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Good morning, Chairman Oxley and Congressman Frank. My name is Richard Trumka and I am the Secretary-Treasurer of the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO). On behalf of the AFL-CIO and our affiliated unions' 13 millions members, I am pleased to have the opportunity to participate in these hearings to mark the second anniversary of the "Public Company Accounting Reform and Investor Protection Act of 2002," better known as the Sarbanes-Oxley Act. This Act is the cornerstone of a dramatic reform effort over the last several years addressing both corporate governance and capital market regulation. That effort is unfinished, and there are those who would undo the good that has been done already. But two years after its enactment, the Sarbanes-Oxley Act remains an outstanding example of government acting in the public interest.

Union members participate in benefit plans with over $5 trillion in assets. Pension plans sponsored by unions affiliated with the AFL-CIO hold almost $400 billion in assets, and union members also participate in the capital markets as individual investors. America's working families' retirement security is, in large part, dependent on the integrity of our capital markets. Consequently, the systemic failures in our corporate governance system led to serious losses for union members' pension funds—we estimate more than $35 billion in losses in Enron and Worldcom alone.

But for those with the bad luck to work directly for companies like Enron and Worldcom, the consequences were far more serious—lost jobs, lost health care, and for many the complete loss of their 401(k) retirement savings, invested at the urging of their employer in what ultimately became worthless company stock.

The AFL-CIO came to the aid of the laid off non-union employees at Worldcom and Enron, helping them to win more than $100 million in severance to which they were entitled. But the labor movement recognized that this victory addressed only a fraction of the harm done, and that systemic corporate governance and capital market reform was necessary to restore confidence in our capital markets and to ensure others did not go through the experience the Enron and Worldcom workers endured.

And so in the wake of Enron and other corporate scandals, the labor movement strongly backed the reform legislation that became the Sarbanes-Oxley Act. We were particularly pleased that the Act addressed many of the systemic issues we urged this Committee and the SEC address in our December, 2001 testimony on Enron's collapse—issues like auditor and director independence.[1]

I would like to review the key features of the Act that have markedly improved investor protections.

- the Act puts an end to most consulting by public company audit firms;

- the Act created the Public Company Accounting Oversight Board, which after a controversial start has proven to be a strong, yet flexible independent regulator;

- the Act requires independence and expertise on company audit committees, and makes clear the importance of strong and independent boards generally;

- the Act bans loans to insiders at public companies, putting an end to a key executive compensation abuse; and provides for disgorgement of executive stock profits in certain circumstances; and

- in a variety of ways, the Act reinforces the fundamental principle of our securities law—that companies must disclose to investors what a reasonable investor would want to know before making an investment decision, and that the obligation to do so truthfully rests on senior management.

But the success of Sarbanes-Oxley stems not only from the specific provisions of the Act, but also from the tone it set and the message it sent. Since passage of this landmark legislation, these provisions have been impressively augmented by the work of the SEC, the Public Company Accounting Oversight Board the Act created, the regulatory arms of the major exchanges, and the work of state attorneys general, most notably Eliot Spitzer of New York. Equally importantly, the message was heard in corporate boardrooms across the country.

In the two proxy seasons since the Act passed, investors acted themselves to push companies to have really independent boards, to reign in executive pay, and to manage their audit process more effectively. The AFL-CIO is very proud of the role that unions and worker pension funds have played in these efforts by sponsoring 360 such proposals, 48 of which received majority votes at company annual meetings. These proposals led to real changes in executive compensation at companies like General Electric, Coca Cola, Tyco, Hewlett-Packard and Alcoa.

Of course Sarbanes-Oxley has its critics. Many companies seem unhappy with the Act's requirement in Section 404 that companies strengthen their internal controls, together with the PCAOB's regulations addressing this area.[2] Even the new administration at the New York Stock Exchange has spoken out on this subject. These critics say that having outside auditors certify that a public company has adequate internal controls is too expensive.

[1] Testimony of Richard L. Trumka before the House Financial Services Committee on the Impact on Markets of Enron Bankruptcy, December 11, 2001.
[2] See Judith Burns, "Is Sarbanes-Oxley Working?" *Wall Street Journal*, June 21, 2004.

But I can tell you as the chief financial officer of the AFL-CIO that proper financial controls are critical to the responsible management of any large organization. The events of the last few years have shown the need to strengthen these controls at public companies, and to give company management who are trying to do the right thing some guidance as to what are appropriate safeguards.

Of course there is no question that compliance with Sarbanes-Oxley imposes real costs on American business. But there is ample evidence that incurring these costs is better than the alternative. Last year, internal control problems were reported by outgoing auditors at 58 public companies -- six percent of companies that switched auditors.[3] A recent survey found that after an initial investment of approximately $5 million, large companies expect to spend roughly $1.5 million a year to comply with Section 404.[4] Though $1.5 million may sound like a substantial sum, each of the S&P 500 companies could spend a hundred times that sum and the cost would still be less than the direct shareholder losses associated with Enron or Tyco.[5] A Financial Executives Institute study found that the first-year cost of Section 404 compliance was less than one percent of revenues,[6] and much of this was a one-time investment.
It is often noted that General Electric spent $30 million last year upgrading its internal controls to comply with Section 404. Few, however, mention that General Electric Chief Financial Officer Keith Sherin has said he is pleased with the results: "We have seen the value in the 404 work. It helps build investors' trust and helps give them more confidence," reported Sherin.[7] Likewise, Jeff Henley, Chairman of Oracle, said new internal control drills were worthwhile, despite the cost.[8]

Critics also allege that Sarbanes-Oxley deters companies from going public or from listing on US stock exchanges. New York Stock Exchange Chairman John Thain, for example, has blamed Sarbanes-Oxley and the PCAOB for the fact that fewer foreign companies are choosing to list their shares on the Big Board.[9] However, NASDAQ CEO Robert Greifeld has pointed out that Sarbanes-Oxley has not deterred foreign companies from listing on *his* exchange.[10]

The managers of some small public companies have announced plans to go private, blaming the expense of Sarbanes-Oxley compliance. We do not view this as an unwelcome development, since we believe many of these companies should never have been public in the first place. During the technology boom, many immature and unprofitable companies participated in initial public offerings, and most of these did not fare well when the market collapsed.[11] In any case, the *New York Times* reports that while some companies are going private to avoid the tougher

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[3] Adrian Michaels, "Survey Reveals Changing Culture at Big Four Firms," *Financial Times*, February 9, 2004.
[4] Paul Volcker and Arthur Levitt Jr., "In Defense of Sarbanes-Oxley," *Wall Street Journal*, June 14, 2004.
[5] Direct shareholder losses from the Enron and Tyco scandals were each in the $90 billion range, which is more than $150 million multiplied by 500. (Paul Volcker and Arthur Levitt Jr., "In Defense of Sarbanes-Oxley," *Wall Street Journal*, June 14, 2004; Anthony Bianco, William Symonds, and Nanette Byrnes, "The Rise and Fall of Dennis Kozlowski," *Business Week*, December 23, 2002).
[6] Judith Burns, "Is Sarbanes-Oxley Working?" *Wall Street Journal*, June 21, 2004.
[7] "Corporate Regulation Must Be Working -- There's a Backlash," *Wall Street Journal*, June 16, 2004.
[8] Adrian Michaels and Dan Roberts, "Compliance Brings Business Benefits," *Financial Times*, April 23, 2004.
[9] John Thain, "Sarbanes-Oxley: Is the Price Too High?" *Wall Street Journal*, May 27, 2004.
[10] Andrei Postelnicu, "Sarbanes-Oxley Act 'not harming Nasdaq'," *Financial Times*, June 1, 2004.
[11] Stavros Peristiani and Gijoon Hong, "Pre-IPO Financial Performance and Aftermarket Survival," *Federal Reserve Bank of New York Current Issues in Economics and Finance*, February 2004.

accounting standards required under Sarbanes-Oxley, other private companies are adopting these standards voluntarily.[12]

The attack on Section 404 and its implementing rules is only the latest example of a series of unwarranted criticisms directed against the Act. Before the law was passed, its opponents warned that audit fees would skyrocket, a prediction that has not been borne out. Even including one-time implementation costs, Glass Lewis found that audit fees at large companies rose just 16 percent in 2003.[13]

Similarly, those who opposed the Act's independent director requirement warned the Act would interfere with the functioning of public company boards. Instead, a recent survey of directors by *Corporate Board Member* magazine found that over 70 percent thought Sarbanes-Oxley had had a positive effect on their boards -- and this is the view *inside* boardrooms.[14] And another recent study found (not surprisingly) that the greater the number of independent directors on a board and its key committees, the lower the likelihood of corporate fraud.[15]

Senator Sarbanes recently noted that "the job is not done."[16] One could come to that conclusion simply by looking at the data on issues like financial statement integrity. Last year, for example, a record 206 public companies revised their annual financial statements, according to preliminary figures compiled by the Huron Consulting Group;[17] and PCAOB Chairman William McDonough announced last month that his examiners are still finding significant problems with auditor compliance.

But there is a deeper sense in which corporate reform is an unfinished task. Our corporate governance and capital market system is supposed to result in investors and company management having the information and the incentives to make decisions that create value in the long run for our society in the form of jobs, profits, and economic activity. In recent years, that system failed to function at multiple levels. Sarbanes-Oxley addressed some of the most egregious aspects of that failure—compromised public company audits and weak audit committees, corporate executives who did not take responsibility for their financial statements, and corporate lawyers who looked the other way while their client, the corporation, was harmed. The Act was passed at a time of crisis, when many doubted the reliability of any U.S. company's financial statements, and it was designed to address that crisis.

However, the job begun by Congress in 2002 is not complete, and, as a result, fundamental root causes of the corporate governance crisis remain unaddressed. In the remainder of my testimony, I would like to lay out some key elements of what remains to be done.

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[12] Anne Field, "Some Private Companies Embrace Tougher Rules," *The New York Times*, July 15, 2004.
[13] Gretchen Morgenson, "Counting the Hats on Auditors," *The New York Times*, June 27, 2004.
[14] Paul Volcker and Arthur Levitt Jr., "In Defense of Sarbanes-Oxley," *Wall Street Journal*, June 14, 2004.
[15] Hatice Uzun, Samuel H. Szewczyk, and Raj Varma, "Board Composition and Corporate Fraud," Financial Analysts Journal, May-June 2004, as cited in the Wall Street Journal, "Two New Studies Could Provide Ammo Vs Governance Backlash," June 29, 2004.
[16] Judith Burns, "Is Sarbanes-Oxley Working?" *Wall Street Journal*, June 21, 2004.
[17] Jonathan D. Glater, "Financial Restatements Rose To Record in 2003, Study Says," *The New York Times*, January 13, 2004.

First, our legal system continues to suffer from real deficiencies in the extent to which both individuals and institutions can defraud the investing public and get away with it. In many circumstances lawyers, accountants and investment banks can still aid and abet companies that commit securities fraud and enjoy immunity from investor lawsuits. This is wrong, and really only Congress can fix it.

There are also areas where the Private Securities Litigation Reform Act ("PSLRA") has made it easier to defraud the investing public and get away with it. Sarbanes-Oxley addressed one such area by lengthening the statute of limitations, but there are others such as the PSLRA's repeal of joint and several liability for securities fraud and the blanket immunity it grants for "forward looking statements" that remain. Again, these problems with the PSLRA can only be addressed by Congress.

However, as important as litigation can be to both deterring corporate wrongdoing and dealing with its consequences, it cannot substitute for real working corporate governance and accountability on the part of company management. And as long as CEO's dominate the selection process for company directors, we simply will not see at problem companies the kind of vigorous independent boards that we need and that Sarbanes-Oxley called for.

That's why the labor movement believes the most important effort now underway to address the continuing governance problems at our public companies is the SEC's rulemaking initiative to give long-term investors with a substantial stake in public companies the right to have their board nominees included on management's proxy.

Today, it is practically impossible for even the largest long-term investors -- the TIAA-CREF's and CALPERS -- to nominate and run their own candidates for the boards of public companies. So we have elections in name only. At one company we know of, Lockheed Martin, a former Enron director continues to be nominated by management despite unprecedented shareholder opposition, and the only thing shareholders can do is withhold their vote. They have no alternative candidate for whom to vote.

And of course, CEO's know that investors have limited options. They know they can ignore shareholder votes on runaway executive compensation or company audit policies, and there is little that shareholders can do.

Under the current system, directors essentially pick their successors, though companies are required to go through the motions of having a shareholder vote. All it takes is one vote to be elected to a corporate board, and that vote can be the CEO's.

Investors who want to support dissident candidates must shoulder the cost of soliciting votes by mail, since management can exclude opposition candidates from the proxy ballot. Imagine if the same were true of political elections! This is why we strongly support the SEC's proposal to allow candidates nominated by substantial groups of shareholders to appear on proxy ballots that are mailed to all shareholders.

The Commission's proposed rule is a moderate proposal that gives long-term investors the right to nominate one or two directors, facilitating independent voices but not subsidizing takeovers. The proposed rule includes serious hurdles before this right can be exercised. For example, the SEC would limit who would be allowed to nominate candidates, and under what circumstances. For example, shareholders with a longstanding, significant ownership stake in a company might be allowed to place an opposing candidate on the proxy ballot if more than 35 percent of votes were withheld from the incumbent in the previous election. Such a high "no" vote is a rare occurrence and generally signals a deeply troubled company. Last year, for example, directors at fewer than five percent of large companies received such a vote of no confidence.[18] And, of course, any successful candidate under the rule would have to receive the votes of more shareholders than management's candidate received.

The Commission's proposed rule on proxy access is an example of real bipartisan leadership, and it received more public comment than any other proposal in the Commission's history—over 14,000 comments, the overwhelming majority supporting the Commission's rule.

In recent weeks, the press has reported that there is internal division within the Commission on this rule, perhaps as a result of the extreme pressure being brought to bear by the CEO community and its political allies. In that context we were very pleased to note the recent statements by the Division of Corporation Finance that the Commission remains focused on bringing a final rule to a Commission vote in the near future. At the end of the day there is no way to have corporate boards that are accountable to long term investors if long term investors have no economical way to select board members.

Finally, I would like to note that despite everything that has happened, we still have inadequate disclosure to investors of the facts of executive pay and what financial impact that pay has on the companies that award it.

The most important step in this area is the proposal by the Financial Accounting Standards Board ("FASB") for mandatory stock option expensing. The fact that stock options do not have to be deducted from earnings as a compensation cost has encouraged their overuse for executive compensation and has widened the pay gap between executives and ordinary workers. Stock options create perverse incentives that are not in the best interests of shareholders -- promising all the benefit of share price increases with none of the risk of share price declines. Most importantly, options reward short-term decision-making, and, as Enron demonstrated, create a strong incentive to manipulate company stock prices through creative and even fraudulent accounting.

This is an area where FASB has known the right answer for more than a decade, and yet at every turn has been prevented by political pressure from restoring integrity to our accounting system in the area of executive compensation. This week the House appears bent on once again subverting

[18] "Forty-six Russell 1,000 companies had at least one director who received withhold votes from at least 35 percent of those cast at 2003 meetings." (Richard J. Daly, ADP Investor Communication Services, as cited in "Panelists Discuss Proxy Access, Brokers Votes at ASCS Annual Conference," IRRC *Corporate Governance Highlights*, July 9, 2004.)

the integrity of our financial accounting system by giving runaway CEO pay special legislative protection by passing intellectually dishonest and economically irresponsible legislation.

The battle against option expensing is being waged on behalf of CEOs with option megagrants who, frankly, want to hide the true cost of their compensation from their shareholders. According to SEC filings, the CEOs of the eleven public companies who are members of the International Employee Stock Option Coalition ("IESOC") hold on paper a combined $977 million in unexercised stock options.

These CEOs are going against the express wishes of shareholders. In 2003, a majority of shareholders at 30 companies voted in favor of proposals sponsored by worker funds to require stock option expensing. So far in 2004, shareholders at Hewlett-Packard, Intel, PeopleSoft and Texas Instruments have all voted in favor of expensing options, despite strong opposition from management. Intel, for example, is one of eleven companies belonging to the IESOC, and Intel CEO Craig Barrett and Chairman Andy Grove have led the fight against option expensing.

We have waited long enough to close this accounting loophole. The latest rationale for delay being proposed by irresponsible elements in the business community is that companies are still reeling from the cost of Sarbanes-Oxley. This is frankly ludicrous, since the cost of mandatory option expensing is *nil*. Companies are already obliged to calculate the cost of stock options in a footnote, and the only difference is that all companies would now be required to deduct this cost from earnings.

Clearly, as reform efforts get closer to the heart of what has gone wrong in our corporate governance system, resistance from the CEO community intensifies. However, only by truly creating transparency and accountability in the boardroom can the underlying dynamics that brought us Enron and Worldcom be addressed and the purposes of Sarbanes-Oxley be fulfilled.

Yet even though Sarbanes-Oxley is not a completed effort, we should not fail to recognize its enormous contribution to repairing our system of corporate governance, both through its substance and through the message its enactment sent to CEO's and boards, and to the range of institutions charged with administering our corporate governance system. Both Houses of Congress and both sides of the aisle have reason to be proud of the Sarbanes-Oxley Act.

Let me conclude by expressing my deepest appreciation to the Committee on behalf of the working families of the AFL-CIO for inviting the AFL-CIO to appear today, and our hope that we will continue to be able to work together on these vital issues for all Americans. Thank you.