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Mr. Chairman and members of the House Committee on Financial Services, I am pleased to have the opportunity to express our views on how corporate governance issues impacted on the demise of Enron, and on which corporate governance improvements in that area would be helpful.

My name is Peter Clapman, Senior Vice President and Chief Counsel for corporate governance of TIAA-CREF. TIAA-CREF is the largest private pension system in the world, providing retirement and other benefits for the educational community, with approximately $275 billion under management. We also sell mutual funds and other financial products to the general public.

I have managed our corporate governance program for a number of years. In recent years, I also have been working on the global dimension of corporate governance. Currently I am chairman of the International Corporate Governance Network, an organization with 250 members worldwide with combined assets of approximately $12 trillion under management. Until recently, US corporate governance was regarded as the most protective of shareholder interests in the world. That high regard is now being challenged by events such as the Enron collapse.

TIAA-CREF LEADERSHIP ROLE IN CORPORATE GOVERNANCE

TIAA-CREF has been a leader in corporate governance for many years. We are convinced our initiatives to improve corporate governance will produce better returns for our more than 2 million pension participants and shareholders. We also believe it is our responsibility to monitor the managements of our portfolio companies and hold them accountable. Fulfilling this responsibility includes conscientious use of our proxy vote, and proactive efforts to encourage better governance standards generally and in particular at our portfolio companies.

Strong corporate governance is particularly a concern for CREF, our public equity arm, which holds about $150 billion in equity in U.S. and other public companies. It has to be understood that, unlike other groups that have dealings with the corporation, common shareholders do not have contractual protection of their interests. They must rely on the board of directors—whom they elect—and on the governance structure of the corporation to protect their interests. Over the years many shareholders have followed the practice of simply selling stock in companies in which they did not have confidence in management and in governance arrangements. CREF long ago found this response inadequate, both because the exercise of shareholder responsibilities is important for the proper functioning of the overall system, and because CREF was so large that limitation of investments posed problems. By the early 1970s, CREF had concluded that it was important to exercise its ownership responsibilities by using its proxy vote consistently and conscientiously and by advocating good corporate governance. Today, a major component of our equity investment is indexed, meaning that we maintain our investments in each company for the long haul. We are long-term investors through our common stock holdings in about 3,000 U.S. and 1,500 non-U.S. companies.

THE CRITICAL ROLE OF THE BOARD OF DIRECTORS

In basic terms, corporate governance is the relationship between the management, the board of directors (including its committees) and the shareholders. Shareholder rights are important in this equation, but the board of directors is the fulcrum for managing this relationship, and for holding management accountable to shareholders. Thus, good corporate governance depends critically on the performance of the board of directors and on its key committees – the compensation, audit and nominating committees. Shareholders do not attend board meetings, and must rely on the quality of board processes. The primary responsibility of the board of directors is to foster the long-term success of the corporation consistent with its fiduciary responsibility to the shareholders. If the board is not independent; if the directors lack the proper qualifications; if the directors do not pay sufficient time and attention to fulfill this role—then, an Enron is not only possible, it is likely. Are there other Enrons out there? We can hope there are not, but prudently cannot trust that will be the case without reforms.

The *TIAA-CREF Policy Statement on Corporate Governance*, our basic formal guidance on these issues, puts great emphasis on the independence of the board and of its key committees. We believe the board should be composed of a substantial majority of independent directors, by a stringent definition, and that the board should have audit, compensation and nominating committees that consist entirely of independent directors. In determining board independence, it is helpful to have strong standards for such independence, that, for example, would exclude individuals with financial ties to top executives (as well as to the company itself). We were heartened over the last few years as the New York Stock Exchange and Nasdaq provide strengthened definitions of independence for purposes of the board audit committee, but the definition should be strengthened further, and extended to the compensation and nominating committees, as well as to the full board.

Independence is a necessary but not sufficient criteria for board success. Board members also need to be qualified, engaged, and dedicated to effective oversight. They must be able to work with each other and with management collegially, while also bringing tough-mindedness and courage to their directorships. This is a challenging assignment, particularly when companies run into difficulty, and the effectiveness of boards—and particularly of individual directors—is hard to evaluate from the outside. In our own attempts to evaluate boards and urge their strengthening, we look at such elements as long-term company performance (which, when consistently subpar and when combined with lack of action to change management, can indicate board passivity); excessive takeover defenses (which can indicate a mindset of management to entrench itself, and of board willingness to protect management at the expense of shareholders); and executive pay practices (which, when marked by clearly excessive pay, dilutive and unfairly enriching stock plans, and loose and subjective bonus awards, can strongly suggest weakness and the need for fresh perspective at the board level).

NEEDED REFORMS

I will now address more fully which reforms are needed and how they may best be accomplished. This includes the proper role of the professionals such as the accountants, the lawyers, the major stock exchanges, the SEC, institutional investors, and the legal system. Also, is there a role for Congress? Our goal should neither be to merely punish the wrongdoers—although that must happen to demonstrate the system does not protect the "mighty"—nor to make board membership so onerous that we discourage such service. Our goal must be to identify those areas of corporate governance that perform badly, and then determine the most efficient and effective means to improve the governance system.

CONFLICTS OF PROFESSIONALS

One area that must be addressed is the conflicts within the key professions. Too often accountants and lawyers ostensibly representing the company in fact wind up representing only its senior management. Such conflicts were at the heart of the problems at Enron. The professional organizations themselves must do a better job through education and discipline to minimize these abuses.

Related to this is the imperative that boards control—and not cede to management—their relationships with professional advisors. Boards must properly exercise authority over appropriate areas of their responsibility. This includes, perhaps foremost, control of the relationship with the outside auditor.

The conflict issues inherent in some of the non-audit relationships of accountants played an important role in the Enron story. Congressional hearings have uncovered that the accounting practices of Enron were recognized by Enron auditors early on as aggressive and creative, terms not usually used as a mark of respect. Later, these financial statements were shown to be incorrect, requiring a restatement. It seems clear that the audit firm in this case demonstrated its primary loyalty to senior management. If accounting practices were aggressive and creative, these facts should have been immediately reported to the audit committee and the board. Subsequently, these facts should have been disclosed to the market. Disclosure is critical here. In the aftermath of Enron, the market showed its skepticism of accounting practices across the board, as many other companies were viewed with suspicion. It should be added that the conduct of inside and outside counsel of Enron raised similar conflict issues.

The board and the outside auditor should both see to it that in fact as well as appearance the outside auditor reports only to the independent board audit committee, acting on behalf of shareholders. A key reason why the fact of consulting contracts and other non-audit work awarded to the audit firm is troubling—a reason that many have overlooked—is that while the audit committee is formally (and should be in fact) responsible for hiring and firing the outside auditor, management controls virtually all the other types of work that firm may do for the company. These contracts therefore help to blur the reporting relationship, and it is difficult to believe that auditors can totally put aside awareness of the extent to which the success of their firm, and even their own compensation packages, may be tied to services being provided by their firm to management of the company in question.

More generally, we think that auditor independence from management is important to investor confidence in the reliability and transparency of corporate financial reporting. Aside from the issue of non-audit fees to the auditor, we believe that companies should consider rotation of auditors, and of limitations on hiring executives from the ranks of their audit firm (something that apparently was quite common at Waste Management and Enron). In his testimony before the Senate Banking Committee on February 27, TIAA-CREF Chairman and CEO John H. Biggs noted that we have a rule excluding the outside auditor from other work for TIAA-CREF, and that we consider the rotation of the auditor after a five- to ten-year period. As Mr. Biggs said, we believe the rotation policy has been successful and highly energizing for our financial management work, and that costs of such a policy can be managed.

Finally, another step that a board can take to enhance the independence of their outside auditor is to institute explicit policies limiting hiring of company finance staff from the ranks of the outside auditor. If the career path of individuals on the outside audit team lead directly to the company being audited, the independence of the auditor can be compromised.

REGULATION OF ACCOUNTING PROFESSION

The regulation of the accounting profession demands change and already excellent proposals have been made. In his Senate Banking Committee testimony, TIAA-CREF Chairman and CEO John Biggs urged among other things that an independent board oversee the accounting profession with its own funding and with the legal authority to enforce rules and regulate wrongdoing. He suggested that this is one area where Congressional action may be appropriate, to assure that the disciplinary board will have a clear public mandate. There is fear, as Columbia University Law Professor John C. Coffee has stated, that "Three years from now, when nobody is paying attention, a private board can just let things slide." Moreover, the investigative authority of a new accounting regulatory body needs to be clear-cut, and not simply a derivative of the SEC. Accounting firms must know that they cannot refuse to open their books or prevent their staff from cooperating with the new agency. Moreover, as Mr. Biggs testified, the new agency should have a reliable funding source that does not come from the accounting profession on a voluntary basis. We also should end what he called the "tin-cup" process now used for support of the Financial Accounting Standards Board and the International Accounting Standards Board.

EXECUTIVE COMPENSATION: STOCK OPTION ACCOUNTING, NEED FOR SHAREHOLDER APPROVAL

Related corporate governance reforms that are needed relate to executive and director stock ownership, executive compensation, and the use of stock options. President Bush and SEC Chairman Harvey Pitt have proposed a simple and crucial reform in this area, with a new rule that would require prompt disclosure of executive stock sales. Under present rules, if the executive sells stock to the company directly, it need not be reported for a period that can stretch more than a year. The President's proposal would require disclosure of <u>all</u> stock purchases and sales by executives and directors within two days after the fact, which will be very helpful.

But there is a more fundamental problem here with reference to stock options. Options can be a very useful tool for management and of great value in providing some alignment of managerial and employee interest with that of shareholders. But options are overused and at times abused, we believe, with the accounting rules largely to blame. The true costs of fixed price options escape the earning statement, encouraging this overuse. Financial statements thus obscure transactions rather than provide full disclosure about them.

FASB and the SEC have taken important steps to enhance disclosure of stock option plans, including a new SEC rule that will kick in later this year that will provide greater transparency on potential dilution from stock option plans. But in our view, the fact that most companies shield the earnings statement from the impact of stock options has a huge behavioral effect on boards and management, which are very focused on enhancing that earnings number. We have been told repeatedly by companies that they would not consider expanded use of alternatives to fixed-price stock options—which get this preferential accounting treatment—because of the accounting hit they would take. The accounting tail is wagging the dog here. Optimal compensation strategies, which could include more cash compensation, or pay in restricted stock or a variety of performance-based programs (including stock options tied to an index such as the S&P 500, which would reward only above-average performance), may be sacrificed in the interest of protecting that earnings figure.

The perversity of the current system is revealed by the number of companies in the last year or so that have repriced their stock options—setting new, lower exercise prices because of the declines in their stock prices—in a manner that is manifestly worse for shareholders, but that escapes taking an accounting charge. In the last year, more than 100 companies, according to proxy advisory firms, have cancelled stock options with a promise to issue new options in six months plus one day, which permits this repricing without taking an accounting hit. This creates an incentive for executives and others receiving these options—even outside directors in some cases—to reduce the stock price in the short term, so that the new exercise price, which is the market price six months and one day out, will be as low as possible.

Moreover, shareholders are not always allowed to vote on stock option plans. Increasingly, companies are adopting plans that meet loose stock exchange rules for "broad-based" stock option plans that can be implemented without shareholder approval. The lack of accounting and increasing lack of control by shareholders are a major structural failure of our corporate governance system.

The reforms needed are (1) require that the cost of stock options be reflected in financial statements, and (2) require shareholder approval for dilutive stock option plans, thus introducing greater accountability in this most important area of executive compensation.

WHERE WILL REFORM COME FROM?

- **Role of National Stock Exchanges**

As a group, the national stock exchanges—the New York Stock Exchange, NASDAQ and the American Stock Exchange—must be an important engine for needed reform. The exchanges, however, have dual objectives as organizations. While they must regulate companies and brokers in the public interest, they also as businesses seek listings from the very companies they must regulate. Nevertheless, listing must be meaningful in terms of the quality of corporate governance practices. To the credit of Chairman Harvey Pitt, the SEC has already requested that the exchanges evaluate which corporate governance reforms are necessary. The exchanges must respond by imposing stronger standards of independence, requiring shareholder approval of all material equity compensation plans, promoting education of directors, and more stringent policies to ferret out conflicts of interest. If the exchanges fail to act, the SEC using its regulatory powers and persuasive influence should press for needed reforms.

- **Education of Directors**

The education of directors is a major concern. Not all individuals are qualified to be directors in today's complex market place simply because they are asked to serve. Directors on audit committees only recently had to meet a standard of financial literacy---literally to have the ability to understand a financial statement. We believe directors on compensation committees at times do not take a pro-active role on behalf of the company because they lack understanding of compensation issues and do not obtain independent consultants when needed. The abuse and overuse of stock options, with the lack of complete and transparent reporting of the cost, is a product in part of inadequate performance of compensation committees and the board as a whole.

- **Role of Congress**

What is the role for Congress? It is not clear how many new laws are needed. But your oversight role is critical. At some point, memories of Enron may fade as other issues take center stage. But the corporate governance problems that Enron's downfall revealed will still be there unless properly remedied. It is important that the reforms being suggested not lose their momentum.

CONCLUSION

I have outlined a number of corporate governance problem areas where I believe reform is both possible and necessary, including:

- Conflicts of Professionals
- Regulation of Accounting Profession
- Executive Compensation: Stock Options
- Role of Stock Exchanges
- Education of Directors

You may be sure that TIAA-CREF, as an organization will continue to press for these reforms. We hope that the current widespread public interest in such issues will produce the necessary impetus for these reforms.

Thank you for giving me the opportunity to comment on these matters.