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The Prophet

An exclusive TIE interview. Former SEC Chairman Arthur Levitt, who warned of potential U.S. accounting irregularities, surveys the post-scandal landscape.

TIE: ***You have obviously been way out in front on concerns about misleading behavior by equity analysts, insider information, accounting failures, and other problems in the financial markets. We have always had some of these problems in our large market system but it seems we have never had the rash of activity that we've seen in the last year or so. In your opinion, what are the major reasons why this has happened?***

AL: Over the past two decades we have experienced a gradual erosion of ethical values on the part of corporate America. A raging bull market, either a byproduct or consequence of the moral decline, seduced investors and created the kinds of excesses that ultimately resulted in the bear market and severe investor backlash.

TIE: ***To what do you attribute this kind of ethical breakdown?***

AL: We have such a competitive economy that if companies A, B, and C begin to stretch the envelope then E and F can't be far behind. Behavior that verges on the ethical becomes less ethical and sometimes outright unethical in order to meet short-term demands of analysts and shareholders. The kind of hype and exaggeration that has always been present in bull markets becomes exacerbated by the leverage inherent in products such as derivatives and options. This gives greater velocity to the consequences of all investment decisions. The euphoria of the period persuaded analysts, brokers, and investors that all of their decisions made money and that their wisdom and insights would invariably lead to success.

TIE: ***Do you think some of the changes underway like the Sarbanes-Oxley Act or some of the other regulatory rule changes being proposed are going to correct many of the major flaws? And do you think these changes are headed in the right direction, or if not, what would you do differently?***

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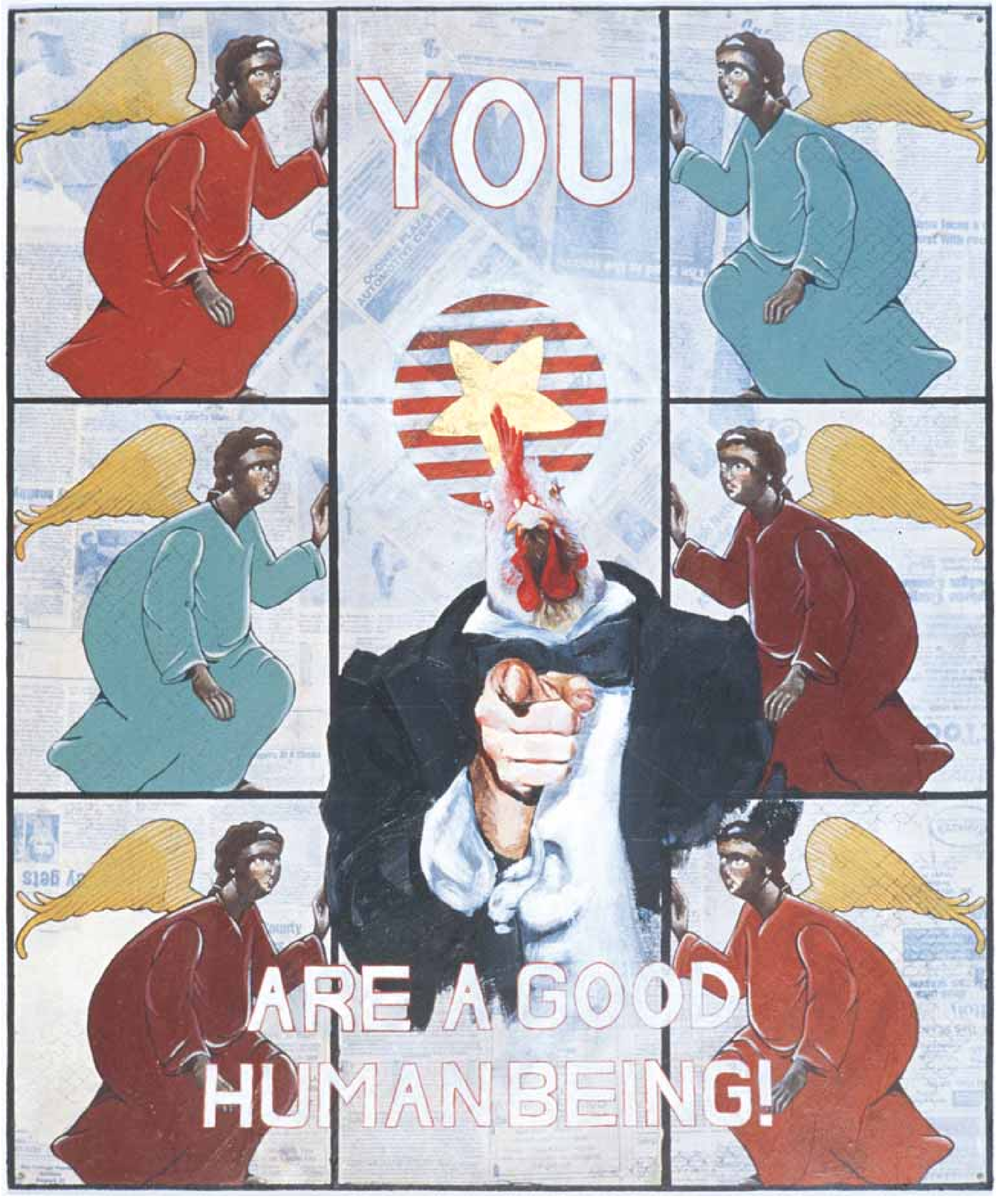

Ryan Miller, *you are a good human being!*, April 2001, Acrylic, gold leaf and newspaper on wood, 36”x30”, Private collection of John S. Anderson

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AL: I personally believe that humiliation and embarrassment has already changed behavior. Whether that will endure depends upon some of the changes we've seen. I think that over the years the economics of the accounting industry changed to a point where accountants became either perceptually or actually compromised by relationships they had with their clients. Time for self regulation has passed, and to restore public confidence we need to have the kind of oversight promised by the Sarbanes-Oxley bill. Whether or not this legislation will do the job depends, to a large extent, upon the credibility of the people chosen to serve on the audit oversight board. They will make the difference between a panel that is thoughtful and meticulous and mindful of the importance of preserving independence versus one that is either heavy handed and bureaucratic or the passive handmaiden to corporate interests. Hopefully the board will encourage the kind of behavior that restores public confidence in an accounting profession that has simply not been mindful of the public interest. The bill also does a number of other very important things by giving the SEC badly needed resources and providing independent funding to the Financial Accounting Standards Board. Of all the elements in the Sarbanes-Oxley bill, the funding of the independent standard setter may be the most significant element.

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TIE: ***Do you think the accounting standards themselves are a problem or is it more the auditing process that we need to worry about?***

AL: I think that clearly we have to question both our methodology in how standards are set as well as the actual standard setting itself. We've taken the position in this country for some years that ours is the only method. The accepted thinking was that U.S. GAAP is as close to perfect as you can get and that principle-based standards were too imprecise. I'm not prepared to say that formulaic standards have failed and principle-based standards are the answer, but I do believe we can no longer assume that there are not other ways of looking at the standard-setting process.

TIE: ***If you mention principle-based standards to FASB, one of their responses is that they would be happy to have simple standards with less complicated guidance and rules but in many ways complexity is demand driven by the preparers themselves who want protection from lawsuits and protection from nitpicking by the SEC. Do you think that's right or do you think that they really have become too bureaucratic?***

AL: I believe that more disclosure will diminish the importance of rules. It's very hard to draw a firm line in this regard. There's something to the arguments made by the FASB that it's not easy to short-circuit some of these decisions. When you have a standard that has been debated for nearly 12 or 14 years, however, that suggests that system is imperfect and needs fixing.

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TIE: ***It makes a lot of sense to go to a system that's more principles-based in terms of accounting standards. It's easier to understand and also more practical, but at the same time it does require more disclosure and explanation of how the financial statements were prepared to meet these principals. Do you think corporations, even though they seem to be wanting this new approach today, are prepared for the more extensive disclosure that goes with it or do you think in the end they'll want all these troublesome rules to protect themselves?***

AL: Self interest is very much a part of any society and any economy. Corporations very often don't act in terms of the greater good and that's where the role of oversight becomes quite important—oversight by regulators, and oversight by business leaders who embrace the notion that a fair and ethical and transparent economy is in the best interest of any nation's economy. I think the United States will lead in that direction and will not be dragged to the table. We've gone through the trauma of post- bull market public backlash many times before and the public and legislative outrage directed at corporate America was totally predictable. Investors who were emotional rather than thoughtful have not yet accepted their roles in being part of a market that was characterized by "irrational exuberance and infectious greed." Every bull market sadly leads to anti-business sentiment. Legislative proposals often move us toward costly and inefficient overregulation but invariably the nation's centrist instincts move us back to a point of balance.

TIE: ***All of these ethical breakdowns in the financial markets have raised a lot of arguments again that we may have gone too far, as you mentioned, with deregulation and that even though there were a lot of flaws in old laws like Glass-Steagall, there were also some important protections like prohibitions and firewalls. And, trying to synergize all of these various financial functions in one institution is really too risky so we should go back to something that avoids these conflicts of interest between underwriting and selling and other types of financial services. Where do you stand on that issue?***

AL: Once you take the kind of step we took in getting rid of Glass-Steagall, it's almost impossible to go home again. But I clearly believe that that step was misguided in a number of ways. I think that we are going to experience a period of bank bashing over the course of coming months and years and the conflicts of interest that were prevalent in the investment banking business will become even more visible in the commercial banking business. Also, the incidence of tying, which supposedly was forbidden by Gramm-Leach-Holling's legislation, has become almost the rule of the road rather than the exception, and that's going to cause us to revisit aspects of that legislation. Rather than going back to where we were I hope we take a good hard look at where we are and develop rules that address these conflicts that are prevalent and that undercut market confidence. I think we are going to hear much more about that over the course of coming months.

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TIE: ***Do you think what's happened in the United States with accounting scandals and some of the other equity market concerns has set back the convergence and globalization process or are we in a position to move ahead?***

AL: I think what happened will expedite the move toward international standards. The fact that the international standards setters are seriously considering expensing stock options is going to move this country in that direction. Today we more clearly recognize imperfections in the U.S. system which will enable us to take a somewhat more realistic view of international standards that may ultimately move us toward the goal of harmonization. It's not going to be easy, but recent developments make me more sanguine about the possibility of globalized standards than ever before.

TIE: ***Do you think that it's a problem that we don't have an SEC-type organization outside the United States, maybe in the United Kingdom, but we don't really have a securities policeman for the rest of the world like we do in the United States, and how do we solve this problem so that we can move the globalization process along with some confidence?***

AL: I think more and more countries realize that a strong securities law and a strong regulator are fundamental to the creation of a world-class market, and if you look at the United Kingdom and Hong Kong in particular, they've made great progress in this regard. Even China has embraced a series of laws that are very much stronger than anything they've had before. They have tried very hard to emulate U.S. markets and U.S. security laws. In the process, they recognize that in order to have credibility and to develop world class markets they must have strong laws and markets that are credible and transparent. As we look around the world you will see more countries embracing equity cultures than ever before. Germany and the United Kingdom are probably good examples of that. A true equity culture depends to the greatest extent upon laws, oversight, and regulation.

TIE: ***The globalization process has been attacked by various critics for trying to force western-style capital markets on emerging economies too quickly and we end up with hot money and not enough infrastructure in place to regulate the process, and in the end we create a boom-bust cycle for these countries. Joe Stiglitz who was Chief Economist at the World Bank and is now at Columbia University has made that criticism. How do you feel about that, do you think that view is overblown or not?***

AL: It's something we have to keep our eyes on. The road toward globalization is not a smooth one because of vast cultural differences. I think the United States has long been the primary capital market of the world and there are other markets that would like to emulate ours, and they recognize the reason that we are the primary market is because of the way our markets are structured and overseen. The best way to approach this is with the kinds of laws and regulation that give all investors a fair break by putting them on an equal footing with issuers and institutions. Again, Stiglitz recognizes that the tensions in this process have created some distortions—I can't deny that—but the movement I believe is in the right direction.

TIE: ***Thank you, Mr. Levitt.*** ◆