TESTIMONY OF RICHARD L. TRUMKA

SECRETARY-TREASURER, AFL-CIO

BEFORE THE SUBCOMMITTEES ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES AND THE SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

DECEMBER 11, 2001

Good morning Chairman Baker. My name is Richard Trumka, and I am the Secretary-Treasurer of the AFL-CIO. On behalf of the AFL-CIO and our unions' 13 million members, I am grateful to the Financial Services Committee for affording us the opportunity to express our views on the implications of the collapse of Enron. In particular I would like at the outset to commend this Committee and Chairman Baker in particular for his leadership in calling this hearing and his foresight in looking at the issue of analyst independence last summer. As I will describe below, that issue is a significant part of what went wrong at Enron.

My purpose in appearing here today is threefold. First I would like to give the committee some sense of the impact the collapse of Enron has had on workers trying to invest for their retirement, and on unions and employers trying to help workers achieve retirement security. Second, I would like to take a moment or two to talk about why Enron collapsed, and the links between Enron's collapse and the issues that were already facing this Congress on the day the Enron disclosures began. Finally, and perhaps most importantly, there is a clear regulatory agenda that the Securities and Exchange Commission and the Department of Labor must take up. Today the AFL-CIO has sent rulemaking petitions to the SEC embodying this agenda of auditor independence and Board integrity. With this Congress' support, the relevant regulatory agencies could take a series of initiatives that would go a long way toward protecting workers' retirement security and the investing public from the conflicts of interest that led to the collapse of Enron.

We are here today because Enron's bankruptcy was of a size and speed not experienced since some of the famous debacles that followed the Great Crash of 1929. And we must begin by recognizing that its collapse has had a real impact not just on big Wall Street firms, but on millions of working people and their pension funds.

This is a catastrophe rich in irony. Enron was a company that talked about a future of transparent markets, but whose CFO openly bragged to the financial press that its own accounting was a black box, saying "We don't want anyone to know what's on those books. We don't want to tell anyone where we're making money."[1] This was a company that complained about the costs of corruption in the global economy, but made campaign contributions an integral part of its business strategy; a company whose own governance was a web of conflicts of interest that completely stymied the protections our legal system provides investors. And finally this was a company whose mantra was deregulation and privatization, but which has ultimately become an advertisement for why workers need both defined benefit pension plans and a Social Security system safe from the conflicts of interest rampant in the capital markets.

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We must, however, begin with those who have been hurt worst and most unconscionably by the conduct of the Board and officers at Enron--the employees of Enron, more that 5,000 of whom have already lost their jobs, and more than 12,000 of whom participated

in Enron's 401(k) plan.[2] Enron's contribution to these employees' retirement security was to donate stock to their accounts and to encourage employees to put their own savings into company stock as well. They appear to have done this without even giving their employees a prospectus, as required under current law.[3] The result was that on the eve of the collapse over half of the assets of Enron's 401(k) were invested in the company's stock, and many individual workers had all of their 401(k) assets in company stock.

Then on October 17, 2001, the same day that the Securities and Exchange Commission announced it was investigating Enron, the company chose to implement a plan to switch 401(k) administrators, knowing that their decision would freeze employees' accounts, leaving them unable to get out as the stock price went into freefall.[4] Meanwhile the insiders continued their insider selling, selling that netted a handful of people over $1 billion.[5] The blackout continued for three weeks, two weeks longer than the industry standard for such a change, according to Plan Sponsor magazine.[6] Then at the end of November when the market price of Enron's stock was under $1, Enron placed shares of stock it had purchased earlier this year into the frozen accounts and charged employees' accounts $61 per share. The final insult was that as Enron laid off thousands of employees, management tried to extort waivers of 401-k claims by threatening to withhold portions of worker severance payments.[7] Now Enron employees' only hope of recovering the retirement money they entrusted to their own company lies in the hands of the courts. And frankly, there does not appear to be sufficient assets available to come anywhere near close to the claims against the company.

Ironically, Congress passed the Employee Retirement Income Security Act (ERISA) to prevent situations in which corporate bankruptcies meant workers lost their jobs and their pensions, just like what happened to thousands of workers at Studebaker in the 1960s. Decades later, thousands of Enron employees find themselves in the same position.

I focus particularly on these workers because, unlike most other investors in the company, by and large Enron workers did not have diversified portfolios. The bulk of their retirement savings was in Enron stock. Many of the 1,000 members of the International Brotherhood of Electrical Workers at Enron's subsidiary Portland General Electric have suffered catastrophic losses, members like Roy Rinard, who watched helplessly, his accounts frozen, as his twenty two years of retirement savings dwindled from $472,000 to less than $3,500. Ken Kahloni, a former information and technology manager at Enron, lost $75,000 in his 401(k). He said, "I took a pay cut to work there two years ago, because I wanted to work for the 'best company.'"

But the harm Enron's collapse has caused America's working families by no means stops there. Workers' retirement funds have lost tens of billions of dollars in the collapse of Enron. Earlier this year, Enron was the 7th largest company in America measured by revenue.[8] Enron's equity at its peak was worth about $63 billion, and its bonds another $6 billion more. There was almost twice as much money invested in Enron stock than in General Motors stock.[9] Most pension funds and institutional investors held some Enron

stock or bonds. If any person in this room has an S&P 500 index fund in your 401(k) or your mutual fund portfolio, you lost money in Enron-- probably about half a percent of your total assets in that fund. And this is if you invested in index funds-- in a strategy that is designed to cheaply mitigate the risks of investing in any single company.

Let me give you some examples of the monies lost by pension funds. The Amalgamated Bank of New York, a major index fund manager for union and public pension funds, has filed court papers stating index funds it sponsored lost approximately $10 million in Enron equity and debt.[10] The Georgia State Board of Investment has said in court that it has the largest losses. Filings by major commercial money managers with tens of billions of dollars of worker retirement money under management such as Alliance, Janus and Fidelity suggest each has losses in the hundreds of millions of dollars.[11] Most of this money is being invested to fund pension benefits for working families-- for the public employees we are counting on to protect us during this period of national crisis, for the pensions of the iron workers who are as we speak clearing the rubble at Ground Zero, for the firefighters who today, as on September 11, stand ready to give their lives to save ours. Because of the way that our retirement system has become increasingly interwoven with the capital markets, practically every American fortunate enough to be able to save for retirement in any form was hurt by the collapse of Enron.

In part, the moral of this story is that conflicts of interest in the capital markets can do a lot of damage to America's working families. Currently, Congress is considering

legislation sponsored by Rep. Boehner that would remove the ban on conflicts of interest in the provision of investment advice to 401(k) participants.[12] Mr.Boehner's bill would leave 401(k) participants prey to the same conflicts that have so distorted the analysis of individual stocks, and as Enron shows, conflicts of interest can truly harm 401(k) participants' retirement savings. Similarly, consider how much worse this situation would be for Enron employees if their Social Security benefits had been invested in Enron, as they would if the privatization advocates had had their way.

Now some may ask, don't people gain and lose money in the markets every day-- isn't the Enron story just a particularly dramatic example of the dynamics of risk and return. Our answer, as stewards of worker capital, is emphatically no-- this is not how the financial markets should work. This is not a story of risk or of ignorance. It is a story of conflicts of interest, of duties breached and duties ignored, of loyalty betrayed. This is a story of vital information whose disclosure might have saved the company being withheld until it was too late. It is a story of people so shameless and greedy that literally as the bankruptcy papers were being drawn up they were still passing what remained of the firm's cash out to themselves--$55 million on the last working day before they filed for Chapter 11.[13]

Now obviously a lot of people have sued in court alleging some of these things. In the end the facts, many of which today are murky, will be sorted out. But even today certain things are clear.

Though Enron began as a utility and pipeline company, and its hard assets remain just that, Enron had become a new kind of financial intermediary. Enron brokered a huge number of contracts allocating price risk and other kinds of risk in an increasingly bewildering array of commodities-- from natural gas and electricity to Internet services to the weather. In that kind of business, a company's most valuable asset is trust-- trust that you are telling all your constituencies the truth, trust that you are a market maker and not merely a gambler. And what seems to have fundamentally happened to Enron is that the company's management abused that trust and ultimately destroyed it. Almost overnight Enron turned from a market colossus with an enterprise value of well over $70 billion to a mere collection of pipes and computer terminals worth considerably less than its debts.

The story of Enron's unraveling begins with self-dealing-- with transferring business out of the company into the hands of related entities that were in large part owned by Enron executives. These transactions were approved by the Board of Directors, the auditors and the lawyers. According to the chairman of the Compensation Committee, Charles Le Maistre, the partnership arrangements served in part to retain executives, saying "We try to make sure that all executives at Enron are sufficiently well-paid to meet what the market would offer."[14] But there was no mention of these transactions anywhere in Enron's extensive disclosure of its already extremely generous executive compensation practices. And the company funds that were put into these partnerships were accounted for as investments, not as payments to executives. These partnerships then went on to

lose Enron and its shareholders over $1 billion.[15] The disclosures around these partnerships and the loss that suddenly appeared on Enron's balance sheet in October was the first of a series of increasingly devastating revelations that both recast the company's historic performance and completely destroyed the credibility of Enron's management.

How was this allowed to happen? Let's begin with the first line of defense when management goes bad-- the Board of Directors. At Enron most of the Board was independent of the company according to the SEC's requirements. But look another layer deeper, as we did after the initial revelations, and you find the majority of the supposedly independent directors were dependent on Enron or its executives-- dependent on them for political support, dependent on them for investment opportunities—and were ultimately unsuited to sit on the Audit Committee or the Compensation Committee. Some of these "independent" directors were actually investing in Enron-sponsored limited partnerships. Is it any wonder that when the crisis began and shareholders needed desperately to hear from outside directors, all they got was silence?

Then there were the auditors. Arthur Andersen was the company's long-time auditor. And until its division into a consulting company and an accounting firm, Andersen had been receiving millions of dollars per year in consulting fees.[16] But even on the accounting side, Andersen marketed a variety of consulting services to Enron, including, many believe, advising Enron on the structure of the special purpose vehicles. So you had an audit firm that was dependent on Enron management for higher margin consulting

services, purporting to provide independent review on behalf of investors of transactions some of which they themselves, may have designed and charged a fee for.

On the subject of auditors, some have suggested that auditors are not able to detect a carefully hidden fraud, one where the truth is completely hidden by management. And that may very well be true, but that was not what happened at Enron. The financial statements themselves contain the proof that the auditors were aware of each of the transactions that led this company to grief—the self-dealing with the CFO, creating partnerships to trade in the company's own stock, other partnerships whose purpose seemed to be to generate dubious revenues, hide liabilities and otherwise bookable derivatives positions from the investing public.[17] While none of these were disclosed in a way to make them transparent to the investing public or to Enron's employees, there was more than enough information in those statements alone to sound warning bells among the auditors that signed off on them.

Then finally there were the Wall Street analysts. Ultimately investors look to the expert analyst community to interpret the numbers released by the companies they invest in. And here we saw again the spectacle of conflict of interest triumphing over duties to investors. Enron was such a large firm doing so much business in the financial markets that practically every Wall Street firm and post-Glass-Steagall commercial bank had an interest in courting the company. And in the eyes of their analysts, Enron was always a good buy. Of course, if you knew enough to seek out independent analysts, many of

whose advice comes with a price tag beyond that of the average 401(k) participant, you would have heard a different story.

As late as October, Salomon Smith Barney, whose parent Citigroup is one of the largest creditors of Enron and a provider of investment banking services, rated Enron a "buy" until October 26, then it went to "neutral" where it remained until the company filed Chapter 11.[18] Lehman Brothers, who stood to earn a large advisory fee if the Dynegy deal closed, rated Enron as a strong buy right through to the end; Lehman Brothers then abruptly dropped coverage of Enron after it filed Chapter 11, stating that the "filing had complicated [the] outlook for [Enron] stock."[19] Out of thirteen analysts that covered Enron in October, according to Forbes Magazine, eleven were bullish.[20] But among eight independent investment newsletters tracked by Forbes, by August, when Enron CEO Skilling mysteriously resigned, four were already bearish and two more went bearish by October.[21]

Finally, the last link that failed was the active money managers. And here again investors faced conflicts of interest, including the same conflicts that compromised analysts. But the most glaring apparent conflict is the case of Alliance Capital, a major manager of worker pension fund assets and its link to Enron through Enron board member Frank Savage, a former senior executive and board member of Alliance. In the second quarter of 2001, while Mr. Savage was an executive of Alliance, Alliance Capital increased its Enron holdings by 71 percent to become the largest Enron shareholder,

while other large investment managers reduced their stake in the former energy giant during the same time period.[22]

The result was that for years the marketplace set the price of Enron's stock artificially based on fictitious accounting, passed on by a conflicted Board and conflicted auditors, and hyped by conflicted analysts. And both sophisticated institutions and the average investor, following the advice of experts, bought at that price. And at least some of us were buying from insiders, who all this past year were unloading stock at an astounding rate.

Of course I have just described what happened before the attempted Dynegy acquisition. In the weeks that followed the announcement, the same dynamics that appear to have prompted the crisis led to the creation of a new myth-- that the problems at Enron were manageable. Many people had an interest in that myth-- most importantly Enron executives, the investment bankers who stood to reap large fees if the deal went through and the commercial lenders whose ability to avoid an Enron bankruptcy depended on steering the company into the Dynegy safe harbor. No one wanted to disclose what the real state of Enron's finances was, clearly because some very scary things were hidden there. But what this secrecy did was make certain that once the news of the extent of the problems began to leak, no one could stop the collapse.

The AFL-CIO and worker pension funds took several steps during the collapse of Enron to try and reform corporate governance and disclosure, and then as the situation worsened to protect workers' investments in the courts. Initially, the AFL-CIO and the Amalgamated Bank, a large index manager of union pension fund assets, reached out to outside directors. We wrote to Enron's Board asking that a special committee of the Board that had been set up and chaired by Thomas Power, Dean of the University of Texas Law School, broaden its agenda from merely investigating specific past transactions to reforming both the company's executive compensation and its audit policies.[23]

When the Dynegy transaction was announced, we again wrote to the Enron Board, pointing out that the markets continued to be in turmoil due to incomplete disclosure and that investors more than anything needed enhanced disclosure both to stabilize prices and to enable investors to evaluate the Dynegy transaction. We suggested the company immediately recruit people with credibility in the capital markets to its Board. We offered to meet with the Board and discuss possible candidates, but never received a substantive reply. Given what we all know now about the lack of independence of the Board, this is no surprise.[24] Copies of our letters are attached.

As the situation deteriorated the AFL-CIO, together with other large institutions, contemplated a state court action to obtain Enron's books and records to be able to evaluate the Dynegy deal. But before we could begin that process the deal collapsed. In

the wake of Enron's bankruptcy, the Amalgamated Bank took the last step remaining open to investors, bringing suit in federal district court in Houston on behalf of Enron's shareholders against both Arthur Andersen and Enron's Board and officers.[25]

The most important lesson to be learned from the collapse of Enron and from our unsuccessful efforts to protect workers' investments is how hard it is to repair the damage done by rampant conflicts of interest aided by regulatory loopholes. We have to get the regulatory system right in the first place. And though the Securities and Exchange Commission has made great efforts in recent years to strengthen investors' regulatory protections, the truth is that too often steps that were necessary have not been taken due to resistance by a variety of entrenched interests. Union pension funds have tried through corporate governance efforts like the building trades funds' support of independent auditors to strengthen these protections firm by firm, but we cannot do it alone.

Therefore, the AFL-CIO is today submitting two rulemaking petitions to the Commission aimed at addressing the structural problems in our securities laws that gave rise to the Enron fiasco, which are attached to our testimony. We ask in these petitions that the Commission act to tighten the definition of who is an independent director, and require the disclosure of the full range of ties that can exist between directors and the corporate officers they oversee. In the accounting area, our proposals address most of the practices I have discussed. Our proposals include a prohibition on accountants reviewing transactions they themselves structured, direct audit committee approval of any auditor

consulting arrangement and the audit engagement itself, and a variety of steps designed to ensure that public auditors are always looking at the firms they audit with a reasonably fresh eye. In addition, I would call your attention to testimony the AFL-CIO has previously submitted to this Committee on the subject of analyst independence and the regulatory changes that could improve that situation that contributed so significantly to the debacle at Enron.[26]

While we do not believe legislation is necessary, the fact is that without Congressional support for these kinds of regulatory changes, the interests that profit from the loopholes that brought us Enron will prevail again, as they so often did in the regulatory fights of the 1990's. We hope very much that Chairman Harvey Pitt takes up the agenda embodied in our rulemaking, but frankly we know he cannot do so successfully without the support of this Committee and your counterparts in the Senate.

I urge this Committee and this Congress to support both the Administration's enforcement actions against Enron and its Board and executives, and to urge the SEC and the Department of Labor to step forward and act against the rampant conflicts of interest and the defects in our disclosure system that gave us the Enron debacle. Our funds will fight as hard as we can to get our money back. But the truth is only strong government action can ensure that investors are not victimized again in this way. The AFL-CIO looks forward to working with you in the coming days on these important tasks. Thank you.

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1 "Is Enron Overpriced?", by Bethany McLean. *Fortune*, March 5, 2001, Pg. 122.

[2] "Enron: Let Us Count the Culprits." *Business Week*, December 17, 2001, pg. 154

[3] Roy E. Rinard and Steve Lacey, v. Enron Corp. and the Northern Trust Company, Class Action Compliant Filed in the United States District Court Southern District Of Texas.

[4] "Enron Faces Suits by 401 (k) Plan Participants," by Theo Francis and Ellen Schultz. *The Wall Street Journal*, November 23, 2001

[5] Amlagamated Bank et. al. v. Kennath L. Lay et. al. Cass Action Complaint Filed in the United States District Court Southern District Of Texas.

[6] "Recordkeepers: Blackouts can be Shorter," *PlanSponsor.com*, December 10, 2001.

[7] "Enron asks Staff to Drop 401 (K) Suits for Severance," *Wall Street Journal*, Nov 29, 2001, page C13.

[8] "Power Failure: As Enron crashes, angry workers and shareholders ask, Where were the firm's directors? The regulators? The stock analysts?," by Daniel Kadlec. *Time Magazine*,
December 10, 2001, Pg. 68.

[9] As measured by market capitalization on December 29, 2000.

[10] Amlagamated Bank et. al. v. Kennath L. Lay et. al. Cass Action Complaint Filed in the United States District Court Southern District Of Texas.

[11] Alliance, Janus and Fidelity Investments were among Enron's five largest shareholders as of September 1, 2001, as reported in "Enron: Running On Empty As The Collapsed Energy Giant Seems Headed For Liquidation, Many Losers Count Their Losses," by Peter Coy et al. *Business Week*, December 10, 2001, pg. 80.

[12] The Retirement Security Advice Act of 2001 (H.R. 2269).

[13] "Enron Made Payments in Bid To Hold Top Energy Traders", by Richard A. Oppel Jr. *New York Times*, December 10, 2001, pg. C2.

[14] "Enron Jolt: Investments, Assets Generate Big Loss --- Part of Charge Tied To 2 Partnerships Interests Wall Street," by John Emshwiller and Rebecca Smith. *Wall Street Journal*, October 17, 2001, pg. C1.

[15] Enron Corp.'s Form 10-Q for the quarter ending September 30, 2001 filed with the U.S. Securities and Exchange Commission on November 19, 2001.

[16] In 2000 Arthur Andersen received $27 million in other consulting fees and only $25 million in auditing fees. Enron Corp.'s Proxy Statement for 2001 Annual Meeting of Shareholders filed with the U.S. Securities and Exchange Commission on March 27, 2001.

[17] Enron Corp.'s Form 10-K for the year ending December 31, 2000 filed with the U.S. Securities and Exchange Commission on April 2, 2001.

[18] Salomon Smith Barney analyst reports dated July 13, 2001, October 5, 2001 and October 26, 2001.

[19] Lehman Brothers analyst reports dated October 23, October 24, November 12, November 28 and December 7, 2001.

[20] "While Enron Burned, Wall Street Fiddled", by Dan Ackman. Forbes.com, November 29, 2001.

[21] "Enron: An Unreported Triumph For Investment Letters." Forbes.com, December 7, 2001.

[22] AXA Financial, Inc., Form 13-F, September 30, 2001, file with the Securities and Exchange Commission, November 13, 2001.

[23] Letter dated November 2, 2001 to William Powers, Jr., Chairman of Enron Special Committee, and Kenneth Lay, Enron Chairman of the Board and Chief Executive Officer, from Richard L. Trumka, Secretary-Treasurer of the AFL-CIO, and Gabriel P. Caprio, President and CEO of Amalgamated Bank.

[24] Letter dated November 9, 2001 to William Powers, Jr., Chairman of Enron Special Committee, and Kenneth Lay, Enron Chairman of the Board and Chief Executive Officer, from Richard L. Trumka, Secretary-Treasurer of the AFL-CIO, and Gabriel P. Caprio, President and CEO of Amalgamated Bank.

[25] Amlagamated Bank et. al. v. Kennath L. Lay et. al. Cass Action Complaint Filed in the United States District Court Southern District Of Texas.

[26] Testimony of Damon A. Silvers, Associate General Counsel, AFL-CIO, before the House Subcommittee On Capital Markets, Insurance, And Government Sponsored Enterprise on "Analyzing the Analysts—Are Investors Getting Unbiased Research From Wall Street", June 14, 2001.

December 11, 2001

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

Re: Petition for rulemaking

Dear Mr. Katz,

The American Federation of Labor and Congress of Industrial Organizations (the "AFL-CIO") hereby petitions the Securities and Exchange Commission (the "Commission") to undertake a rulemaking proceeding to amend the rules governing auditor independence to revise the definition of an independent auditor and limit the services accounting firms may provide to their audit clients. We also ask the Commission to require additional proxy statement disclosure regarding the role of the audit committee in approving both audit engagements and non-audit consulting agreements with the audit firm. As shown by the scandal currently unfolding at Enron Corporation, investor confidence in the U.S. capital markets requires that auditors be, and be perceived as, truly independent from their clients.

The AFL-CIO is a federation of trade unions that represent 13 million working men and women who participate in the capital markets as investors through defined benefit and defined contribution plans as well as through mutual funds and individual accounts. Our member unions sponsor benefit plans with over $400 billion in assets, and our members are participants in public employee and collectively bargained single-employer plans with over $5 trillion in assets. Our union-sponsored funds alone are the beneficial owners of approximately 3.1 million shares of Enron stock, through both actively-managed and passive (or indexed) portfolios.

Background

Independent auditors occupy a central position in promoting confidence in the integrity of the financial reporting system and U.S. capital markets. Because the Commission requires that financial information filed with it be certified or audited by independent auditors, auditors are, as the Commission recently stated, the "gatekeepers" to the public securities markets.[1] Auditors work not only for their clients, but also for the investing public.

The role of the independent auditor is once again in the spotlight, as it was following relevations of accounting fraud at Sunbeam, Cendant and Waste Management. Now, the stunningly rapid failure of Enron Corporation, where there is evidence that Enron's auditor, Arthur Andersen, knew about and identified accounting errors but did not insist on their timely correction, focuses attention on the factors that might lead a company's auditor to sign off on misleading financial statements. Foremost among these is a dependence on a company and its management that can serve to undermine an auditor's objectivity.

Independence can be compromised in various ways. The provision of certain kinds of non-audit consulting services to audit clients may create economic incentives that can lead a firm to devalue the audit services and focus on retaining the client, even at the cost of making inappropriate audit judgments. In 2000, Arthur Andersen received more non-audit fees than audit fees from Enron. A "mutuality of interest" not conducive to independence may develop from the provision of certain kinds of non-audit services or from the employment by an audit client of former employees of the auditor. Certain services result in the auditor acting as management or an employee of the client. Finally, auditors may not be able to audit objectively work performed by the audit firm itself under a consulting agreement.

Over the past several decades, the proportion of audit firms revenues derived from non-audit services, such as internal audit, information technology, financial advisory and appraisal and valuation services, has grown steadily. At the five largest public accounting firms, revenues derived from non-audit services grew from 13% of total revenues in 1981 to half of total revenues in 2000.[2]

The 2000 Commission Rulemaking

Citing these threats to independence and their potential effect on capital formation, as well as the increased pressure on companies to make or surpass analyst earnings estimates, the Commission undertook last year to revise its rules governing auditor independence. With respect to the provision of non-audit services to audit clients,

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[1] Revision of the Commission's Auditor Independence Requirements, Exchange Act Release No. 43602 (Nov. 21, 2000) (adopting release).

[2] Revision of the Commission's Auditor Independence Requirements, Exchange Act Release No. 42994 (June 30, 2000) (proposing release).

the Commission solicited comment on three alternative approaches: banning the provision of such services altogether, imposing limits on the provision of those non-audit services deemed most likely to impair independence, and requiring only additional disclosure.[3]

Although a number of commenters and those testifying at the Commission's public hearings favored a ban on non-audit services, there was also significant opposition, mainly from the accounting profession, to any substantive reform. As a result, the final regulations reflected a compromise in which auditors could provide those non-audit services that posed a danger to independence, but only under certain circumstances. (The proposed limitation on providing expert testimony were dropped in its entirety.) A compromise was also reached regarding the additional disclosure required of registrants regarding the non-audit services provided by their auditors and the involvement of their audit committees with respect to auditor independence issues.

In light of subsequent developments, however, we ask the Commission to revisit some of the issues raised in the 2000 rulemaking, and to consider some new reforms, in order to strengthen its auditor independence safeguards. As discussed more fully below, both substantive reform and additional disclosure are necessary to preserve confidence in our capital markets.

The Rules on the Provision of Non-Audit Services Should be Strengthened

We believe that the Commission's final rules give too much flexibility to audit firms to provide non-audit services that could compromise the firms' objectivity and create economic incentives that may undermine the effectiveness of audits. A December 5, 2001 Washington Post article highlighted the pressures on individual auditors to "cross-sell" non-audit services to audit clients, recounting a case in which a Coopers & Lybrand accountant's performance review varied according to the amount of such services he was able to sell. That case involved Phar-Mor, which later filed for bankruptcy protection following revelations of accounting fraud; a jury found that Coopers, Phar-Mor's auditor, had committed fraud.

We believe that in some cases the sheer amount of the consulting services may create perverse incentives. During testimony in connection with the 2000 rulemaking, much was heard about the "loss leader" phenomenon, in which firms submitted artificially low bids, not consistent with providing high quality audit services, as a way to establish a relationship with a client and sell audit services. The audit then makes up an even smaller proportion of the total revenue stream from the client. And here, the danger not only lies in the auditor's impaired judgment. Anecdotal evidence suggests that executives of some companies encourage audit firms to undertake non-audit consulting as a way of obtaining leverage for the company over the audit process.

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[3] See id.

Certain non-audit services pose a more significant threat to an auditor's independence than others. The Commission recognized this in the 2000 rulemaking, when it prohibited firms from providing certain services, like bookeeping services. However, the Commission determined that audit firms could continue to sell information technology and internal audit consulting services to audit clients, as long as certain requirements, designed to lodge ultimate responsibility for the systems with the client, are satisfied. We believe this was a mistake.

The provision of information technology and internal audit services raise several serious problems. First, in cases where an information technology project is unsuccessful, a company may not be permitted to capitalize the costs of the project on the balance sheet (thereby creating an asset), but rather is required to expense them, thus reducing income. An accounting firm that botched the consulting job will be less likely, we think, to be assertive with management about the need to expense the item.

Similarly, if the auditor discovers, during the course of an audit, a theretofore undiscovered problem with software or an internal audit system the auditor designed and installed, the auditor is in the uncomfortable position of having to inform the client about the audit firm's own error. Finally, in a real sense the audit firm is auditing it own work because assessing the reliability of the numbers generated by an information technology or internal audit system is a part of the audit function.

We believe that the conditions imposed on audit firms in connection with information technology and internal audit consulting services are easily manipulated and do not mitigate the danger that the auditor and client will come to view the auditor as an extension of management and that the auditor will experience difficulty in vigorously auditing its own work.

Attention should be focused on another kind of consulting service, one that was not raised in the 2000 rulemaking but that has been brought to the fore by the Enron debacle. Enron's restatement of several years' worth of financial statements stemmed in part from the acknowledgment by Enron that the financial results of off-balance-sheet special purpose entities ("SPEs") set up by Enron—and in some cases managed by Enron officers—should have been consolidated with Enron's own results. In one case, Enron conceded that consolidation was necessary because the SPE had been inadequately capitalized when it was established.

Enron paid Arthur Anderson $27 million in 2000 for non-audit consulting services, including fees for "business process and risk management consulting." We are concerned that this category may include consulting regarding the transactions pursuant to which one or more of the erroneously non-consolidated SPEs were established. Such an arrangement would, we think, create an unacceptable conflict of interest, requiring Arthur Andersen's audit personnel to question the judgment of its consultants on a matter which could—and eventually did—have a major impact on Enron's financial results. We urge the Commission to consider amending Rule 2-01 of Regulation S-X to provide that

an independent auditor may not design and/or structure a transaction the audit firm must pass on in connection with the audit.

Auditors Should be Rotated

Currently, audit firms must rotate the audit engagement partner every seven years, in order to remove the risk of over-familiarity with the client. However, the engagement partner may remain in a relationship management position with respect to the client, which mitigates the effect of partner rotation.

We believe a more sensible approach is to require mandatory rotation of audit firms every seven years. Such rotation would provide a number of important benefits. First, a new audit firm would bring to bear a skepticism and fresh perspective that a long-term auditor may lack. Second, auditors tend to rely excessively on prior years' working papers, including prior tests of the client's internal control structure, particularly if fees are a concern.[4] Relatedly, longtime auditors may come to believe they understand the totality of the client's issues, and may look for those issues in the next audit rather than staying open to other possibilities. Finally, an auditor may place less emphasis on retaining a client relationship even at the cost of a compromised audit if it knows the engagement will end after several years.

In our opinion, the benefits to shareholders, lenders and the investing public from requiring rotation of auditors outweighs the additional cost that may be entailed in connection with a new auditor becoming familiar with the client. We urge the Commission to consider revising Rule 2-01 of Regulation S-X to provide for mandatory auditor rotation.

Additional Disclosure Should be Required

We also think that additional disclosure regarding the involvement of the audit committee in entering into the audit engagement and pre-approving non-audit consulting arrangements would enhance the effectiveness of audit committees and provide valuable information to investors. The Commission originally proposed in 2000 to require disclosure of whether the audit committee, before any disclosed non-audit service was rendered, approved and considered the effect on independence of such service. Only the latter disclosure was included in the final rule.

Requiring disclosure about the audit committee's role with respect to both the audit engagement and non-audit consulting contracts would advance important goals. Disclosing whether the audit committee, rather than the registrant, entered into the audit engagement would give investors information about whom the auditor views as its audit

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[4] See Richard G. Brody & Stephen A. Moscove, "Mandatory Audit Rotation," The National Publc Accountant 32 (May 1998).

client. Commentators have noted that an auditor that views a registrant's management as its client is less likely to challenge that management in the context of an audit.

Similarly, investors would be better informed about the extent of the audit committee's involvement if the Commission required disclosure regarding audit committee pre-approval of consulting arrangements. The Panel on Audit Effectiveness organized by the Public Oversight Board, which was convened on the request of the Commission and issued its report last year, recommended that audit committees pre-approve non-audit services that exceed a threshold arrived at by the committee. Disclosure will assist investors in determining whether a registrant has implemented that recommendation.[5]

We urge the Commission to consider taking the steps proposed herein as soon as practicable. It is vital, we think, in light of recent events, to assure the investing public of the integrity and reliability of the audited financial statements of U.S. public companies. We believe that the reforms we propose to the auditor independence and audit committee disclosure rules can be an important step in that direction.

If you have any questions regarding this petition, please do not hesitate to contact Damon Silvers at 202-637-3953. We look forward to discussing this with you further.

Very truly yours,

Richard Trumka
Secretary-Treasurer

[5] The Panel on Audit Effectiveness Report and Recommendations, sec. 5.30 (Aug. 31, 2000).

December 11, 2001

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

Re: Petition for rulemaking

Dear Mr. Katz,

The American Federation of Labor and Congress of Industrial Organizations (the "AFL-CIO") hereby petitions the Securities and Exchange Commission (the "Commission") to undertake a rulemaking proceeding to amend Items 401 and 404 of Regulation S-K to require more proxy statement disclosure regarding conflicts of interest on the part of directors and director nominees. We believe that recent events at Enron Corporation have made plain that the existing disclosures are simply inadequate to ensure that shareholders are informed of all relevant information about director conflicts of interest.

Background

Our system of corporate governance relies heavily on independent directors to act as vigorous monitors of management behavior and to represent shareholder interests. For example, a committee of independent directors is often constituted to evaluate potential transactions or litigation involving a company. Similarly, the tax code requires that incentive compensation in excess of the $1 million cap on deductibility be awarded by a compensation committee composed of independent directors. Many institutional investors, following on that requirement, take compensation committee independence into account when voting on pay packages and deciding whether to withhold votes from director candidates.

One of the most important functions entrusted to independent directors is oversight of the financial reporting process, which is of vital importance both to a company's shareholders and the markets in general. To that end, listing standards of both the New York

Stock Exchange and the Nasdaq market require listed companies of a certain size to maintain audit committees composed of independent directors, and the Commission requires companies to disclose information regarding the mandate, membership and functioning of the audit committee.

Current Disclosure Requirements

The Commission's rules also, in essence, define independence by requiring disclosure in the proxy statement of certain relationships between directors (or director nominees) and the registrant (and in some cases its executive officers) that could compromise the director's objectivity. These requirements focus on employment, family, and business relationships. Currently, the following relationships involving directors and director nominees must be disclosed:[1]

1. Current or past employment by the registrant;

2. Family relationships between the director or nominee and the registrant's executive officers;

3. Transactions with the registrant or any subsidiary in which the amount involved exceeds $60,000 and in which the director or nominee has a direct or indirect material interest;

4. Indebtedness to the registrant or any subsidiary in an amount in excess of $60,000;

5. The ownership of certain equity interests in, or service as an executive officer of, a business or professional entity (a) that is a significant customer of the registrant, (b) that is a significant supplier of the registrant, or (c) to which the registrant is indebted in an amount exceeding a threshold;

6. Status as a member of, or of counsel to, a law firm that the registrant has retained during the last fiscal year or proposes to retain during the current fiscal year, subject to a minimum threshold;

7. Status as a partner or executive officer of an investment banking firm that has performed certain kinds of services for the registrant during the last fiscal year or that the registrant proposes to have perform services during the current fiscal year, subject to a minimum threshold; and

8. Any other relationship similar in scope and nature to the relationships listed above.

[1] These disclosure requirements are set forth in Items 401 and 404 of Regulation S-K.

Enron Corporation

As you are no doubt aware, Enron Corporation recently filed the largest bankruptcy case in U.S. history, precipitated by a massive crisis of investor and customer confidence. Enron has already announced plans to lay off or put on leave 7,500 workers, and the value of Enron stock held in employees' 401(k) retirement accounts has declined by $1.3 billion since the beginning of 2001. The market capitalization of Enron, which was the seventh largest company in the Fortune 500, plunged from over $60 billion at its peak last year to under $1 billion last week. Enron's inclusion in the S&P 500 index until shortly before the bankruptcy filing means that the broader market and the many investors who index their equity holdings are also suffering as a result of Enron's failure.

The AFL-CIO is a federation of trade unions that represent 13 million working men and women who participate in the capital markets as investors through defined benefit and defined contribution plans as well as through mutual funds and individual accounts. Our member unions sponsor benefit plans with over $400 billion in assets, and our members are participants in public employee and collectively bargained single-employer plans with over $5 trillion in assets. Our union-sponsored funds alone are the beneficial owners of approximately 3.1 million shares of Enron stock, through both actively-managed and passive (or indexed) portfolios.

Enron's meltdown was caused by a number of factors, among them a cavalier attitude toward disclosure, inadequate internal controls and an approach to accounting that at best can be characterized as careless and at worst constituted a conscious effort to mislead investors and the public about the profitability of Enron's operations. These problems point to an abject failure by Enron's board, especially its finance and audit and compliance committees, in the discharge of its monitoring duties. We believe that the lack of independence on Enron's board and key committees contributed to this failure.

At first glance, Enron's board and key committees appear to be composed primarily of independent directors. According to Enron's 2001 proxy statement, of the 14 directors nominated for reelection at the 2001 annual meeting,[2] eight, or nearly two-thirds, lacked disclosable relationships with Enron. Of members of the audit and compliance committee, which was responsible for reviewing the effectiveness of internal controls and the application of accounting principles, only one, John Wakeham, has disclosable ties to Enron, in the form of a $72,000 per year consulting arrangement. A majority of members of the finance committee, which oversaw Enron's risk management activities, are similarly independent.

However, further research reveals that several of the eight ostensibly independent directors, including two who serve on the audit and compliance committee and one who serves on the finance committee, actually have relationships with Enron or its senior

[2] One of those directors, then-CEO Jeffrey Skilling, resigned from both his executive and director positions in August 2001.

executives that could interfere with those directors' ability to be objective and to challenge company decisions and policies.[3]

- Audit committee member John Mendelsohn is the president of the University of Texas M.D. Anderson Cancer Center. The Cancer Center has received contributions from Enron, and Enron chairman and CEO Kenneth Lay was part of what the Houston Chronicle characterized as a "coalition" to lobby the Texas legislature for $20 million worth of infrastructure improvements to support the development of the Southeast Texas BioTechnology Park, which will be built on University of Texas land and house the Cancer Center's Life Sciences Center. Compensation committee chairman Charles LeMaistre is the Cancer Center's president emeritus and serves on its Board of Visitors.

- According to Enron's 2001 proxy statement, directors Norman Blake and John Duncan own common units of EOTT Energy Partners, L.P. ("EOTT"), a limited partnership whose general partner is a wholly-owned subsidiary of Enron. Enron thus exercises significant control over EOTT, which could affect the economic return available to Messrs. Blake and Duncan. Mr. Blake serves on Enron's finance committee; Mr. Duncan is a member of the audit and compliance committee.

- Wendy Gramm, a member of the audit and compliance committee, is director of the Mercatus Center at George Mason University. According to a December 10, 2001 article in Time magazine, Enron contributed $50,000 to the Mercatus Center.

Uncovering the relationships described above was neither easy nor inexpensive. An investor thus cannot evaluate the independence of the board and key committees at all or even a substantial number of the companies in its portfolio without expending significant funds. Because of the economics involved in undertaking such research, even proxy voting and research services such as the Investor Responsibility Research Center—which exploit economies of scale in assembling corporate governance data—rely solely on the disclosures set forth in the proxy statement when evaluating boards and key committees. Accordingly, we believe that additional proxy statement disclosure regarding relationships between directors and director nominees, on the one hand, and registrants and their senior executives, on the other, is vital in enabling investors to select investments wisely, monitor companies in which they have invested and cast informed votes in director elections.

Specifically, we urge the Commission to amend the rules to require disclosure of:

1. Relationships between the registrant or any executive officer of the registrant and any not-for-profit organization on whose board a director[4] or immediate family member[5] serves or of which a director or immediate family member serves as an officer or in a similar

[3] We raised these concerns in a letter to Enron's special committee, which is attached to this petition.
[4] For the sake of simplicity and readability, "director" also refers to director nominees.
[5] "Immediate family member" should be defined to include a person's spouse, parents, children, siblings, in-laws and first cousins.

capacity. Disclosable relationships should be defined to include contributions to the organization in excess of $10,000 made by the registrant or any executive officer in the last five years and any other activity undertaken by the registrant or any executive officer that provides a material benefit to the organization. "Material benefit" should be defined to include lobbying efforts such as those engaged in by Mr. Lay on behalf of the M.D. Anderson Cancer Center as well as fundraising activities undertaken by the registrant or any executive officer on the organization's behalf.

2. Relationships in which the registrant or any executive officer exercises significant control over an entity in which a director or immediate family member owns an equity interest or to which a director or immediate family member has extended credit. Significant control should be defined with reference to the contractual and governance arrangements between the registrant or executive officer, as the case may be, and the entity. For example, in most cases, a general partner exercises significant control over a partnership, while a limited partner may exercise significant control depending on the terms of the partnership agreement.

It may be necessary to provide that the existence of significant control may depend, in part, on the overall ownership structure of the entity and not just the stake held by the registrant or executive officer. For example, the owner of less than a majority of a corporation's stock may nonetheless exercise significant control if the other stockholders are numerous and fragmented.

3. Joint ownership by a registrant or executive officer and a director or immediate family member of any real or personal property.

4. The provision of any professional services, including legal, financial advisory or medical services, by a director or immediate family member to any executive officer of the registrant in the last five years.

We understand that in 1998 the Council of Institutional Investors ("CII") filed a petition for rulemaking relating to disclosure of director conflicts of interest and that the Commission has not responded to that request. Although CII's proposed language is more general, we believe that our request covers many if not all of the conflicts that were of concern to CII.

We urge the Commission to take up these important issues immediately. Investor confidence in the United States capital markets depends in large measure on their transparency. Full disclosure of director conflicts of interest will improve transparency and enable investors to assess more accurately the quality of companies' governance structures.

If you have any questions regarding this petition, please do not hesitate to contact Damon Silvers on 202-637-3953. We look forward to discussing this with you further.

Very truly yours,

Richard Trumka
Secretary-Treasurer