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CONCERNING TRANSPARENT FINANCIAL REPORTING FOR STRUCTURED FINANCE TRANSACTIONS

Before the Permanent Subcommittee on Investigations
Committee on Governmental Affairs
U.S. Senate

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The Securities and Exchange Commission ("SEC" or "Commission") is pleased to submit this written statement about our efforts to monitor the use of and promote transparent financial reporting for structured finance transactions.[1]

Structured finance plays an important role in the modern business environment. When used properly, it can provide needed liquidity and funding sources, investment opportunities, and can facilitate risk dispersion. There are numerous participants in any structured finance transaction. The principal actors in the transaction are, of course, a company and its counterparties, which can include various combinations of financial institutions and intermediaries. Investors also act as principals, but most transactions are brought to investors and not designed by them. Each principal player also brings to the deal table advisors representing many disciplines, including accounting, tax, legal, and valuation services. A regulatory framework and infrastructure, again with many components, surrounds each transaction and can affect the various players. These components involve regulators such as the various banking regulators, the Internal Revenue Service, and the SEC, the accounting standard setters, and various professional bodies that maintain codes of conduct and other professional standards for their disciplines.

Each of the various components in the regulatory framework plays a crucial role in maintaining confidence in our financial markets. This is especially evident in the use of structured finance transactions, which, notwithstanding the benefits noted above, have at times been used inappropriately to achieve a specific accounting or tax result or provide "window-dressing" for financial statements. Sometimes this inappropriate use has been achieved only by violating existing regulations or accounting standards.

It is important to note that the Commission's statement will relate to the Commission's recent and ongoing efforts related to structured finance transactions, as well as to completed investigations and enforcement cases in this area. The Commission does not comment on specific ongoing investigations or enforcement actions.

This statement will describe the role of the SEC in the regulatory framework that surrounds structured finance transactions. It will begin by describing the primary mission of the SEC, and providing some context as to how that mission fits within the overall regulatory framework. The statement will then discuss the relevant activities of the Commission's Divisions and Offices to regulate structured finance transactions.[2]

The Commission's Role in the Markets and Financial Reporting

The primary mission of the SEC is to protect investors and maintain the integrity of the securities markets. In this effort, the Commission is responsible for administering the federal securities laws. The Commission does not have authority to approve or disapprove various securities transactions on their merits. Rather, the Commission's primary job is to ensure that companies properly account for and fully disclose material transactions and fully inform investors of their impact on the company's financial condition so that investors can make informed investment decisions. This system is designed to maintain market transparency. It allows market forces rather than regulatory controls to determine what securities transactions occur and at what prices a company's securities will trade. Without full and fair disclosure, markets cannot assign an appropriate value for the securities of public companies, whether they are large or small companies, or financially-stable or financially-troubled.

The SEC also oversees key participants in the securities market, including stock exchanges, broker-dealers, investment advisors, mutual funds, and public utility holding companies. Here again, the SEC is concerned primarily with protecting investors who interact with these various organizations and individuals.

Crucial to the SEC's effectiveness is its enforcement authority. Each year the SEC brings between 400-500 civil enforcement actions against individuals and companies that violate the securities laws. Typical infractions include insider

trading, accounting fraud, and providing false or misleading information about securities and the companies that issue them.

Many of the Commission's efforts are focused on protecting investors by requiring full and fair disclosure of material information about publicly-traded securities. Full disclosure ultimately benefits both investors and the capital markets. By enhancing investors' confidence in the completeness and accuracy of information about public companies, these full disclosure requirements encourage investor participation in the capital markets. This full and fair disclosure necessitates transparent financial reporting, a concept elaborated on in the discussion of the activities of the Office of the Chief Accountant.

The SEC's Enforcement Authority and Relevant Activities

The SEC has significant powers to investigate possible violations of the federal securities laws and to enforce those laws through civil actions in federal court or before an administrative law judge. In its federal court actions, the Commission seeks injunctions; a person who violates an injunction is subject to fines or imprisonment for contempt. In addition, the Commission often seeks civil money penalties and the disgorgement of ill-gotten gains. Both the courts and, pursuant to the Sarbanes-Oxley Act, an administrative law judge may also bar or suspend individuals from acting as corporate officers or directors. Also, the Commission can bring both civil and administrative actions against broker dealers in a variety of contexts. Further enhancing its enforcement authority in this area, the Commission can charge such regulated entities for failing to supervise their employees, including salespersons and broker-dealers. While the SEC has civil enforcement authority only, it works closely with various criminal law enforcement agencies throughout the country to develop and bring criminal cases when the misconduct warrants more severe action.

In the aftermath of Enron's collapse, the SEC initiated and is continuing to conduct an enforcement investigation to identify violations of the federal securities laws that may have occurred, and those who perpetrated them. The Commission to date has charged two former Enron officers with fraud based on their participation in transactions designed to mislead investors about Enron's financial results. The Commission's investigation is continuing and the Commission's Division of Enforcement continues to work diligently and vigorously with the Justice Department's Enron Task Force to make sure that all those responsible answer for their misdeeds. Any further information relating to that investigation is nonpublic at this point. The public can have full confidence, however, that our Division of Enforcement is conducting a thorough investigation and that the Commission will redress any and all wrongdoing and wrongdoers.

As a general matter, however, the Committee may find several aspects of the Commission's authority particularly relevant to its interest in the regulation of financial institutions that structure transactions that may be used by public companies engaging in improper financial reporting practices.

First, the Commission has clear authority to proceed against public companies that file false information as part of their financial statements. Such conduct is potentially subject to various provisions of the federal securities laws, including the requirement that companies' filings with the SEC be materially complete and accurate and the SEC's general antifraud authority. The Commission brings numerous actions – 163 this past fiscal year — based on false and fraudulent financial reporting and disclosures. Among these was an action the Commission recently brought against a public company for, among other things, using an undisclosed off-balance sheet special- purpose entity to dramatically overstate the company's cash flow from operations.[3] Cases like this make clear that public companies using off-balance sheet special-purpose entities must ensure not only that their accounting treatment complies with generally accepted accounting principles ("GAAP"), but also, that they have accurately portrayed the economic substance of the transactions.

Second, the Commission has explicit statutory authority not only to proceed against primary violators of the federal securities laws, but also against aiders and abettors of those violations.[4] The Commission aggressively employs this authority. In addition, the Commission also may order any person who is or was a *cause* of a violation of any provision of the Exchange Act, due to an act or omission the person knew or should have known would contribute to the violation, to cease and desist from causing such violations. A person may be a cause of a non-scienter based violation, such as a reporting violation, through negligent conduct that contributes to the violation. Intentional or reckless conduct is not required.[5]

In this regard, in a recent case, the Commission found that a public company called Ashford.com had improperly deferred $1.5 million in expenses under a contract with Amazon.com, causing Ashford.com to materially understate its marketing expenses and allowing the company to report a pro forma net loss that was less than analyst's expectations. The improper deferral resulted from the settlement of a dispute with Amazon.com using two separate documents that were

prepared by Amazon.com at Ashford.com's request. Ashford.com subsequently failed to disclose one of the two documents to its auditors. The Commission found, based on this and other conduct, that Ashford.com had violated the reporting and antifraud provisions of the securities laws. The Commission also found that Amazon.com was a cause of Ashford.com's reporting violations.[6]

Another weapon against secondary actors—available to both the Commission and private litigants—is the fact that there can be and often is more than one primary violator in any securities fraud. The parameters of this doctrine are still uncertain as the federal courts are working through the issue of who is a primary violator. The Commission is taking an active role in shaping the law in this area by, in appropriate cases, filing briefs *amicus curiae* addressing the liability of such "secondary actors."[7]

Liability of secondary actors is an issue in the class action litigation pending against Enron and numerous secondary actors, including financial institutions, in the Southern District of Texas.[8] The Commission filed a motion in that case, as *amicus curiae*, asking for permission to submit its Klein *Amicus* Brief as guidance to the court on the legal question of whether a person who creates a misrepresentation can be liable as a primary violator (the Commission's position) or whether the person must be publicly identified as the author of the misrepresentation. The Court granted this motion and the matter is under consideration.

Third, and finally, the Commission has a long history of cooperation with the federal bank regulators on enforcement matters. The SEC obtains evidence of possible violations of the securities laws from many sources, including its own surveillance activities, other Divisions and Offices of the SEC, the securities self-regulatory organizations, securities industry sources, press reports, and investor complaints. The Commission also not infrequently receives evidence of possible violations from other regulatory authorities, including the federal bank regulators. In addition, when appropriate, the Commission coordinates its investigations with federal banking regulators, often resulting in coordinated and global regulatory settlements.

For example, in a recent case, the SEC took action with respect to accounting improprieties by The PNC Financial Services Group, Inc., a bank holding company. The Commission's Order found, among other things, that, in violation of GAAP, PNC transferred from its financial statements approximately $762 million of volatile, troubled or under-performing loans and venture capital assets sold to three special-purpose entities created by a third party financial institution, which resulted in material overstatements of earnings, among other things. Based in part on this conduct, the Commission found that PNC had violated the antifraud and reporting provisions of the securities laws.[9]

At the same time the Commission's order was issued, the Board of Governors of the Federal Reserve System announced that PNC had entered into a written agreement with the Federal Reserve Bank of Cleveland to address bank supervisory matters. The Commission acknowledged the substantial cooperation provided by the Board in this matter.[10]

Recent Rulemaking Initiatives Enhancing Financial Disclosure

The Chief Accountant is the principal adviser to the Commission on accounting and auditing matters. The Office of the Chief Accountant also works closely with domestic and international private-sector accounting and auditing standards-setting bodies (such as the Financial Accounting Standards Board ("FASB"), the American Institute of Certified Public Accountants ("AICPA"), and the recently established Public Company Accounting Oversight Board). The Office of the Chief Accountant consults with registrants, auditors, and other Commission staff regarding the application of accounting standards and financial disclosure requirements, and assists in addressing problems that may warrant enforcement actions.

The Division of Corporation Finance's mission is to see that investors are provided with material information in order to make informed investment decisions - both when a company initially offers its stock to the public and on a regular basis as it continues to give information to the marketplace. The Division also provides guidance to companies on SEC rules and forms and proposes new and revised rules to the Commission.

One of the highest priorities in the Office of the Chief Accountant and the Division of Corporation Finance is to support the Commission's various initiatives to deliver to investors the information required to make informed investment decisions. This includes transparent financial reporting in financial statements and footnotes thereto, as well as full and fair disclosures throughout the remainder of a filing with the Commission.

The Need for Transparent Financial Information

Tremendous emphasis is placed on the price of a company's stock. Investors' requirements provide the motivation for much of the emphasis. In addition, management may have an additional incentive to see that its stock price increases as price increase may influence management's compensation either directly or indirectly. A significant factor considered by the market in determining a company's stock price is its earnings. This includes not only the most recent earnings, but also the trend in the past and, more importantly, the expected trend in the future.

In response to the market's emphasis on earnings, management may have an incentive to adopt strategies that produce short-term results at the expense of longer-term shareholder interests. Financial engineering can be one of those strategies. Financial engineering occurs when the terms of a transaction or series of transactions are structured to achieve a particular result. This often is accomplished through the combination of simple instruments and basic structures in a much more complex, interconnected transaction. While a transaction may be engineered to achieve a valid business purpose, such as reducing the cost of capital or managing risk exposures, it also may be engineered simply to achieve a specific accounting result by arbitraging the accounting standards. The latter strategy, while creating a desired accounting effect, often will come at a true economic cost in terms of fees and other charges to structure a transaction that complies with the accounting rules.

Financial engineering is sometimes inappropriately used as a synonym for structured finance. As noted earlier, structured transactions are not inherently improper. They can be used to provide important liquidity resources and disperse risk among parties willing to accept it. However, given the overall increased use of structured transactions and the potential for their use in arbitrage strategies as window-dressing, investors and creditors have begun to focus not only on the amounts and trends of earnings, but also on the "quality" of these reported measures. At a conference addressing the quality of earnings, one analyst described the highest-quality earnings as "the earnings that can be taken right to the bank and deposited," and which are "replicated every quarter with 100 percent certainty."[11] If a company relies on a structured transaction for a one-time boost in earnings or liquidity, or a series of structured transactions to continue a trend, the investing public absolutely must understand that when evaluating the company. Transparent financial reporting facilitates this evaluation process.

Transparent financial reporting enables investors, creditors, and the market to evaluate the financial condition of a company. In addition to helping investors make better decisions, transparency increases confidence in the fairness of the markets. Further, transparency is important to corporate governance because it enables boards of directors to evaluate management's effectiveness, and to take early corrective actions, when necessary, to address deterioration in the financial condition of companies. Therefore, it is critical that public companies provide an understandable, comprehensive, and reliable portrayal of their financial condition and performance. If the information in a financial report is transparent, then investors and other users are less likely to be surprised by unknown transactions or events.

Current Initiatives in the Office of the Chief Accountant

Recently, companies such as Enron, Xerox, and WorldCom disclosed that their financial statements were not in compliance with GAAP. It is important to note in these cases that the financial reporting model did not necessarily fail. The Commission has alleged that these companies, as further acknowledged by their restatements, failed to properly apply the financial reporting model. Nonetheless, the existing financial reporting model can be improved. This includes both improvements in the underlying GAAP accounting, as well as improvements to other elements of the model.

There are currently numerous efforts underway within the Commission to improve the overall financial reporting model. Since July 30, 2002, our efforts have also focused significantly on meeting our responsibilities under the mandates within the Sarbanes-Oxley Act of 2002.

The Commission has several rulemaking initiatives recently completed or underway which focus specifically on the nature and quality of financial information that is reported to the public. This includes the financial impact of structured finance transactions. At the same time, the Commission has been fulfilling its oversight role with other private-sector standard setters, including the FASB and the AICPA, and several initiatives in those areas will be addressed.

Commission Rulemaking

The Commission has adopted, or has proposed, rules related to the quality of reported financial information, the reliability of that information, and the timeliness of that information. In addition, the Commission has proposed rules to strengthen the regulation of the "gatekeepers" of our capital markets, such as accountants and lawyers who work with public companies as part of the financial reporting process. Individually and in totality, these rules should have a significant effect on the quality and reliability of financial reporting and, accordingly, should serve to enhance investor confidence. In this statement, we will focus solely on those regulatory actions that directly related to the use of structured transactions and the disclosure of these transactions.

Even before the passage of the Sarbanes-Oxley Act, the Commission was communicating with registrants its expectation for more transparent financial reporting. These communications included three Financial Reporting Releases issued in December 2001 and January 2002 addressing pro-forma measures, critical accounting policies, and MD&A disclosures. Of particular note in this testimony is Financial Reporting Release No. 61 ("FR 61") issued in January 2002 addressing MD&A disclosures.[12] Among other items, this release provided additional insight into the Commission's expectations for disclosures related to liquidity and capital resources, including off-balance sheet arrangements, and the effects of transactions with related and certain other parties.

FR 61 served as the basis for our recent rule proposal addressing MD&A disclosures for off-balance sheet arrangements and other contractual and contingent obligations and commitments, as required under the Sarbanes-Oxley Act.[13] The rule is expected to address off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of an issuer with unconsolidated entities or other persons that have, or may have, a material effect on financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources. It is important to note that FR 61 remains in effect and the proposed rules simply add additional precision to the existing MD&A requirements, as the disclosures under the proposed rules would be located in MD&A. The proposals would require a registrant to provide, in a separately captioned subsection of MD&A, a comprehensive explanation of its off-balance sheet arrangements. The proposals also would require registrants to provide an overview of its aggregate contractual obligations in a tabular format and contingent liabilities and commitments in either a textual or tabular format. FR 61 also addresses MD&A disclosure of relationships and transactions with persons or entities that derive benefits from their non-independent relationships with the registrant or the registrant's related parties.

Oversight of Private-Sector Standard Setters

The Commission, through the Office of the Chief Accountant, has been exercising its oversight role in regards to the private-standard setting bodies. This has resulted in significant improvements in several areas of the auditing and accounting standards.

Until the formation of the Public Company Accounting Oversight Board, the AICPA, through its Auditing Standards Board, promulgated the auditing literature used by accountants and auditors.[14] In part as a result of the increased use of structured finance transactions and at the urging of the Commission, the AICPA recently addressed two aspects of its auditing literature: the issuance of reports by accountants on the accounting to be applied to given transactions and the consideration of fraud in financial statement audits. In addition, it is working on improvements to the guidance that addresses an auditor's identification and assessment of general risk factors in an audit.

First, at the request of the Chief Accountant, the AICPA amended Statement on Auditing Standard No. 50, *Reports on the Application of Accounting Principles*, ("SAS 50") effective June 30, 2002. A SAS 50 engagement requires the reporting accountant (the one issuing the SAS 50 report) to obtain an understanding of the form and substance of the transaction, review the applicable accounting standards, consider consulting with other professionals or experts, and perform research or other procedures to ascertain and consider the existence of creditable precedents or analogies. A "SAS 50 letter" was originally intended to serve as a mechanism for obtaining accounting advice or perhaps resolving differences between an auditor and client while avoiding "opinion shopping" from among different accounting firms.

However, over time, SAS 50 letters were used almost as part of the marketing literature by financial institutions pitching structured finance products. The SAS 50 letter would address the accounting for a "hypothetical transaction" with a given set of facts, including the terms of financial instruments involved in the transaction. It would represent the reporting accounting firm's view of the application of the accounting literature in that limited set of facts. The SAS 50 letter was then shared with the financial institution's potential customers as a way of saying, "You can get this accounting treatment." The Office of the Chief Accountant was concerned that it was not possible for the reporting accountant to know if the final, actual transaction would conform to the facts set forth in the SAS 50 report, or whether the potential customer's continuing accountants had reached different conclusions on the same or similar transactions in the past. As a result, SAS 50 was amended to preclude the issuance of a report on "hypothetical transactions."

The AICPA has also amended its guidance on the consideration of fraud in a financial statement audit by issuing Statement on Auditing Standard No. 99, *Consideration of Fraud in a Financial Statement Audit* ("SAS 99"). This standard supersedes the previous guidance on the consideration of fraud. It requires a more expansive consideration of fraud throughout the performance of an audit. Required procedures include discussions among the audit team personnel during the planning phase of the audit, obtaining information to assess the risk of material misstatement from fraud,

assessing the impact of an entity's programs and controls on the risk of fraud, and responding to the identified risks in terms of the nature, timing, and extent of procedures performed during the audit. It also requires certain documentation of the procedures performed and reporting to management and the audit committee.

Many of the fraud risk factors identified in SAS 99 correspond to business factors that could motivate management to inappropriately use structured finance transactions. For example, some of the factors identified include: the perceived or real adverse effects of reporting poor financial results, the profitability or trend level expectations of analysts and institutional investors, and significant portions of management compensation tied to operating results. In an audit, the consideration of these factors, coupled with an observation that a company has used a structured transaction or unusual series of transactions, should cause the auditor to more closely examine the reporting for and disclosure of the transaction.

The AICPA is proposing seven Statements on Auditing Standards to provide improved guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks.[15] Additionally, these proposed SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit. In companies where structured transactions are material, these proposed changes in the auditing literature should serve to emphasize the auditor's need to more closely examine the transactions in the course of the audit.

The FASB is a private-sector body that promulgates GAAP. The Commission currently looks to the FASB, under the Commission's oversight, to provide leadership in establishing and improving accounting principles used to prepare financial statements filed with the Commission.

The FASB also has underway projects to clarify and strengthen the GAAP reporting requirements for key elements related to structured finance transactions. These include projects to address the consolidation of and disclosures for special-purpose entities and the accounting and disclosures for guarantees. The SEC encouraged the FASB to complete these projects on an expedited basis, and as a result, these projects were placed on a "fast track," which is resulting in timely guidance.

The FASB has spent a considerable amount of its time and effort this year developing an interpretation of GAAP as it relates to consolidation by companies of special-purpose entities (SPEs). As this subcommittee is aware, transactions involving SPEs have become increasingly common. This FASB project is intended to establish a model for the consolidation of a SPE where the normal condition for consolidation, which is the existence of voting control, is not present. In addition, the FASB's proposed accounting guidance is expected to require certain disclosures about SPEs and the company's activities with SPEs in instances where SPEs are consolidated by a company, and even in instances where a company does not consolidate, but is significantly involved with SPEs.

The FASB has completed its re-deliberations of this issue and expects to issue final accounting guidance early in 2003. In all, we believe the accounting guidance will improve financial reporting by companies involved with SPEs. It is also important to note, however, that under the Commission's proposed rules regarding disclosure of off-balance sheet transactions, there would be enhanced disclosures of this aspect of structured finance transactions whether or not SPEs are consolidated as required under the proposed accounting guidance.

In November 2002, the FASB issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.* Guarantees often play a significant role in structured finance transactions. This Interpretation, effective for certain guarantees issued or modified after December 31, 2002, requires that guarantees within its scope be recognized at inception within the financial statements at fair value. It also requires disclosure of information such as the nature and term of the guarantee, events that trigger performance, and the maximum potential amount of future payments.

The FASB is also in the process of amending its guidance regarding the accounting for derivatives in Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.* A key aspect of this amendment process is the definition of a derivative, which would impact instruments often associated with structured transactions. Recent structured transactions have attempted to classify certain contracts as derivatives, such that they were reported as risk management contracts in the balance sheet and the related cash flows are reported as cash flows from operations, as opposed to treating the contracts as a debt instrument with financing cash flows. The FASB's amendment process will examine how to better distinguish between a derivative contract with an acceptable element of financing and a derivative contract with so much financing that it should be considered a debt instrument. Prepaid commodity contracts, a recent focus of interest, will be among the instruments likely addressed by this project.

Finally, the FASB's Emerging Issues Task Force ("EITF") is addressing several practice issues that are relevant to transparent reporting for structured transactions. The EITF was established by the FASB to, when possible, quickly address emerging issues before they become widespread and before divergent practices become entrenched. Recent EITF activities have included the effective rescission of EITF Issue 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities," which had allowed any contract qualifying as an energy trading contract to receive fair value, or "mark-to-market," accounting.[16] Now essentially only energy contracts that qualify as derivatives under Statement 133 are accounted for at fair value using mark-to-market accounting. Also, the EITF is addressing the issue of when two separate financial instruments should be combined and accounted for as if they were a single contract.[17] This will also help avoid the misuse of structured transactions where an entity may enter into multiple contracts that produce a desirable accounting result when entered into and accounted for separately, but where a single contract with the exact same economics would produce a less desirable accounting result.

It is important to note that while the Commission has looked to the FASB to promulgate accounting standards, it retains the authority and responsibility for setting accounting standards for registrants. While the final conclusions in the current FASB projects are uncertain, the staff of the Office of the Chief Accountant is diligently monitoring the progress of the projects and communicating with the FASB staff when appropriate to ensure the interests of investors are met.

Working with Banking Regulators

The Commission has long recognized the need to consult and coordinate with the federal banking agencies on matters involving financial institutions that are public companies. The Chief Accountants of the Commission and the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision meet periodically to discuss matters of mutual interest. These matters include accounting, disclosure, and corporate governance issues. The staffs of the agencies communicate on a regular basis both about banking industry issues, such as accounting and disclosure issues that affect a number of institutions in the industry, and individual institution issues, when it is appropriate to do so. The Commission and the federal banking agencies have brought joint enforcement actions against particular financial institutions, including those that inappropriately apply off-balance sheet accounting.[18] In addition, as required by the Gramm-Leach-Bliley Act, the Commission staff consults with the federal banking agencies on comments to be issued to public companies related to their reporting of loan loss allowances in the financial statements.

In recent years in particular, the Commission and the federal banking agencies have worked cooperatively together to improve financial reporting by financial institutions. In 1999, the agencies set up a Joint Working Group to study issues related to loan loss allowances. These efforts result in the 2001 issuance by the agencies of parallel guidance to improve institutions' documentation of loan loss allowances.[19] Additionally, the Commission staff has been supportive of federal banking agency efforts to assist institutions in following GAAP by providing clarifying guidance in the areas of loans held for sale and accounting issues affecting credit card operations.[20] Further, the Commission, the Federal Reserve Board, and the Office of the Comptroller of the Currency have supported private sector and regulatory efforts to improve disclosures by financial institutions about risk exposures.[21] The Commission fully expects to continue to work with the federal banking agencies in these and other areas of mutual interest.

Inspections and Examinations of Financial Institutions

The Office of Compliance Inspections and Examinations administers the Commission's nationwide examination and inspection program for registered self-regulatory organizations ("SROs"), broker-dealers, transfer agents, clearing agencies, investment companies, and investment advisers. The SEC's regulatory examination authority does not extend to parent companies or affiliates of SEC-registered entities, including banks. However, if compliance, risk management or other information relating to the SEC-registered entity is located at a parent company or an affiliate, the SEC requests and reviews this information during examinations of the broker-dealer. The SEC routinely shares information with banking regulators.

The Office conducts inspections to foster compliance with the securities laws, to detect violations of the law, and

to keep the Commission informed of developments in the regulated community. Among the more important goals of the examination program is the correction of compliance problems. When the Office finds deficiencies, it issues a "deficiency letter" identifying the problems that need to be rectified, requires firms to correct the problems, and follows up to ensure corrective action has been taken. Serious violations are referred to the Division of Enforcement for formal action.

Currently, there are approximately 8,100 broker-dealers, 7,700 investment advisers, 1,000 fund groups, and 950 transfer agents registered with the SEC. The SEC's examination staff consists of 688 staff located in headquarters and in the SEC's regional and district offices, 390 staff in the investment adviser/investment company examination program and 298 staff in the broker-dealer and SRO examination program. In the fiscal year ending September 30, 2002, the SEC examined 659 broker-dealers, 32 SRO programs, 1,569 investment advisers, 278 investment company complexes, 2 clearing agencies, and 152 transfer agents.

All broker-dealers must be members of at least one SRO such as the NASD or the NYSE, and many, typically larger broker-dealers, are members of several SROs. Pursuant to the Exchange Act, SROs have examination authority over their member broker-dealers and conduct routine cyclical examinations. The Office of Compliance Inspections and Examinations regularly inspects SRO programs and operations, including the SRO's examination program. In addition, the Office conducts several types of examinations of broker-dealers: oversight examinations of the SRO's review; special purpose examinations that focus on a particular regulatory concern such as anti-money laundering or best execution; and cause examinations to respond to concerns that come to staff's attention, for example through a customer complaint.

Most examinations focus on reviewing broker-dealers' compliance with rules governing the sales of securities to retail investors, and with reviewing broker-dealers' compliance with net capital and financial responsibility rules. The SEC also conducts special purpose examinations to review broker-dealers' internal controls and risk management systems. This type of review is designed to evaluate the processes and procedures that broker-dealers have in place to identify, assess, monitor, and control risks to the broker-dealer. These examinations are focused on measures that the broker-dealer takes to monitor the overall risks from its operations to the broker-dealer, and do not involve a review of specific transactions. Some of the areas reviewed include broker-dealers' systems and procedures for monitoring or controlling risk exposure associated with proprietary trading, lending to counterparties, and contingency planning in the event of a significant business disruption.

Conclusion

Thank you for this opportunity to submit this statement for the record of the Committee's hearing on the role of financial institutions in structured transactions. The Commission takes the need for clear and transparent disclosures very seriously. We intend to continue our vigorous efforts in this area and appreciate your emphasis on the need for the transparent financial reporting that is crucial to our capital markets.

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[1] For purposes of this testimony, the use of the term "structured finance transactions" is not limited to asset backed securities.

[2] The Committee's letter of invitation also asks for an evaluation of the "post-Enron reforms put in place by Citicorp, JP Morgan Chase, and other financial institutions and to develop guidance on best practices in the U.S. financial industry to prevent involvement in misleading or improper structured finance, accounting or tax transactions." While the Commission, in general, supports private parties' efforts to improve their internal compliance practices, it would be inappropriate for the Commission to comment on these companies' particular policies while the Commission's Enron investigation is continuing.

[3] See In the Matter of Dynegy, Inc., A.P. File No. 3-10897 (September 24, 2002). Dynegy settled this case, without admitting or denying the Commission's findings, by agreeing to, among other things, a cease-and-desist order and a $3 million fine.

[4] Most notably, as added by the Private Securities Litigation Reform Act of 1995, Section 20(e) of the Exchange Act provides that "any person that knowingly provides substantial assistance to another person in violation of a provision of this title, or any rule or regulation issued under this title, shall be deemed to be in violation of such provision *to the same extent as the person to whom such assistance is provided*." 15 U.S.C. §78t(e) (emphasis added).

[5] *See KPMG, LLP v. SEC*, 2002 U.S. App. LEXIS 9119, *25-27 (D.C. Cir. May 14, 2002).

[6] Both Ashford.com and Amazon.com consented, without admitting or denying the findings in the Commission's Order, to cease-and-desist orders.

[7] See, e.g., Brief of the Securities and Exchange Commission as *Amicus Curiae* in Klein v. Boyd, 1998 U.S. App. LEXIS 2004 (February 12, 1998), vacated and reh'g granted, 1998 U.S. App. LEXIS (March 9, 1998). The Klein *Amicus* Brief was filed by the Commission to inform the full court of the Commission's views on the issues before the court on en banc review. Because the case was settled, there was no en banc decision.

[8] Newby v. Enron Corp., Civ. Action No. 13624.

[9] Without admitting or denying the Commission's findings, PNC agreed to a cease-and-desist order.

[10] The Committee's letter of invitation also asks about the SEC's role in working with the Internal Revenue Service "to detect, deter and stop U.S. financial institutions or U.S. branches or agencies of foreign financial institutions from selling products, offering services, or structuring transactions which result in U.S. publicly traded companies issuing misleading or improper tax returns." The Commission, of course, is not authorized to enforce the Internal Revenue Code and does not directly play a role in the IRS or the Department of Justice's enforcement of these laws. The Commission does, however, at times come across evidence of possible violations of the tax laws in the course of its investigations or other regulatory activity. The Commission's practice is to refer these matters to the IRS. In addition, the Commission has often cooperated and worked closely with the IRS in investigations of conduct that implicates both the securities laws and the U.S. tax laws. For example, the Commission and the IRS closely coordinated their investigations of the practice of "yield burning" in the municipal securities industry.

[11] Comments by Bear Stearns analyst Pat McConnell at the "Benchmarking the Quality of Earnings Conference" in April 2001. The conference was jointly sponsored by the Financial Executives Institute and the American Institute of Certified Public Accountants.

[12] "Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations" Release Nos.: 34-45321; FR-61 (January 22, 2002).

[13] "Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments" Release No. 33-8144 (November 4, 2002).

[14] After it begins operations, the Public Company Accounting Oversight Board will have the authority to set auditing standards for public companies. See Sections 101 and 103 of the Sarbanes-Oxley Act of 2002.

[15] Exposure drafts released by the AICPA December 2, 2002 – "Amendment to Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards;*" "Audit Evidence;" "Audit Risk and Materiality in Conducting an Audit; Planning and Supervision;" "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement;" "Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained;" and "Amendment to Statement on Auditing Standards No. 39*, Audit Sampling."*

[16] EITF Issue 02-3, "Issues Related to Accounting for Contracts Involved in Energy Trading and Risk Management Activities." EITF Issues No. 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities," and No. 00-17, "Measuring the Fair Value of Energy-Related Contracts in Applying Issue No. 98-10," and *EITF Abstracts*, Topic No. D-105, "Accounting in Consolidation for Energy Trading Contracts between Affiliated Entities When the Activities of One but Not Both Affiliates Are within the Scope of Issue No. 98-10."

[17] Issue No. 02-2, "When Separate Contracts That Meet the Definition of Financial Instruments Should Be Combined for Accounting Purposes."

[18] See SEC Accounting and Auditing Enforcement Release No. 1597 (July 18, 2002) (Administrative Proceeding File No. 3-10838) regarding PNC Financial Services Group, Inc.

[19] See SEC Staff Accounting Bulletin No. 102 and Federal Financial Institutions Examination Council (FFIEC) "Policy Statement on Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Institutions" (July 2001).

[20] See the "Interagency Guidance on Certain Loans Held for Sale" (March 2001) and "Interagency Advisory on the Accounting Treatment of Accrued Interest Receivable Related to Credit Card Securitizations" (December 2002).

[21] For example, the agencies supported the efforts of the Working Group on Public Disclosure (also known as the Shipley Group) and the Multidisciplinary Working Group on Enhanced Disclosure (MWGED) (also known as the Fisher II Group). Both of these groups issued reports in early 2001 recommending improvements to institutions' disclosures about their exposures to market, credit, liquidity and other risks. Staff representatives of the SEC, Federal Reserve Board, and the Office of the Comptroller of the Currency are currently participating in a working group of the Joint Forum that is following up on the work of the MWGED to recommend further enhancements to disclosures by financial institutions (including firms in the banking, securities, and insurance industries).