

Testimony of Sean Harrigan
President of the Board of Administration, CalPERS
Senate Committee on Banking, Housing and Urban Affairs
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Chairman Shelby, Ranking Member Sarbanes and members of the Committee, it is an honor and pleasure to be here with you today to discuss a topic of such importance to investors.

My name is Sean Harrigan. I am the President of the Board of Administration of the California Public Employees' Retirement System (CalPERS).

CalPERS has long been a leader in Corporate Governance. It goes without saying that CalPERS has had serious concerns over the crisis in our financial markets. Our organization was one of the first investors to embark upon an initiative of financial market reform as the depth and magnitude of the crisis facing our markets became increasingly apparent in early 2002.

Now, almost two years later, we have accomplished a great deal. The primary vehicle for reform has been the Sarbanes-Oxley Act that was passed just over one year ago. While I recognize that implementation of the Act will realistically go on for some time, I think it is safe to say that this historic legislation is to be credited with an excellent start toward restoring investor confidence and improving the credibility of our financial markets.

Today, I would like to highlight some of the important elements of the Sarbanes-Oxley Act which have had a tremendous impact. I would also like to offer some suggestions for the next steps that are critical to completing the job that we have all set out to accomplish – restoring the public's trust and confidence in our financial markets. I still believe that this goal is an admirable one. It will help us as long-term investors to satisfy our obligation to our membership. But it will also help strengthen the efficiency of our markets which is crucial for effective capital allocation and sustainable economic growth.

First, however, I would like to offer my sincere gratitude on behalf of CalPERS and its members for all that this Committee, and in particular Senator Sarbanes, for his leadership on this issue. As can be expected when industries with a vested interest face real reform, there was significant resistance to the Sarbanes-Oxley Act. We are proud to have been a vocal supporter, and we continue to play a role in implementing the Act and evaluating the effectiveness of reform.

It is from this perspective that I offer our analysis and comments on the impact of the Act over one year after its enactment and on what we are focused on going forward.

There are several components of the Act that we feel are most important and I will focus on those areas broadly.

Auditor Independence

We believe there are significant conflicts of interest created when an auditor is simultaneously receiving fees from a company for audit services and non-audit services such as consulting. CalPERS supported an outright ban on non-audit services for the external independent auditor. The Sarbanes-Oxley Act went a long way toward addressing this issue by establishing a list of prohibited services.

However, from our perspective as a significant investor and user of financial statements, this is perhaps the main area in which the Act can be improved.

Investors rely upon financial statements for accurate and objective information. We have witnessed how much harm can come from inaccurate and fraudulent accounting. Auditors play a crucial and irreplaceable role in ensuring the accuracy of financial statements.

While the goal of the Act was certainly aimed at eliminating the conflicts inherent when an independent auditor receives fees for non-audit services, two significant types of services remain permitted. Under the rules implementing the Act, auditors may still under certain circumstances provide tax planning and consulting services as well as certain information technology consulting.

CalPERS continues to feel that an outright ban on non-audit services is necessary. In response to this issue, CalPERS has taken steps to communicate our concerns directly to companies in which we invest. During the 2003 proxy season, CalPERS withheld its votes for Audit Committee members when they used their auditors for any non-audit services (1).

We have also analyzed proxy disclosures in an effort to monitor how companies use their external auditor. Again, it is important to remember that the rules adopted by the SEC related to audit independence are still being implemented. However, our

analysis indicates that approximately 50 percent of the total revenue to the audit firms in our study was non-audit related. More specifically, approximately 40 percent can be attributed to consulting, advisory or planning services that include tax related work. This remains a deeply troubling situation that we feel has the significant potential to impair the objectivity of the independent auditor.

In the coming proxy season, CalPERS will continue to withhold its vote for Audit Committee members at companies that use the auditor for non-audit services. Because this remains such a significant concern we urge you to pursue tougher rules through the Securities and Exchange Committee (SEC) and the Public Company Accounting Oversight Board (PCAOB) to address this issues.

Accounting Industry Oversight

In response to the clear failure of the accounting industry to self regulate, the Act created a new independent body to oversee audit firms. CalPERS strongly supported this provision. In particular, we advocated for strong independence, strong regulatory powers (such as the ability to subpoena and discipline), and independent funding.

The PCAOB is now operational and is making progress toward its inspection and disciplinary programs. I am pleased to see that the PCAOB is preparing its own auditing and attestation standards. As you are aware, the Board is currently focused on internal controls over financial reporting. To investors, ensuring proper internal controls over financial reporting is critical. I do not accept the criticism by some in the business community that the additional focus on this area is misplaced or the cost associated with improving internal controls is not worth it. To investors that rely on financial statements and controls, it is completely worth it. The benefits clearly outweigh the costs. I applaud your focus on internal controls in Sarbanes-Oxley.

Strengthening the Enforcement of Federal Securities Laws

The Act provided numerous enforcement tools to strengthen the ability of the SEC to regulate the securities markets and compensate injured investors. It will take a number of years to completely evaluate the effectiveness of these new tools. However, there are some areas where we feel particular attention should be paid to ensuring that the SEC is adequately equipped. The Committee should consider studying whether additional authority for the SEC to ban individuals from serving as an officer or director at public companies is appropriate. In addition, the committee may wish to study additional authority for the SEC to claw back gains from executives that are in any part attributable to misconduct. The SEC has already exercised new authority (under Section

1103) to escrow “extraordinary payments” during an investigation. In its most recent action under Section 1103, the SEC successfully petitioned the court to escrow for 45 days a total of \$37.64 million intended for two former executives of Gemstar International. CalPERS applauds this action and in fact filed an amicus brief in support of the SEC’s efforts.

Scenarios in which a significant payment follows corporate failure as a result of poor financial performance adds insult to injury for harmed investors. This is especially true when any portion of a gain realized by an executive can be attributable to malfeasance. Any reasonable authority we can provide for the SEC to rectify these types of situation should be duly considered.

Scenarios in which a significant pay-out follows corporate failure as a result of poor financial performance adds insult to injury for harmed investors.

Next Steps

There are too many other detailed provisions within the Act to mention today. At this time, I would prefer to focus on some of the actions we think still need to be addressed.

The next steps that we think are most important are still focused on the same goal, which is to help restore investor confidence in the U.S. financial markets. While there are many issues we feel are important, I would like to focus on five reform items that are among our most important:

Audit Independence

As I mentioned, CalPERS will continue to take action through its Governance Program and other means to help strengthen the independence of the external auditor. As a major investor and financial statement user, we feel strongly that there should be a bright line ban on non-audit services. Again, the primary concern we have is that external auditors are still permitted under certain circumstances to provide tax consulting and planning services and certain IT consulting services. These services provide a clear conflict of interest because the auditor may still be in a position to audit their own advice and must maintain a “client” relationship beyond the audit that impairs objectivity.

Examining the Role of Market Participants

The SEC as well as other organizations continue to conduct analysis of the role of varying constituencies within the financial system. Much like the audit industry, many of

the remaining constituencies have a role in maintaining the market's integrity. In some cases these players are proving that their industry has significant structural impediments or conflicts that are contrary to the interests of investors and the markets. For example, CalPERS has been active in helping to curb conflicts inherent in firms that provide both investment banking and equity research. We urge the Committee to continue to examine these various constituencies with a balance in mind that recognizes both their need to operate in an effective manner and yet fill a meaningful role in helping ensure the integrity of the financial markets.

SEC Budget

Congress and the President have dramatically increased the budget of the SEC, and CalPERS has supported this action on numerous occasions. As our primary market regulator, The SEC plays a crucial role in ensuring the integrity of the U.S. capital markets. This has obvious long-term implications for the health of our economy and on our ability as an investor to satisfy our obligation to our members. We feel that the focus on increasing the resources for the SEC is highly appropriate (and a good long-term investment in our market), but it is only half of the problem. To ensure that the SEC can be an objective market regulator and continue to build a sustainable and consistent program it should have a greater degree of independence from the federal budget process. This position is similar to the support CalPERS has given for independence in funding for the PCAOB and the Financial Accounting Standards Board (FASB). Congress recognized the merits of providing a safe and independent funding source for these organizations, and we believe the same arguments apply to the role of the SEC, and are perhaps even stronger given the SEC's prominent role.

Open Access to the Proxy

The SEC is currently considering action that would provide investors with greater ability to nominate directors and have those candidates appear on the same proxy as management nominated directors. Of all the reforms that have been considered or enacted since the crisis began, this is perhaps the most significant one for investors. At the heart of many problems that face investors is a lack of accountability of board members to the owners of the corporation. We believe that one of the root causes for such issues as abusive executive compensation, lack of oversight that helps permit fraud, and plain old sub-optimal financial performance is the lack of accountability of board members to their owners.

A reasonable and balanced approach to providing investors with greater access to management's proxy statement will directly address this problem. Because we will be able to gain greater accountability we will expect more behavior that is consistent with

long-term owners' interests and less short-term decision making and self-interested behavior that has been so damaging to all of us.

We urge the Committee to help us in support of a reasonable open access policy that provides long-term investors with the ability to nominate directors without the prohibitive costs involved in launching a full blown proxy contest.

NYSE Reform

As this Nation's principal securities market and a so-called self regulatory body, the NYSE has a distinctive role in helping to restore and then maintain the integrity of our financial markets. We were appalled with the disclosures that came from the NYSE regarding the compensation package of the former chairman. We feel that the NYSE has a unique opportunity to meet the challenges that it now faces and to set an example for corporate America and indeed the world. I sincerely hope that the resignation of Chairman Grasso does not take the focus away from more substantive reform. Among some specific governance reforms that the Exchange should consider, we feel strongly it is time to have real investor representation on the NYSE. This reform alone would provide a change in perspective that would help ensure that the governance of the exchange will be responsive to its primary constituency and that any regulatory role it retains going forward is meaningful.

In summary, I would like to once again offer my sincere gratitude for all that Sarbanes-Oxley has done for investors. This has been a truly remarkable time in the history of the U.S. financial markets. I feel strongly that your leadership has been a significant boost in our efforts to recover. We still need that leadership. I hope you take my comments accordingly, and as we celebrate the early success of Sarbanes-Oxley, we also keep a watchful eye on its continued implementation and pursue opportunities to responsibly improve upon its reforms.

Thank you and I would be pleased to answer any questions you may have.

(1) CalPERS adopted two narrow exceptions to this rule. Under these exceptions we consider corporate tax form preparation and SEC compliance work to be acceptable services for external auditors.

