Lessons Learned

From the Failure of Market Discipline and Regulatory Lapses—

How to Prevent Future Busts

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Thank you for that kind introduction. I also want to thank Francois Gianviti for the invitation to this very timely and important seminar. I am always honored to join such a distinguished and wise group of individuals.

One of the things I have found distinguishes wise individuals from those who may be intellectually superior, but not as wise, is the ability to avoid repeating one's mistakes. Inherently, this also encompasses the ability to forecast or see changes as they unfold, and then adapt to them. In a way, wise people are much like the top athlete who constantly studies film to find deficiencies in their form, no matter how small, and then correct them. Likewise, those who fail to learn from their mistakes and repeat them, will, sooner or later find themselves on the sidelines, no matter how talented.

With that in mind, I would like to address what are some of the lessons we have seen and experienced in recent years. Certainly, the Enron's in the United States, the Parmalat's of Europe, and the failed financial reporting of financial institutions in Asia all provide more than ample opportunities for study. Since they all involve human behavior, and we all put our pants on the same way, it is no surprise that lessons are universal and global in nature.

We have experienced corporate boards that became entrenched and attached to imperial CEO's. We have seen management who took the cash but failed to deliver performance. In some cases, the CEO's and CFO's knowingly lied to the owners they worked for, seeing them more as servants than as investors. And time and time again, gatekeepers have failed to provide warnings to investors despite their knowledge of improper conduct.

When it came to Wall Street, the Chinese Walls designed to protect investors crumbled and in fact, resemble the Great Wall of China today, where little of the original is left standing. Investment bankers lined their pockets at the expense of those whose money they took, while doling out favors to those who would return them in kind. Analysts hyped stocks of dot.coms whose lives in some cases turned out to be shorter than that of a bad movie.

And we found that financial engineers were not second to their electrical counterparts. Indeed, financial engineers dreamed up new products that would not only dodge the rules intended to provide transparency, but they also generated large sums of fees for which one could be handsomely rewarded. Professionals such as the accountants and attorneys were only too willing to stick their hand in the cookie jar as well when they saw the financial rewards for such behavior.

Lessons Learned

So what are some of the lessons, in no particular order? Let me cover ten that come to mind.

Number One is the realization that financial incentives, such as stock options, can create both good and bad behavior. We witnessed throughout the 1990's how incentives fostered innovation, economic expansion, building of plants and the accompanying creation of jobs. Yet, at the same time, when left to their own devices, some people believed the incentives created an environment in which the end came to justify the means, even if that end could ultimately inflict tremendous personal and economic damage to thousands of others. And what of all that wealth the stock options supposedly created for technology investors when the NASDAQ raced to 5200? Where is it today and what have those options done in recent years to create value for shareholders?

Number Two, in major systemic market breakdowns, including that accompanying the depression of the 1930's, the bear market of the 1970's as well as the bubble of the 1990's, is that the whole orchard of market participants is not rotten to the core. Yet at the same time, such widespread failures are not the result of a "few bad apples" either. Rather they tend to be the result of a few bad actors that initially crossed over the line of ethical conduct. Seeing that created an uneven and sometimes lucrative playing field, others followed. As a result, when I hear talk today of just a few bad apples, I immediately think of the picture of three chimpanzees, “See No Evil, Hear No Evil, and Speak No Evil.”

Number Three in the list of lessons is that the capital markets may be efficient in the longer run, but in the short term, they can be highly ineffective.

Number Four is that the lack of timely, high quality transparency with respect to what is creating or destroying value, greatly contributes to inefficient markets. This is especially true when the shortcoming is used to mask real economic condition and performance of companies. While there is a cost to transparency, especially to those who are responsible for providing it, the lack of transparency can have a much greater cost (and benefit) to those who use the information to make informed decisions. Without transparency, investors, creditors and regulators cannot make reasoned decisions and ultimately, make wrong decisions; leading to poor allocation of capital. Ultimately that has ALWAYS led to national or international economic consequences.

This also includes accounting and financial disclosure standards. We have learned standards that are the result of compromises to meet the needs of preparers, to the detriment of the ultimate customers, investors and creditors, are neither principle based or reflective of the true economics of the business.

Markets can discipline market participants, but only if the market can measure and hold those responsible accountable. Lesson **Number Five** is you successfully manage <u>only</u> what you measure. In order for the market to measure accountability for each and every market participant, be it public companies, investment funds, stock exchanges or regulators, there must be high quality disclosures of financial performance and those indicators that are critical to the success of the enterprise. Without these disclosures on a comparable, consistent and timely basis, the market cannot provide discipline in an effective and efficient manner.

As a result:

- Management fails to measure in terms of economic reality that which must be managed;
- operational issues that need fixing in the business fail to get fixed;
- the numbers get managed by management as a way of fixing the problem; and
- in the end, to the surprise of many, the business implodes and is no longer capable of being fixed by management and fails.

In lesson **Number Six,** we have learned that to provide oversight and counter balances to financial incentives that may create a negative incentive for some, the necessary role of gatekeepers has been created. Independent auditors have been empowered to provide a third party perspective of the financial statements and accompanying disclosures. The legal profession provides their expert opinion on the legality of transactions and filings with regulators and investors. And investment bankers are required to perform a level of due diligence as a sort of sanity check, if you will, with respect to their undertakings. Yet, the very financial incentives that create the need for these gatekeepers can also compromise their ability to perform their function. The ethics of these market participants are not without challenges and potential for breakdown, which in turn can have disastrous effects well beyond market participants.

Number Seven may well be the most critical and important lesson one can learn when it comes to capital markets. It is the simple and yet powerful and self-evident concept of independence. Independence that is vital and critical to the success of any functioning market system. When the independence of corporate boards, gatekeepers, stock exchanges, analysts, investment bankers, accounting standard setters or regulators is compromised, at best a weak link in the chain is created. But all too often, the markets deflate as if a balloon pricked by a sharp pin.

Often it has been argued that market participants, such as the major auditing or Wall Street investment banking firms, are not willing to compromise their reputations and independence in exchange for fees. Yet, that is exactly what occurred during the bubble as names like Merrill Lynch, J P Morgan Chase, CitiGroup, Putnam, Janus and each of the Big Five accounting firms became household names tarnished by repeated negative exposure in the media.

I have also heard members of the accounting profession say there is a lack of empirical evidence demonstrating that the large consulting fees they took; $2.69 for each dollar of audit fees in 2000 impacted their judgments. Yet, time and time again at the SEC we saw situations such as at Waste Management where the auditors found the problems, and then failed to report them, instead choosing to give the company a clean bill of health. As Paul Volcker once said at a roundtable we jointly presented at, "you do not need studies to figure this one out."

Yet defining independence is a struggle as financial incentives push some to fight for weaker independence regulations, while others push for unquestionable rules. However, it is in the mind and ethics of the decision maker that the answer will ultimately rest. Only time will provide the ultimate proof.

Number Eight is that politics and transparency are like oil and water. They don't mix. When politicians, whose political machines are "well oiled" by special interests, place special interests ahead of transparency for investors in the form of full and fair disclosure, trouble is just around the corner. Such actions are like a film of sludge covering what would otherwise be transparency, clear like a glass of fresh water. It is beyond question that some politicians in the United States directly contributed to the systemic breakdown that permitted the "bubble" in our markets towards the end of the 1990's.

Lesson **Number Nine** is capital markets are not "self-healing." The very real existence of inherent financial conflicts, a lack of independence and political interference prevent and inhibit capital markets from taking self-correcting actions.

In the United States, businesses, auditors, analysts, corporate boards and others had been urged to adopt best practices, sometimes for decades. For example, the organization of Financial Executives International had for many years urged its members to report on internal controls, consistent with recommendations of highly respected commissions arising from debacles in the 1970's and 1980's. These same executives had been urged to address the shortcomings of their "pro forma" earnings releases that included everything but the bad stuff. During 2000, the SEC urged and pushed the profession, along with a panel of experts led by the former chairman of Pricewaterhouse, to adopt more effective and stringent oversight. And of course, our own Financial Accounting Standards Board or FASB had been working on a project that would have solved the accounting for special purpose entities such as existed at Enron for over two decades.

Yet, none of these solutions came to fruition. Instead, one out of every ten public companies in the U.S. has had to restate their financial statements as shortcomings in their internal controls were exposed, the off balance sheet transactions of companies such as Enron and Parmalat surprised investors, and investors were mislead by earnings numbers that were more representative of the Grimm's fairy tales than economic truth. Billion dollar errors in financial statements have become a recurring rather than an extraordinary event.

Lesson **Number Ten** states that when there is a lack of enforcement of rules, be it those regarding conduct on Wall Street, the major international stock markets, the independence of gatekeepers or corporate boards, the transparency of financial disclosures or the ethics of management, there are in fact and substance, no such rules. Time and time again we have seen rules ignored when management believed the benefits of such behavior outweighed the costs associated with ethical and proper conduct. It has been like a speeding car whose driver had seen the sign, "Next policeman – 500 miles."

And with trade becoming more global with each new day, perhaps the sign might more appropriately say "Next policeman an ocean away."

Change Is Inevitable – One Another

As I now think back over the events of the last few years, it reminds me of a story I once heard.

One night at sea, a ship's captain saw what he thought were the lights of another ship heading toward him. He had his signalman blink to the other ship, "Change your course 10 degrees south."

The reply came back, "Change your course 10 degrees north."

The ship's captain answered, "I am a captain. Change your course south."
Another reply came back, "Well I am a seaman first class. Change your course north."

The captain was mad now. "Darn it, I said change your course south. I'm on a battleship."

To which the reply came back, "And I say change your course north. I'm in a lighthouse."

And so, we too have come to that point when change is required as staying the course will only bring about the sinking of the ship. To date, in some countries, change has and continues to occur. Here in the United States, public sentiment illustrated clearly in polls, led politicians to pass what has affectionately become known as Sarbanes-Oxley. Change is also occurring internationally as we have seen new rules and regulations passed and/or proposed in countries such as Italy, England, Germany, Canada and Australia. We have seen the OECD adopt new measures and likewise, the International Accounting Standards Board has also adopted new measures such as those requiring expensing of all forms of compensation. The International Organization of Security

Regulators, IOSCO, has also been working hard to facilitate greater coordination among its members, including in the field of enforcement.

But whether these measures and steps taken ultimately receive a passing grade will depend on whether in time they resolve the matrix of inherent financial conflicts, lack of independence, lack of transparency and accountability by bringing them clearly into the sunlight through high quality disclosures. Just as people like financial rewards, they also tend to guard their reputations with zeal. Quite often, they act with more ethical behavior when the risk of getting caught with one's picture plastered on the front page of a major national or international newspaper increases. As the weekly newspaper in Aspen, Colorado succinctly touts, "If you don't want it printed, don't let it happen."

To that end, let me cover some of the things that I believe will yield a passing grade. They focus on the issues of independence, accountability, adequate controls and oversight, and effective enforcement of those who chose to break the law.

Changes to Prevent Future Busts

First, in the area of corporate governance, boards need to govern with investors clearly in mind. To that end, corporate boards need to become more independent of the CEO's they oversee. The days of the "good old boys' club" of board members needs to become as much a relic of the past as the dot.coms and the horse and buggy. That is not to say we need professional board members. But we do need experienced, knowledgeable members who ask tough questions, and when the answer isn't satisfactory, they ask them again and again until the answer is complete. To help accomplish this, I believe corporate boards should be 75% or more independent, and the role of the Chairman and CEO should be separated. That has become more commonplace elsewhere than here in the States and I think we need to follow the lead of others. As for mutual funds, as the Securities and Exchange Commission has proposed, I believe the chairman of the board should always be independent of the fund complex whose fees come from the investor funds.

Second, to help ensure greater accountability of executives, they should have to formally acknowledge their accountability for the truth, the whole truth, and nothing but the truth when they provide information to the owners and creditors of a business.

Third, that accountability should be established and the progress measured through greater transparency in disclosures, than we have today. We should eliminate gimmicks that exist in current international and national accounting standards that permit lease and other forms of financings to remain off balance sheet. Changes in the value of financial portfolios, liabilities and instruments should all be reflected without compromise in the financial statements. The international and national accounting standard setters need to adopt a rule that not withstanding their existing standards, if material information is necessary to an understanding of a business, and that information is not required by a particular rule, then that information must still be disclosed. Key performance indicators, which provide investors, creditors and regulators greater visibility into the future value creation or destruction for a business, should also become a standard part of any disclosure regime.

I have heard some say that we should create differing levels of transparency for businesses or countries based on their size or degree of development. Yet, neither of those two criteria have anything to do with the ability of investors to make reasoned, informed decisions about how to best allocate their capital to maximize their returns. And while I do agree a small business may be less complex than a large multi-international conglomerate, it should nonetheless be very transparent with respect to its disclosures. For example if it has financial instruments or leases or pension plans, it should disclose those and their economic impact on the business in a truthful meaningful fashion. To waive such a requirement is to take the first step away from a principles based approach towards a complex set of rules based on exemptions, waivers and a lack of reality.

I strongly believe that companies and countries that provide transparent disclosures, that enable investors in their quest to maximize returns, will increasingly be able to attract capital at an increasingly attractive price. It is just such a system that allows investors over the long run to maximize their returns and reduce their losses, thereby increasing their trust and confidence.

Fourth, we need to more closely link and align executives' pay to their performance on behalf of investors, over the long run. In all likelihood, this means changing the mix of some forms of compensation, such as decreasing the use of stock options and increasing the use of restricted stock that vests over time and, in some cases, after retirement. It also means measuring performance not on a quarter-by-quarter basis, but by how each of those quarters builds on the long-term strategy of the business.

Likewise, if we are to hold executives responsible for their performance over the long run, then investors must also change how they perceive and measure performance. In particular, portfolio managers at institutional investors should also adjust their compensation schemes to compensate them for their performance over the long run.

Fifth, we need to reduce the financial conflicts inherent in a well working capital market system by increasing the independence of the gatekeepers and overseers. As I have previously mentioned, corporate boards need to become more independent.

Likewise, auditors whose reputations have been bloodied and bludgeoned by the disclosure of one humongous financial fraud after another need to become more independent. After all, if auditors cannot find billion dollar errors as existed at WorldCom, Parmalat and Qwest, or report a serious deficiency to investors and regulators when it is reportably found such as at Tyco, Waste Management or Adelphia, what is reasonable to expect them to be able to find and report? Perhaps the need for periodic mandatory rotation of auditors has come.

Restoration of the public's trust in the auditing profession and firms will only be accomplished if they are prohibited from providing services that conflict with their independence, both in fact and appearance. It is common sense. One does not need to be a rocket scientist to understand that an auditor of a company who audits his or her own work, who acts as an advocate for the company or executives they are responsible for testing, who acts in any capacity as an employee or management or has a financial interest or business dealing with the company, will have their independence seriously challenged by just about any reasonably prudent investor. To that end, auditors should be prohibited from engaging in such acts. While some have proposed letting the auditors themselves decide if there is a threat to their independence and then put in place safeguards, we have found in recent years that type of approach has failed. The auditors seldom see a threat, seeing dollars instead, and before you know it, the fox is gone and the chicken coop empty.

But independence should not be just a lesson for auditors. The objectivity of other gatekeepers such as financial analysts and the legal profession need to be enhanced and strengthened as well. In the U.S., ten investment banks were the subject of a large legal and financial settlement with the SEC and attorney general of the State of New York. Yet that settlement only applied to those ten firms, not the thousands of others that have been left to continue their past practices. The reality is, with the financial rewards being as large as they are, systems involving ethics and regulations need to be put in place and then strictly enforced to ensure analysts do their homework, and then provide independent and timely research to investors. This is an area where much work remains to be done in the U.S.

At the same time, we are debating the role of the legal profession in the financial scandals. The general counsel for Tyco is on trial while counsel at Parmalat is under investigation. Corporate counsel and their roles at companies such as Enron, Worldcom and Spiegal have also come under scrutiny. While the legal profession clearly has a role as a staunch advocate for their client, they are nonetheless the one profession in the business of justice. Accordingly, wise minds must find a way to ensure the profession serves justice and not just those who sign the checks.

Sixth, the independence of those who make the rules, be it accounting standard setters or regulators, needs to be paramount and unquestioned. Those responsible for the independence of the standard setters must protect it with the passion of a zealot. This is an unending task as we see today with certain European financial institutions and the European Commission compromising the principles of the IASB when it comes to reporting financial instruments. Likewise, the high technology industry and some members of the U.S. Congress are attempting to compromise the FASB in its quest to require expensing of stock options. Yet, we have seen all too clearly in the U.S. what the costs are to the capital markets when independence is lost and congressional votes are sold to the highest bidder.

Seventh, investors should have a voice in the corporate boardroom of underperforming companies when the executives and boards become entrenched and unresponsive. In those situations, the investors in the company should be permitted to nominate their own slate of directors, using the same resources and processes available to management and the board. By giving the investors a chance to institute change in those limited situations, it creates an incentive for companies to fulfill their obligations to their investors.

Eighth, adequate internal controls are necessary to ensure the accuracy and adequacy of disclosures, as well as compliance with all laws and regulations. In the U.S., such controls were mandated by legislation adopted in 1977 after disclosure of hundreds of corporations engaging in improper payments. When hundreds of financial institutions failed in this country in the 1980's, costing the taxpayers half a trillion dollars, they were required not only to have the controls in place and operating, but also to have their independent auditors test and report on them.

More recently, with over one out of every ten companies having to redo their financial statements, our Congress has once again required companies to have their internal controls in place, operating effectively with both management and the independent auditor reporting on those controls to the investing public and regulators. Surprisingly, the Financial Executives International has long urged companies to report on their internal controls to their investors. However, that sound recommendation fell for the most part on deaf ears. Indeed, based on the whining we have heard from some in the business community here, one wonders just how many companies have had effective systems of internal controls in place. While businessmen have complained about the costs they are incurring to make their internal controls adequate to provide information necessary for investors, and quite frankly successful management of the company, those same businessmen fail to note the hundreds of billions of dollars lost by investors, and the resulting impact on our economy. While they say legislation should “do no harm” to business, they have failed miserably to ensure business does no harm to investors.

Ninth, we need to see stronger enforcement in all areas affecting the financial markets. From enforcement of accounting, auditing and disclosure rules, to independence standards, to ethical conduct, to fiduciary responsibilities of boards and gatekeepers, law enforcement agencies need to take more timely and rigorous action against those who fail in their legal or fiduciary responsibilities to investors. When laws are broken, action needs to be taken promptly so as to keep a level playing field for those who chose to play by the rules.

As many global businesses have a significant portion of their operations outside of the country they are domiciled in, the regulators need to find ways to more effectively and efficiently cooperate and prosecute illegal behavior when it occurs. It is no longer acceptable in a global society for one regulator alone to investigate and prosecute cases such as Enron, Parmalat, Shell or Nortel. Those who chose to ignore the law need to understand the policeman is just around the corner. As I have said in the past, there is nothing like the picture of a stout oak tree and ten feet of rope to influence one’s thinking when contemplating the law.

This also means that those who fail in their obligations and responsibilities should not be given immunity from penalties associated with their behavior. For example, in some countries the accounting profession has asked for limits to their exposure to lawsuits by those who have suffered damages, including when the auditor failed in their profession responsibilities. On this point, I believe the European Commissioner, Fritz Bolkenstein, has it right. He has noted that exposure to that liability does have an impact on auditors when they contemplate the work they need to perform. If an auditor is able to escape meaningful responsibility for their product, one can only wonder what the quality of the product will be in the future.

Tenth, finally and foremost, the mission of those responsible for the capital markets must be based on and driven, just as it is with every successful business, by the quality of the product needed and desired by the end customer. When a business fails to deliver a product its customers demand, it becomes a dinosaur. Likewise, in a globally connected world of international trade, finances and markets, those who deliver the highest quality product to investors will become the successes of the future. Those who don't will become extinct.

Thank you.