That is through FASB which is supposed to be independent but in fact is very much subject to political forces and we saw that in the case of stock options, but also to a lesser degree in oil and gas accounting. When the crunch really comes, FASB will end up getting whipsawed by Congress. Therefore, we are very much in favor of market-driven standards. Not standards that are set by political institutions. That will come up in our recommendation that I'll give you in a moment.

Number three. What about the reform? I won't go into all the details. Here we sort of have it on the one or the other hand view.

On the one hand we like some of the reforms. We think the independence requirements will probably be good, independence of boards of directors, although there's an uncertainty about the long-run effect of that as Dan implied in the introduction. We're very much in favor of audit committees doing the hiring and firing of accountants. And we are very much in favor of taking away CEO compensation when earnings are restated. So those are good things.

Now from a more controversial point of view we are critical of a number of other reforms. Number one, we're skeptical about all the criminal penalties, the piling on. It's still going to be hard to prove in a lot of these cases that there was knowing criminal intent. While the Justice Department has been successful in getting some guilty pleas, the fact is it may have difficulty getting the big fish and we're uncertain of what the impact of the criminal punishment will be.

Second, we're skeptical about the auditor rotation. Not the rotation of the individual audit partners, but the auditing firms. You've only got four firms. How much is rotation really going to do? And when you run these beauty contests of running only four firms we're really skeptical that you're going to get a lot of improvement from audit rotations.

Third, we're actually skeptical of the whole wave of trying to keep auditors out of non-audit businesses. Now I know this happens to be the consensus view, certainly in Congress and among a lot of financial analysts, but our view is look, if an accounting firm is going to prostitute itself to a client because it fears losing non-audit business, it's going to do the same thing if it's restricted only to auditing because that's its only business. If it's worried about losing business it's going to fall over its face to basically do the same thing. And the only way to protect against that is to vest the decisionmaking about who to hire and fire the accountants in somebody other than management, ergo we are much more optimistic about putting that authority in the audit committee which is outside the hands of management than allowing management to tell the company who the auditor is. So we think that's a key reform, not keeping the accountants out of non-audit businesses.

Finally, we're skeptical about CEO certification and financial statements. First under existing law they're liable for their statements anyhow; and second, they're going to get insurance for it, maybe at high prices, but I'm not sure exactly how effective the certification's going to be although I know again the press has put a lot of emphasis on the fact that CEOs are scared about this.

One final point before I turn to the long-run issues and that is how much have all these

scandals cost the United States economy? We don't have this in the book, although we cite it. We have a policy brief on the web site at *Brookings.edu* called "Cooking the Books" that I did with a couple of other co-authors. We estimate that through the effect on stock prices the corporate accounting scandals cost the U.S. economy in terms of lost GDP about $40 billion a year. $40 billion. Which is basically run off the wealth effect that's based on the set model.

$40 billion, just to give you an order of magnitude, is what the impact on the economy is from roughly a $10 increase in the price of oil which is about what we've had in the last several months. So that gives you an order of magnitude, an estimate, of what the impact in terms of lost output of all these scandals is.

Let me close with a few observations on the long-run challenges that face disclosure. These are the things we started the book with.

First, what about intangibles? Intangibles are important if for no other reason than if you look at the discrepancy between market and book values of companies. Instead of one-to-one, the ratio rose as high as six-to-one in the craziness to even now, now that the stock prices have fallen back you still have a market-to-book ratio of probably four- or five-to-one, and that discrepancy is basically due to intangible assets.

So what should you do? Should companies go out and put values on all their intangible assets? No, we don't suggest that because a lot of intangibles like customer loyalty or employee loyalty and things like that you can't have a market in because there's no objectively verifiable way to put a value on a lot of these intangibles. Nonetheless, we encourage the SEC to begin a process of experimentation with a whole range of non-financial indicators that would help investors better appreciate and understand the sources of the intangible value, and we have a chart and some illustrations about those in the book.

A second point, what about the Internet? Two sub-points here. Number one, this is controversial, but in a world of the Internet ultimately information could be made available instantaneously. Financial companies mark their books-to-market almost every night, in fact every night. In theory, in the long run, maybe even the shorter run, why can't companies do the same? A lot of companies keep track of their internal books as it is on a much more frequent basis than quarterly, perhaps monthly or even weekly. Why not eventually think of a world where we have weekly or monthly reporting of financial data?

People will go nuts. They say my God, our stuff is unaudited, we can't trust it. The fact is the quarterly stuff is unaudited as it is now. But having more information out there I think actually would have paradoxically a beneficial effect. By having information so frequently published I think people and the analyst community would lose interest in the quarterly earnings because no one would be in the business of projecting weekly or monthly numbers. They'd

forget about the quarters. And a lot of this obsession about quarterly earning I think would melt away if we had more frequent disclosure.

The second point about the Internet is that there is going to be a movement led by the development of something called XBRL which is a computer language for manipulating all kinds of financial information. And what XBRL will do, and it's discussed in more detail in the book, I think is lower the barriers to entry into the analyst industry, and for heaven's sake we need more entry into that business from outside the investment banking community.

The final point is what about accounting standards? Should we have one body of accounting standards, namely the international standards or some blend between the U.S. and the international standards or something else?

The current wave in the world led by our esteemed colleague right here to the right, Mr. Volcker, along with Bob Hertz who's head of the FASB, is to try to meld or try to harmonize the two sets of standards. We're skeptical about this. One, because the international standards and the U.S. standards share a very different philosophy so we think this is going to be very hard to do. But even if it's accomplished, we think there is a significant risk of fragmentation of the world standard after you get initial agreement. Fragmentation because you're constantly getting new developments, new financial instruments over time, and there can be impatience with one standard-setting trying to respond to all of these and the impatience will be reflected in national accounting bodies, probably going off and issuing clarifications of the existing international standards. And once those clarifications are issued you've got a breakdown of the international standards. So we do not think one set of standards is stable.

We think the better approach is to have a competition in standards between the U.S. system and the international system, and let American and other companies choose which standard they want to report under.

The one major objection to competition is what about investor confusion? Will they be able to compare apples and oranges? Our answer to this is that companies who access the global capital market will have strong market-based incentives for releasing enough information to the analyst community so that the third-party analysts will be able to reconcile the reports based on U.S. GAAP as well as the reports based on international standards. So for people that want to make the comparison there will be market services that will provide those reconciliations.

That's a snapshot. I know there's a lot of food for thought, and I very much look forward to our panelists' response about this and the broader issues. Thank you very much.

[Applause]

MR. YERGIN: Let me turn now to Paul Volcker who folks know will have views on accounting standards and perhaps will also share your view of how well or not well the system has done in terms of corporate governance over the last 15 months.

MR. PAUL VOLCKER: I feel somewhat handicapped by the fact that I just had to make a talk at another organization where I had to confess I didn't have a Ph.D. I have to confess now I haven't taken Accounting 102. [Laughter] Anyway, I have some opinions.

I do think that all our views are colored by some kind of visceral reactions almost to what has been going on. Do we believe the bad apple theory or do we believe this is rather a pervasive problem? I am afraid I think it's bad apples in its most egregious examples, but I'm afraid even the bad apples are a reflection of a more pervasive and systemic problem so I'm very much on that side.

The differences of view on that matter lead to different concerns. There's concern on one side about overkill, whether Sarbanes actually is overkill or whether other movements are overkill and unintended consequences and all that stuff which I hear about. The concern on the other side is no, just hunker down, let it blow over, nothing much is wrong, and we won't get any reform, business as usual. My concern is more on the latter side than on the former side, just so you know where I am leaning.

I read most of this book anyway in galley, and I'm sure it hasn't been changed. I do have a somewhat different perspective.

I do, first of all, think there are problems with the accounting standards. You mentioned some of them in the book which I think are very real. Just look at the real problems in accounting standards. One is this fair value business which I think has got more problems even than you mention in the book. You have made a big thing about it in the book, but I tell you there is a very strong feeling in the accounting community that that's the way to go. It seems to have some logic to it, some coherent pattern that will solve all these problems. I'm not supposed to comment on the substance of accounting from my position of appointing the International Accounting Board, but I'll tell you, it's a bit of a problem. It's a big problem right now politically because of a proposal that's out for comment now internationally that meets fierce resistance that touches upon this area.

You mentioned intangibles. A big problem, we fuss around with second and third order accounting problems, when you wake up one day and find that Company X has reduced its intangibles by $45 million what's the rest of the balance sheet care? What do you do about intangibles?

That was a political issue in the United States at FASB. I don't think the international people have faced up to it yet. That's another very difficult conceptual issue that I think is far from a solution. I think the off-balance sheet stuff is a problem.

I have a rather kind of classic view about stock options. I think the logic is you expense them. That's easy to say. How you expense them is another question. There's so much controversy about how to expense it it may conceivably even now kill the credibility of expensing them.

I've got a much simpler solution. I state this carefully. I think it ought to be preferred practice that large, publicly held companies with diversified ownership should not use fixed price stock options period. They are so capricious in result, so distorting in incentive, that I see no excuse for a big, publicly owned company with diversified ownership to use them as a tool of executive compensation. I think it is the widespread use of the stock options that has given rise to this egregious increase in executive pay. Nobody would have deliberately set out to say some of these people should have gotten $100 million the year their company went bankrupt, but that's what happened the year before maybe and that's what happens with stock options. It obviously affects some incentives. So it is a big problem as an accounting standard, there's no question about it, but I'll tell you as a matter of corporate governance I think we should, for those companies, wave bye-bye to them.

I do think there is a big problem, and here I do disagree with you, with conflicts of interest in the accounting thing. I would recommend that you read a book which is coming out, I guess her name is Barbara Toffler, who had the assignment of teaching ethics to clients of Arthur Andersen. Corporate ethics. She had increasing difficulty teaching ethics to the clients of Arthur Andersen when Arthur Andersen itself was not anywhere close to the standards she was teaching to the clients. But you cannot read that book without getting some sense of the atmosphere in that company which I sensed in a relatively brief outside look that it was just a hotbed of conflicts of interest where the most tightly controlled, conservative, disciplined of accounting firms in the space of 15 years had decided they are going to become a financial services consultant, and the drive of every partner in that firm was to get revenues. That's how they were paid, that's what their responsibility was, and I think it is simply inconsistent with the disciplined auditing ethic of the firm.

We have this peculiar thing, you wonder whether you're going forward or backwards sometimes. I thought the most egregious outright conflict with other services is what I euphemistically call aggressive tax planning. Because here you had a case where the auditor had to audit a firm in which another partner of the auditing firm is giving particular advice on how to deal with their taxes which may conflict with a conservative auditor judgment as to how you account for the taxes on the income statement or the balance sheet. Just a straight-out conflict.

But it's also a kind of mental conflict. How on the one hand can you be advising a company how to get around the law when kind of at the left side of your brain your responsibility is to tell the company how to stay within the law or within the accounting standard. It just does not mix.

I had great hopes — This was left out of the Sarbanes bill for reasons that are obscure or have not been explained to me. It's possible because they're got a catch-all provision, and much to my surprise the SEC decided they would deal with this off the bat. One day we wise men on this conference board committee recommended that this was a particular conflict of interest that could be dealt with and I expounded that to the press one day. The next day I picked up the paper and found the SEC had backed off of their proposal to deal with it, and two days later we had this great to-do with Sprint where tax advice from the auditor cost the Chief Executive and the Chairman their jobs, may cost them their fortunes, and gravely jeopardizes the company. A straight-out conflict, for the company they were auditing. Extraneous deals. So I do think that's a big problem.

I'd just make one concluding comment in all of this. There is a feeling, certainly widely felt in the international community, that the United States gets in trouble from so-called rules by trying to detail all the application of an accounting standard. I used to, you know, when I began making speeches about this a year ago I would say I am told that the accounting standard for financial instruments is 650 pages long and nobody understands it. In its entirety anyway. I'm told that that is absolutely wrong. It's now 960 pages and nobody understands it.

This attempt to deal with all the complexities of financial markets gets chasing your tail.

If you go to a more general statement of principles, which I suspect we'll end up with a 63-page at least standard on financial instruments or more, it puts a lot more burden on a disciplined, auditing profession around the world to get consistent interpretations. This is nothing that any analyst is going to ferret out. You've got to rely upon the auditors. I don't think you can do that now. I don't think that's been a tradition in the United States.

The tradition in the United States is to say, “not tradition, it's the professional standards.” You issue a statement, this statement is in accordance with Generally Accepted Accounting Principles, period. Which you get a lot of options in many cases and they're very fuzzy.

The American statement does not say what the British statement is, that this is a true and fair representation of the financial position of the company. But that's what you have to do if you're going to have a principle-based standard, I believe, and it puts that kind of burden on the auditors. That takes the kind of reform in the auditing business that I think is incorporated in Sarbanes-Oxley. I think all the efforts at self-regulation, self-oversight, have demonstrably failed. They simply have.

MR. YERGIN: Paul, before we go to Laura, just one question or clarification. At the beginning I think I heard you say that you see there are bad apples but they exist in a larger orchard of pervasive and systemic problems. Did you mean that in terms of accounting or do you mean a larger —

MR. VOLCKER: That's a general comment on the state of corporate governance and discipline and ethical standards. We could go on and on as to why that is. I don't think it's easy to deal with but if you've got a minute, every once in awhile somebody says something that kind of startles you. Maybe it shouldn't. But I was moaning about this with a leading Wall Street figure who at that time I must confess was unemployed which may have colored his response a little bit. But you know, what's going on here? He said to me, what can you expect when every leading business school in the United States for 20 years has been teaching the main thing is, the only thing that counts is your stock price and however you get the stock price is ipso facto the name of the game and they don't exactly tell you to do illegal things but anything short of getting in jail is fair game. That's kind of a persuasive ideology.

So the next day I was in a meeting with some corporate executives, but also I knew a professor from Harvard Business School, so I related this little story thinking I would get a little feedback. The professor from Harvard Business School says you're absolutely right, our ideology has been flawed all this time. [Laughter] I don't know what to do about that but I think there's something to it actually.

MR. YERGIN: Laura?

MS. LAURA UNGER: That's news to me. I went to law school and I thought that was bad. [Laughter] I guess this is a different aspect.

I thank you for being part of this distinguished panel. I only got chapter one. Now I see there is a whole book, so I look forward to reading the rest of the chapters. And I do think from the critic of short, declarative sentences that it's written in short, declarative sentences which I found wonderfully breathtaking. So I highly commend the reading. It's very easy to read.

I did think what I had read raised a number of issues, a lot of which we've touched on and I'm sure Bob will touch on. The role of disclosure, the role of regulation, the role of competition, and the role of industry professionals and how all of these market participants really fit in creating an efficient market.

I think Enron is striking not so much because of Enron itself per se. It was first striking

because in the news was the seventh largest U.S. company announcing that it was restating four years of financial statements, and then later declaring bankruptcy. At the outset that cast doubt on the information, particularly the financial information about Enron but not really the system as a whole, although you had some in Congress looking and conducting hearings to see whether it did reflect or indicate that there was a problem with the system of disclosure or regulation. And there was, of course, a rush by one side of the aisle to legislate the problems.

But really it was the other scandals that followed Enron, the Global Crossing, Arthur Andersen, Adelphia, blah, blah, blah as you put it, that magnified the Enron problem and really made people pause and think again was this a systemic problem.

A lot of conversation was raised as Chairman Volcker said in the context of, as the President referred to, was this a few bad apples or was this systemic, this failure in corporate governance, the failure of the gatekeepers? Would the efficient market sort out the problems or was there the need for Congress and/or the SEC to take decisive action to bring about order in the marketplace?

You definitely saw the efficient market work. Enron stock went from $70 to 70 cents, so the company and its management were punished as a result of the corporate misdeeds or the perceived corporate misdeeds in the short run. Unfortunately, a lot of people who didn't participate in the fraud were also punished in terms of pensions.

What happened though is after eight or nine months of talking about the fact that this was a few bad apples, and more and more bad apples were showing up — I think WorldCom, and you can trace sort of that announcement on June 25th, was the final bad apples that broke the bushel or whatever you want to say. [Laughter] And following that, the President basically insisted to Congress that they put a package of legislation on his desk before the August recess.

I think reference was made to Sarbanes-Oxley as being the most sweeping legislation since the New Deal, and that's absolutely correct. Consider the timeframe in which this legislation was drafted, negotiated, and put on the President's desk — a very short time period.

Having spent time on Capitol Hill and having spent time as a regulator I know for a fact that regulation and legislation is always behind the FIR. I'll return to that notion, but four weeks or six weeks or whatever it was is a very short time to give great thought to the broader issues, the issues of what I said at the beginning which was disclosure, regulation, competition, and industry professionals.

What the bill attempts to do is to create accountability, independence, transparency, all in a series of measures that may appear punitive. But how do you promote independence and accountability and transparency through a body of law and through regulation? You make it

very punitive if you fail to be independent, accountable, transparent in your responsibilities.

So you talked about the fact that the CEO specification was onerous. There was a tremendous increase in jail time and penalties and everything else as a way to bring about discipline in the system.

What I read that Chairman Hicks wanted to do was to stand back and look at the system of disclosure generally. Look at the Internet, the ability to provide real-time information and come up with a very comprehensive system that took that into account in a measured way. He never got that chance, as you can see, and he's gone now so he never will have that chance as Chairman.

So it's not that that idea or notion wasn't at the Agency, they were aware of the need for a broad perspective. I'm sure Congress was too. However, there was not the luxury of time and now we're left with a regulatory regime that may in the long run punish capital formation and impose administrative burdens, especially on small businesses which I'm really concerned about, concerning economic climate and the fact that there's an end to the economic growth.

We can talk about this more. What Sarbanes-Oxley also did was create a new environment both in Congress and at the SEC of hyper-vigilance and zero tolerance and we can see that in the number of cases that have come out, what the penalties have been, Chairmanship resignations itself, the whole controversy associated with the selection of Chairman of the Public Accountability Board, and the fact that there may not have been complete transparency or disclosure about that. How that basically caused him to resign from office. Then just generally now the shift that we see both at the SEC and on Capitol Hill, the oversight of mutual funds. There is no scandal on mutual funds now, but God forbid should there be a scandal that Congress and the SEC is not ahead of. They feel they need to be ahead of the curve which is very hard to be for a number of reasons.

So I will say the last question that I guess I've sort of been hinting at is how do you regulate moral principles, disclosure principles, and accounting principles, all of which should guide, the guiding principle should be information and disclosure and materials at a public company, what the catch-all sort of disclosure principle is that a reasonable investor would want to know. And I think in all of these scandals a reasonable investor would have wanted to know a lot more information than was being presented to the marketplace. I think everybody understands what the principles should be. If there seems to be competition to the bottom in terms of disclosure, and I've heard Peter Fischer say it and I've heard the members that have spoken before me of this panel say it, we need to really find a way to come up with a system of disclosure that doesn't just go to a specific rule, but a culture. And we saw culture, the wrong kind of culture, really bring these companies down, especially Arthur Andersen and especially Enron.

So I think what we have now is the opportunity to step back, we'll probably have to live with Sarbanes-Oxley, but find a way to really take a look at what matters, look at how technology can accomplish a lot of these objectives. Look at the global marketplace. This discussion has been going on for at least 12 years about how to come up with a set of international accounting standards. Now is our chance to really look at the principles and can principles replace specific rules? Because I think the concern at least at the SEC isn't necessarily that we come up, or if and when we do come up with a system of cohesive regulations that everyone can live with in terms of accounting disclosure, but how will those be applied globally? Will there be sufficient enforcement across the board country by country given the different cultures of enforcement and the feelings of enforcement, and without even-handed enforcement of these principles will we ever really achieve the global market that investors feel safe in?

Having said that, I think we need to find a way to bring principles, to bring competition, and to bring culture into the discussion of how to have the right sort of tone and the right kind of corporate America that we can all be proud of.

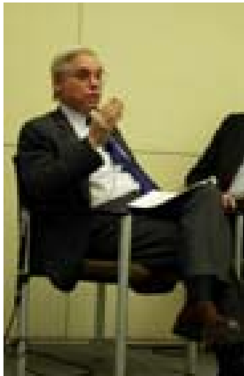
MR. YERGIN: Thank you.

Laura, you might just say something, you mentioned the significant burdens of small businesses from Sarbanes-Oxley. Do you want to just give a sense of what you mean by that?

MS. UNGER: I just mean generally in terms of finding a financial expert, all of the internal controls that are required, all of the disclosure that's required, and I think there's a sense that there's a high price to pay in terms of potential liability and cost of compliance and that many small companies who would otherwise seek to use the capital markets for capital formation are instead looking elsewhere. Of course the IPO environment might have something to do with that, but certainly I've heard anecdotally from a lot of lawyers that companies are looking to go private. So I remember on my time on Capitol Hill and I know they're still saying it, that small business is the engine of economic growth and without that engine driving the capital markets how will the economy recover, how will the market retain the levels, other than having closure [inaudible].

MR. YERGIN: Obviously the capital market leads us to Bob Glauber who before he was head of the National Association of Security Dealers, before he was Under Secretary of the Treasury and when he was working on trying to understand what happened in the 1987 stock market collapse, was in fact a Harvard Business School professor so he knows what was going on there for 20 years.

VOICE: And what did you teach, Bob? [Laughter]



MR. ROBERT GLAUBER: Not accounting. [Laughter] I have the same qualifications as Paul does on accounting.

MR. VOLCKER: You taught them about the importance of the stock market.

MR. GLAUBER: I taught them how to reverse engineer any — [Laughter]

Thank you, Dan. Thanks Bob, for inviting me.

Being third is a hard place to be. These are hard acts to follow. Bob for his clarity of presentation and Laura and Paul for their wisdom and commentary. Of course there's an advantage. You can hear what other people have said.

Let me respond to one thing that Paul said. He talked about Sprint. Sprint is one of the great cases, it seems to me, of conflict of interest. Here a corporation, a board is faced with a very serious problem. They have a conflict of interest between the CEO and the auditors and they say we can't have both, and they choose to fire the CEO and keep the auditors. [Laughter]

It's rather bizarre.

A lot of this has to do with governance and accounting and I should start by saying NASD doesn't have anything to do with that. Those are the province of listing standards and those are administered by the exchanges and of course by the SEC and Congress, the New York Exchange and the NASDAQ which is not a part of us any more. So let me just say that.

But let me concentrate in fact, having said that, on accounting and on the last point that Bob made in his presentation, and that is competition between the two dominant sets of accounting standards. Whether there should be competition or whether there should be convergence. I think Bob is well aware there's a controversial position he occupies that there should be competition, but I think there's a lot to argue for it and not just because it's sort of good publishing strategy. [Laughter]

There's a lot to be gained by regulatory competition. I go back to the banking field that I

was involved with when I was at Treasury, particularly the S&Ls. The S&Ls were the consequence of a chaotic mix of fragmented and conflicting regulations that really led to very serious problems. As you remember the S&Ls were regulated at the federal level, then by the Federal Home Loan Bank Board and by 50 different states. Of course you have even more regulatory competition in commercial banks where you have three different federal regulators as well as the 50 states, but that's another story.

In any case, the sort of lax state regulation of S&Ls I think did a great deal to break the system. This was a world in which in some states like California and Texas S&Ls were permitted to have 40 percent of their money, 39 percent of their money in equities which meant race horses and windmill farms in California. That sounds like I'm building a case for regulatory monopoly rather than for regulatory competition. But the fact is that out of that competitive regulatory environment came some pretty good things, some pretty good innovations as well. Now accounts, variable rate mortgages. So regulatory competition, as Bob argues, is pretty good. I'm one of the people who wanted to see Glass-Steagall repealed. There's a certain barrier between me and my colleague to the left here, I think. But one way it got repealed or one pressure to repeal it was regulatory competition between the Controller and the Fed, so regulatory competition has some real virtues.

Having said that I guess on this issue I don't agree with Bob on the virtues of regulatory competition. The reason I don't, the big problem I think is with capital flows. If we encourage GAAP and the rules of the international accounting standards boards to compete rather than converge, I think it's clearly going to inhibit the flow of capital and I think Bob suggests he's aware of this. But I think that's a big deal.

It will happen I think for two reasons. One is first, reciprocity. Regulators and exchanges are not very interested in listing stocks of issuers that do not use or even reconcile their financial reports to the accounting standards prevailing in their own local markets.

And second, most investors are basically local-minded in their behavior. They may want to invest in international securities but they want to do it on a local market so if they aren't listed there they won't invest in it.

So I think from the sort of standpoint of regulatory theory, this lack of reciprocity, chilled capital flows may not seem like such a big deal, but I think in the practical markets it really is a big deal and to me it's virtually dispositive.

So again, while Bob notes this is a problem I think it's a very big problem.

We had, NASD sponsored an accounting conference at Harvard Law School a month ago. This seems to be a day when we all make reference to Peter Fischer. Peter Fischer was

there who occupies the position Paul did at the Treasury Department many years ago, Under Secretary. Peter was asked as the members of the panel were asked, where do you stand on convergence versus competition. He said convergence. He was asked why and his answer was very simple. It was capital flows, period, end of conversation.

I think that in fact to me it is equally that simple. I come from a particular set of concerns now. I'm worried not about general economic performance but the performance of markets and market transparency, market integrity, investor protection. I think for those reasons convergence is to my mind just much more important, and I don't think on that issue that the case has been made to overthrow convergence.

I understand it's a controversial issue, and to be perfectly fair at the conference at Harvard that we sponsored there was by no means agreement. There were plenty of people arguing, as Bob has, for competition, but I personally don't come out that way.

Let me just say a couple more things that have been mentioned. Maybe you'll talk about them in the questions. I think the Public Company Accounting Oversight Board may be off to a bad start, but it is immensely important and I think it has every possibility of being effective and successful and I think it's very important that it be. It is the right structure. It is a layer of private sector regulation between the industry and the government, the SEC. I like that, not surprisingly, because that's what the NASD is and I think it is the right kind of structure and I think once it gets itself out of the starting blocks it's going to be very very successful.

Beyond that, well, beyond that we've talked a long time. Let me be quiet and let me return to you Dan and answer questions.

MR. YERGIN: Bob, you mentioned that your perspective now as you said, market integrity and investor protection. To what degree do you think these issues, these corporate governance issues still hang over the market or whether it's a whole different set of concerns now?

MR. GLAUBER: I think they're part of it. I was up on the Hill talking to a Senator today, a very knowledgeable Senator on the issue of the stock market and asked sort of the same question. I think it's a piece, and therefore we like to say we're doing our part to rebuild investor confidence. I think the overwhelming cloud has to do with geopolitical issues and economic issues broadly. So it's still there, but if we were able to put the right rules in place and bring the right enforcement actions, that alone isn't going to solve the overhang of the market.

MS. UNGER: Whether or not the burst of the dot.com bubble followed by the corporate misdeeds, followed by uncertainty, they've gone from greed to scandal to stress to uncertainty. I think you wouldn't have seen the enormous impact that we're seeing now that it's had on the

market.

MR. VOLCKER: Let me just address this question of competition and standards. I find it a little difficult to understand this argument I guess. It is comparable, I think, to the banking regulation thing.

I guess I am thought of as a regulator, but I have always been in favor of some diversity of banking regulation in the United States, awkward as that is. But there are certain kinds that I'm not in favor of. When it becomes a competition in laxity or indifference which was the case in the savings and loan, you don't want Texas and California undermining the whole integrity of the Federal Deposit Insurance Corporation, for instance.

Now you have this little taxonomy of different things you like and dislike, whatever it is. I found myself saying my ranking is exactly the opposite of yours. You only deal with the two. If we just had those two it would be an immense advance of where we were. The only argument is between international and U.S.. You've already gone 95 percent of the way toward conformity or convergence.

But let me take the example which is right on the table right now. I don't know where the merits lie in this particular standard but I know it's very controversial.

The international people say we want a standard for derivatives like, they say better, but like the existing FASB standard which is a mark-to-market for derivatives except in very specific circumstances. The European banks and insurance companies are in an uproar about this. They will encourage the European Union to reject that standard. The European Commission has to vote on this, I've got a feeling under intense political pressure. It's at least as hot an issue I would say as expensing stock options in the U.S. Congress. I don't know how they're going to decide.

But suppose they decided that they would keep the existing international standard which doesn't require any accounting for derivatives.

First of all you can't reconcile those two when they don't have the information to reconcile them. And here is a case where you would be left I guess with a competition in standards where one is no standard in this particular area, against a standard.

Now maybe the standard's no good. I don't want to argue the merits, but it's clearly — The SEC would never stand for that. They would never recognize a foreign standard that left that big a gap in GAAP. It's just the kind of thing that prevents them from doing what you want them to do which is recognize the other standard. This isn't a difference in just how they do derivatives. One does it and one doesn't do it, and leaves a great lacuna.

MR. LITAN: You can make the same argument about stock options, though. The international guys want to expense them and we don't do it. Although we're going to change.

MR. VOLCKER: Yeah, but stock options, that's an easy one. You know what the options are, you apply the formula. These things you don't know. A stock option you know. The company has announced what stock options it's giving. It doesn't announce how many options it's got outstanding, or at least what the nature of them is.

MS. UNGER: I don't think this conversation's going to get too far though in light of what's going on with our own standards and for example the Ahold situation. I mean if the SEC just came out and said that the Public Accountability Board is going to regulate foreign auditors, so I know that this whole corporate scandal thing has sort of reignited the EU's at least interest in coming up with global standards. But A, I'm not sure how excited they are to come to our markets right now. And B, now that transparency is part of the center for everyone, especially here, aren't we rethinking the general principles on our side as well as the other side? And why would you have a whole number of set of different standards? Isn't that going the wrong direction?

MR. VOLCKER: You can get a lot of — In my wildest dreams I would not think every country was going to adopt international accounting standards with all the specific interpretations that might be made. Particularly if they're principles. They're going to probably knock down my imagination too, but suppose you have everybody adopt the same principles, there are going to be different interpretations. You'll have different interpreters. That gives you a certain amount of competition and maybe that's what you want. Maybe it's not, but I don't think it's killing anything.

MR. YERGIN: Before we open it up to the floor, I should ask Paul, you of course mentioned derivatives. I guess it was this week Warren Buffet expressed his view of how dangerous in his view they are to the economy. I'd just like to ask the panel whether you share those concerns.

MR. VOLCKER: I have a certain reservation that they may not wish to — too big a strain. Derivatives — people are laying off their risk on somebody else and knowingly or not they're buying it back in another form. They don't know what they have.

I was rather impressed at the time of the Indonesian crisis particularly, that certain institutions which I had some familiarity with found they had a very sizeable exposure in Indonesia that they didn't think they had because it was all through derivatives that they thought were covered, but they found out that the people they thought were covering it weren't covering it. It's a pretty tricky business.

Look, I'm a cynical old man, but 80 percent of the derivatives out there are financial engineers fooling around with some exotic proposals to intrigue some customer that this is the way to make a deal which is of no particular interest to anybody.

I was approached the other day, and I don't get approached with many of these. But boy, have we got a deal for you. Here, you buy this thing and you take all — it's a stock market thing. You take all the losses and we'll pay you three times to gain in the next year up to a limit of X. I don't know whether it's a good deal or a bad deal. All I know is there are about 19 derivatives lying behind that, each one the bank thinks he's making a little spread on.

MR. YERGIN: They offered it to you and you said no. They think it's a good deal for them to offer to you.

MR. VOLCKER: Exactly.

I think the more interesting thing of what Bob has said was what he said he would invest in in the near future, which was nothing

MR. LITAN: He wouldn't invest in common stock.

MS. UNGER: The real problem with derivatives seem to be when they're highly leveraged and the leverage doesn't work out. You've seen the Orange County situation, Long Term Capital. Those were involving sophisticated investors with sophisticated derivatives that were so highly leveraged they exploded, which reminds me of sort of Las Vegas.

MR. VOLCKER: This is interesting commentary. That comment apparently would have been made by Bill McGunner or Peter Fischer or they wouldn't have bailed out Long Term Capital Management in the first place. The whole argument was the market's going to come down around their head if we don't facilitate the — that's a pure derivative.

MR. YERGIN: Let's open it up to the floor.

QUESTION: I'm Jim Smallhout. I'm an independent journalist and one-time guest scholar here at Brookings.

My question is for Bob Litan. Bob, you mentioned that the book takes a skeptical view of auditor rotation with only four firms remaining in the industry. My question is whether you think it's feasible to promote more competition given that competitive structure at the moment, and if so, how can we achieve that?

MR. LITAN: That's a very good question. I don't know what public policy lever I would pull to get more competition. You can't break up the big four right now through the antitrust laws because there's nothing they did wrong. I mean they merged. It's over.

What's interesting is, there's an article in *The Economist* this week that there's a brand new firm in London from a split-off of PriceWaterhouse. I think it's called the Independence, seriously, that's the name of the auditing firm.

MS. UNGER: Good marketing.

MR. LITAN: And it's marketing itself as one of the other outfits, not in the big four.

One of the mysteries to me actually is why there hasn't been a split-up of some of the existing four right now. In fact to me the dream team always would have been, and I don't want to flatter him, I always thought that Paul should go into the auditing business and then attract around him — I'm perfectly serious.

MR. VOLCKER: I tried to.

MR. LITAN: No, you were asked to take over Arthur Andersen. I have a different proposition for you. What if, for example, a bunch of accounting partners from major firms who had never been sued, the clean guys, came to you and said —

MR. VOLCKER: It would be a small firm. [Laughter]

MR. LITAN: It could start out as a small firm but grow into a big firm. But get somebody like Paul Volcker, the stature of that — I'm being perfectly serious — to head it. It then markets itself as the clean auditor, and it could attract business and maybe that — It's a reputational barrier to entry to get into this business, and I exactly don't know how to solve the problem.

MR. VOLCKER: I would like to think what you say is true, there is a market for it. That's what I hoped for Andersen. But the argument for starting one anew is you need the international scope now and you just need that kind of mass and international exposure which a small firm isn't going to have. By definition.

I'm not even sure that's a good argument because some of these firms are so loosely, they're all the same name but they're so loosely affiliated they're not really one [family].

QUESTION: My name is Mortimer Kaplan, I'm a lawyer here in Washington.

I know that you've long taken the position that on the exercise of stock options the executives ought to be required to hold their stock for a certain period of time. I wonder how you feel about that today and how you would enforce that.

I'd also like to turn to you about the SEC. At one time the exercise of stock options was deemed to be a purchase and under 6(d) and (b) the person who exercised the option if it was an officer had to hold it for six months. Why did the SEC change its position?

MR. VOLCKER: I do think that it would improve stock options if you had some kind of retention period of some length and it would help with the most egregious abuses of them. But I don't think there's much you can achieve by a stock option from a kind of legitimate alignment of incentives that you couldn't do with restricted stock or actually give them a bonus in stock itself and have a holding restriction on those too.

But then you've got an exposure, it's up and down, you don't get this repricing, you don't get this kind of thing that we were in CitiBank the other day, he's not taking a bonus, he's taking new stock options at a low price.

MR. LITAN: That's good. I mean restricted stock. Are we talking —

MR. VOLCKER: No, I said —

MR. LITAN: — stock —

MR. VOLCKER: No, no. I'm saying recently they've been given new options, not restricted —

MR. GLAUBER: There's one argument that I think is made for why stock options could exist rather than restricted stock, setting aside the accounting, and assuming the accounting —

MR. VOLCKER: — taxes.

MR. GLAUBER: Well, yeah, the tax argument. And the other is a leverage argument, that you get sort of more bang for the buck because they are leveraged. I don't think that's very — It doesn't convince me and I think Paul —

MR. VOLCKER: That's the problem. They're so leveraged that when the whole stock market went up it had nothing to do with the individual performance. It's leverage that —

MR. LITAN: I agree.

MR. GLAUBER: My bet is that now that options are going to be accounted in the same way that you'll see more and more companies going just as we're talking about, to restricted stock.

MS. UNGER: I can tell you first-hand, serving on a couple of boards, that one company, and this is a technology company, with options-only compensation, has now switched to cash and options. The other was always options and cash and it's considering restricted stock in lieu of options. So I think people are definitely focused on —

MR. VOLCKER: What it proves is that the major motivation for options was the accounting.

MS. UNGER: Some people still believe that, wish to believe that expensing for stock options may not happen. Especially technology companies.

MR. VOLCKER: I think they're probably —

MS. UNGER: — way out in California.

MR. VOLCKER: There's enough controversy over how to do it that that may — But I just want to make sure I am not misquoted. I say I think the temptation to abuse the stock option is too great for big, public companies with widely diversified ownership. Now I'm a private, new technology company, I want to give away part of my stock, my decision, I own it, I own it with my partners, and they for some reason think options are better than something else, let them go do it. Maybe they haven't got any cash, they can't pay them in cash, and they'd rather pay them in options than giving them stock, I don't know, it's their decision. They're not big, publicly held companies, widely diversified ownership. It's the owner making the decision. That's a different proposition.

MS. UNGER: I didn't answer the second part of your question, and I was going to try to get away with not answering it but I don't think that would be very honest. [Laughter]

6(b) is the [inaudible]. I believe what happened was, the purpose was that an insider not buy and sell before the disclosure was made to the public and capitalize on the short term profits.

Now with the ability to make that information more transparent the belief is that that's sufficient to cure the abuses.

QUESTION: — corporate executive, if he knew the stock was going to fall soon, he might exercise the high price and sell right away. We still find instances of that. He had to hold

it for six months and [inaudible].

MS. UNGER: That's true, but the section, the [inaudible] streams [inaudible] generated from Section 6(b) now have like a two-day filing requirement. It used to be from 30 to 120 days. It used to be quite a long period before the public knew.

QUESTION: [Inaudible]

MS. UNGER: No, but the transparency is [inaudible].

QUESTION: First let me say, I sit on a few boards — Bonnie Blocktell. I own a brokerage firm in Washington, D.C. I also sit on a few boards, and I can tell you there is a move away from options only, and to some extent for cash for one good reason. Stocks are not going up. So you get tired enough of options out of the money and look for an alternative.

Could I ask you sort of a broad general question is other than maybe Laura Unger, you mentioned mutual funds briefly. There is a lot of criticism of the companies and the way they do things but there is never very much criticism of the investors. And I'm not talking about the investment banks who have really gotten it across the face many times, but of the mutual funds, of the pension funds who don't seem to analyze very well the information that they're already given.

Just putting that in the, if you believe they don't seem to analyze it, putting that in the context of the stock options I think it's a perfectly reasonable position for a company to take to say yeah, we do these fixed price options. If you don't like them, don't buy the stock. Analyze what the options are worth, which you're perfectly able to do, and figure out what the return is going to be. We supposedly have good capital markets in this country with investors who can figure things out and make decisions as to what they're going to do yea or nay.

I'm just kind of torn on this issue between on the one hand I think the whole compensation issue is a real mess, not just options. The effort to get rid of options I tend to think is really just an effort to restrict compensation and if you have anything to say about that I'd like to hear it. But secondly, as to what your attitude is of the market's ability to police some of these things themselves or failure not to do so. Is your attitude basically the market really can't do it because we get too emotional, we're in a bubble, you don't look. It's hard to know what to say after this.

Anyone who would like to comment.

MS. UNGER: To sort of dissect the question, I think investors retail and institutional have some blame in all of this. I completely agree with that. Everyone's pointing the fingers at

different people, but investors were in the thick of it also. They were scrambling to get IPOs when there was an 86 percent return which was the average during the height of the dot.com bubble. And 25 to 30 percent returns, generally in their portfolio.

Have you been reading *The Wall Street Journal* the last few days with these people who took their entire retirement money and put it into things I would never dream of investing my money in and half of me says fine, and half of me thinks what were you doing? What were you thinking? Who's responsibility is that? Is the SEC supposed to prevent people from doing that? That goes to sort of this whole beginning of a culture where people, there are so many investors, more than half of U.S. households invest in the market. People forget and have lost sight of the fact that investments are not guaranteed. There is no guaranteed return, putting aside fraud, that you are going to make money. In the height of the boom people were thinking 25 to 30 percent was guaranteed. That's sort of number one retail level.

But now, and the SEC was making efforts to educate people. But nobody wanted to listen. Gosh, if I was a participant I probably wouldn't have listened too closely either.

Institutional investors though definitely have a role in all of this. People have questioned why they, who analyze the disclosure statements for investing weren't more proactive, didn't see some of these frauds, didn't question some of the sophisticated investment strategies of Enron, say. And now they're suggesting that institutions need to be more involved in corporate government generally, for example in selecting independent directors, and if you think that the board is going to make the company more accountable that the institutional investors really need to play a stronger role in all of that.

Institutions are loathe to play a strong role in anything. When I worked on the Private Securities Litigation Reform Act the intent was to get the institutions involved, to be the lead plaintiffs, to get out there, to represent investors and not have this one law firm in California taking home all the money from people who have been defrauded. They haven't really been interested in stepping up to the plate. I think that's something that maybe all of us can change.

MR. VOLCKER: I'm going to have to run but I wanted to make the point that you just made before I ran.

One of the great disappointments in this whole thing is the passivity or outright stonewalling of investment companies. They don't want to get involved. They didn't want to get involved in financing the International Accounting Standards Board where I first ran into it, but then you get on these reform things. There are exceptions. TIAA-CREF and a few others. But basically the industry doesn't want to get involved in any of this stuff.

MS. UNGER: Why is that? Extra work?

MR. VOLCKER: No, no. [Laughter] There are several reasons, but the reason they don't want to get involved in corporate government is they don't want to offend their clients. It's quite clear, they don't want to opine about something their clients don't like when they're going to the client to get their 401(k) plan next week.

MR. YERGIN: Bob, if you have to leave, we're going to go for about another ten minutes, but if you need to dash, Paul —

MR. VOLCKER: I've got to run. Thank you for having me.

MR. YERGIN: Thank you.

[Applause]

MR. GLAUBER: I agree with Paul that it's unfortunate that institutions are as passive. I don't think it's surprising. I think they're under tremendous commercial forces, and they've always taken the position that they just want to be left to invest and not be involved in governance as you said, Laura. It's true. It's unfortunate. And it's hard to construct a system around their deep involvement and hope it will work because it won't.

QUESTION: Antoine Fenachtnau, Emerging Markets Management.

Chairman Volcker expressed some polite skepticism about the whole concept of stock options. Rather than going to expensing stock options which in my mind is really only a second best solution, couldn't we ask the question why do we need stock options at all? Aren't there better alternatives to align the interests of both managers and the investors? And can't we get academics and regulators and other people to think about that more clearly? That seems to be the direction.

Could it be if we cannot outlaw stock options, can't we morally outlaw stock options?

If you're a company that uses stock options is that really a good thing? I don't know.

MR. GLAUBER: My immediate response is first of all why do you want to outlaw any of these things? Why don't you —

MS. UNGER: Let the market work.

MR. GLAUBER: If you account for them correctly, let people do what they want to do. My best reading of what's going on is as we're getting closer to accounting for them more

correctly, people are going to use them less and less.

There was a great idea around the Harvard Law School. There was a paper written about how to effect better corporate governance. It was to put more professors of law on boards of directors. [Laughter]

There are lots of things you can do, but I don't think you should by legislation prohibit something. If people find this a useful technique, let them do it.

Let me remind you that the reason we have all these stock options was because of the pressure from a lot of institutions that were viewed as institutions leading the good corporate governance push back in the '80s and early '90s to align managers and shareholders more effectively. They were the ones that pushed for stock options.

So these things happen sometimes as unintended consequences of good ideas, but again, fine, if you've got better corporate governance mechanisms, let's do them, but let's not rule these out. As long as they're —

QUESTION: (Inaudible)

MR. GLAUBER: Make them obsolete because you'll replace them with something better. But don't rule them out.

MS. UNGER: They're just not as compelling generally now as the other woman in the audience pointed out, because they're not really worth a lot. And there being nothing that will get people thinking faster about how to align investors' interests with management if stock options are expensed, than people who don't want to expense them. So I think the natural forces will work.

I've seen, it is a question of the ability to compensate talented individuals in some cases, and the fact that if there's a unified workforce that are able to reap the benefits of the stocks at intervening price, that's a powerful incentive for them to join that particular company. I don't think there's anything wrong with that. Certainly at the workers level, as well as the management level.

QUESTION: Isam Busi, Hispanic Association of Corporate Responsibility.

What companies are doing or should be doing to make their board more independent?

MR. YERGIN: Is ultimately — What should be the role of directors and boards if we're thinking five years down the road? Actually.

MR. LITAN: Okay. First, the exchange is basically as I said, the majority of your board has to be in attendance so there's a big — lawyers are going to go on forever on what independent means. There's going to be a lot of argument, probably lawsuits over all that. There are some bright line tests. You can't be employed with the company. You have to be out for a certain number of years. But then basically as I understand it, the rules basically are you know it when you see it.

MS. UNGER: Financial experts, the same thing.

MR. LITAN: But basically it's a case by case thing, and you sort of know it when you see it. So there's clearly going to be a drive to have more independence and what Dan just raised is a question that I don't know the answer to.

My gut tells me that for now the move to independence is probably a good idea. It's a housecleaning, it's a cleansing thing. But again, this is something that could come back to bite us with the law of unintended consequences five years down the road. That is you could get a number of companies that will have these "independent" people, but they won't know anything about the company, and the companies may be performing worse than they would have otherwise. I'll bet you anything we're going to see academic studies five or ten years from now that are going to show that.

But the question is I don't know how many, and right now it's sort of a shot in the dark. In a way the drive to independence is somewhat like what happened with Glass-Steagall when it was passed in 1933. It's a gut-level reaction to what happened in Enron.

Even though the directors in Enron were independent, they were independent nominally but the fact is — and they would have met a lot of independent —

MR. GLAUBER: They were qualified —

MR. LITAN: But everybody knew they were friends of Ken Lay, all right? So the effort was let's try to write rules that will prevent this from happening again, and that was sort of the gut instinct. And as I said, this is one of those things that we may regret five or ten years from now. But we don't know yet.

MS. UNGER: There are a lot of things to say about this. Management generally always participates in the board meetings. I think the single most important provision that I can see is the ability or the requirement that the independent directors meet independently of the Chairman and CEO. So you have a chance for them to leave the room and say is he full of shit? — [Laughter] You know what I mean? And what about his compensation package? Did you see

his performance? You know. And how about succession issues, and a lot of things you don't necessarily want to bring up in front of the Chairman. AOL did the opposite.

So it depends. I don't want to substitute my judgment for business judgment, and I'm only a year into business. But I do think the ability to really be independent in your decisionmaking and discussions and to promote some candor among the independent directors is important. And what the right mix is I think we'll see. But having a majority doesn't mean it's all independent (inaudible).

MR. YERGIN: Bob?

MR. LITAN: I think there's been enough wisdom on this.

QUESTION: Justin Cole, ASX News.

Mr. Litan at the start, if I understood you correctly, you said that the rundown in corporate failures was due to a failure of enforcement rather than U.S. GAAP. Could you just expand on that? Is that something that the other panelists would agree on?

MR. LITAN: Just very briefly, putting Enron aside which was complicated and it's discussed in the book. If you look at virtually every other case it was either an overstatement of revenues or an understatement of expenses, which would have violated existing GAAP. So the auditors let this happen, so there was a failure of enforcement. That was the only argument I was making.

Now Paul did raise one issue that I did not talk about. We have an extensive discussion in the book. We don't like to drive toward fair value accounting in the accounting standards process. That didn't lead to all these current scandals. That happens to be a separate criticism that we don't like about current accounting standards but I just didn't raise it for reasons of brevity.

MR. GLAUBER: I think what Bob says is 100 percent right. It isn't a problem of needing new rules for much of this, it was enforcing the existing ones.

MR. YERGIN: I think some would say in the case of at least Enron that mark to market marketing and fair value actually was one of the things that led them down —

MR. GLAUBER: I think that's correct.

MR. LITAN: And I say that in the book. So fair value was a problem, that's correct. But in general, I put Enron aside. Virtually all these other cases are pretty plain vanilla.

MS. UNGER: Most of it is out and out fraud, I believe, and I see it more as a failure of the gatekeepers and the resulting loss of confidence in the transparency and information provided (inaudible)

MR. YERGIN: We've reached 3:30. I want to thank Laura Unger and Bob Glauber for joining Bob Litan and all of us here for this very good discussion.

Thank you all very much.

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