Testimony of

Mr. Bruce Raynor

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My name is Bruce Raynor. I am President of the Union of Needletrades, Industrial and Textile Employees, (UNITE). I am also a Vice President of the American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO"), the Vice Chair of the Amalgamated Bank and a Co-Chair of the Council of Institutional Investors. My testimony today is given on behalf of the AFL-CIO, UNITE, and the Amalgamated Bank.

UNITE represents over 250,000 workers in the apparel, textile, laundry, distribution and other manufacturing industries across the United States. UNITE members participate in over 35 multi-employer retirement and other benefit plans with total assets of over $4 billion. The AFL-CIO's member unions represent 13 million American workers and sponsor pension plans with over $400 billion in assets. Amalgamated Bank acts as a financial advisor and custodian to defined benefit retirement plans. Amalgamated has over $6 billion under management in its LongView Collective Investment Trust Fund ("LongView Funds") and over $23 billion in custodial accounts, which collectively represent a portion of the retirement savings of hundreds of thousands of electricians, operating engineers, hotel employees, service employees and public employees as well as textile and garment workers. I appreciate the opportunity to appear this morning before this committee.

Over the past 30 years, as a labor organizer, elected labor leader, Bank official, and investor activist, I have witnessed first hand, at the bargaining table and from the picket line, the ongoing efforts of corporate leaders to bend the rules, hide the facts, and take whatever steps necessary to mislead investors and deny their workers a fair share of a company=s gains. And far too often, these actions impact not only the wages and working conditions of active workers, but also the equally significant pension funds of retirees who have given a life=s service to the very company that cuts them off. Ten years ago, I stood and fought alongside retirees from the Fieldcrest-Cannon textile mills, workers who had put 40 years into mills that filled their lungs with cotton dust and their wallets with meager paychecks. Those retirees had seen their monthly pension checks dwindle to $40 a month, because $39 million from their pension funds had been given to a former owner of their mill as part of the mill=s sale just four years before. And just as we=ve seen in the Enron case, that deal was done by insiders, hidden in the cost of a sale, for the single benefit of one corporate leader, as if it were a minor footnote. For those retirees in 1991, like so many retirees and former workers at Enron, losing one=s pension defined their ability to survive at a time in life when they deserved to retire with dignity.

This fight, like the one we were able to win in Kannapolis NC, is about workers who pay taxes, help build their communities, and deserve the right to trust an economic investment system that they want to support as they seek a stable retirement. And just as then, we hear the same basic refrain on factory floors, Athere ought to be a law against that kind of behavior.@ I hope my testimony today will provide this committee with basic ways that you can act to restore confidence in the public arena and the economic markets.

Worker Funds' Efforts at Enron

On November 2, 2001, the Amalgamated Bank and the AFL-CIO wrote to Ken Lay and Dean Powers and to outside director in response to the initial revelations of insider transactions and false accounting statements. I should note the Amalgamated's Longview index funds held over $15 million in Enron's securities on behalf of our clients. We asked that Enron reform its board, riddled with conflicts of interest, some disclosed and some undisclosed. Receiving no answer, we wrote again on November 9, 2001, after the announcement of the Dynergy transaction, asking that persons of high integrity and reputation, with no prior connection to Enron, be asked to join the Enron board. We also asked that the company immediately disclose all the details of its financial situation in order to restore the capital market's ability to price Enron's securities and reduce the mounting uncertainty among investors.

We received a perfunctory acknowledgement from a corporate staffer. It is quite possible that had Enron taken early on the steps we urged, much of the panic that occurred both among its investors and its customers would have been avoided and a more orderly and less destructive adjustment to the true state of Enron's finances might have been achieved. But as we all know, they did not, and Enron filed for bankruptcy on December 2, 2001.

At that point, the Amalgamated Bank chose to litigate to try and recover some of our worker beneficiaries' money. On December 5, 2001, acting on behalf of the Long View Funds, Amalgamated Bank brought a class action lawsuit suit against Kenneth Lay, Enron's Board Chairman, and other high ranking Enron officials for insider trading, breach of their disclosure duties to their shareholders and other wholesale violations of the nation's securities law. We also sued Arthur Andersen. We are seeking recovery of billions of dollars in damages and the freezing of more than $1 billion in proceeds from insider trading.

Unfortunately, the Enron debacle is no aberration. It is only the most recent and, perhaps, worst case in a series of securities frauds and self dealing acts by corporate executives centered around a corrupted relationship between corporate executives, their boards, attorneys, and public auditors. Absent systematic legal and regulatory reform, the Enrons of the future are a certainty.

Rise of Accounting Fraud

Waste Management, RiteAid, Sunbeam Corporation, McKesson, Cendant, and, most recently, Enron -- these large cap companies are included in many major indices and, as a result, are among the core holdings of public employee and union pension funds. These are also just a few of the companies that in the past few years have admitted to filing false financial statements with the SEC and have, as a result, restated billions of dollars in previously-reported earnings. More than 400 other publicly-traded companies in the past several years have admitted to reporting inflated earnings statements. The resulting drop in share prices has caused over $31 billion of dollars in losses to investors, foremost of whom are workers' pension funds like UNITE's funds and the Amalgamated Bank's clients -- funds that are responsible for investing and safeguarding the retirement savings of millions of working men and women in this country. A headline in USA Today (June 22, 2001) described accurately what is happening: "Fuzzy Accounting Raises Flags -Crafty Accounting Can Steer Investors Wrong," That's why as a benefit plan trustee and fiduciary, I found it astounding to read the quote in Barron's magazine attributed to SEC Chairman Harvey Pitt that "there is nothing rotten with the accounting profession." The evidence suggests otherwise.

The big five audit firms have been engaged in a race to the bottom in financial reporting which has undermined a core element of our capital markets - the integrity of public company financial reporting. Accurate financial statements are essential to informed investor decisions, confidence in our markets, and the allocation of capital to credible businesses that create long-term economic job growth and positive investor returns. The collapse of Enron dramatically demonstrates the systematic failures in these vital controls that are intended to ensure transparency and fairness in business.

Over 9,000 new public companies were created by the IPO boom of the 1980s-1990s - more than half of all existing public companies today. Many of these new public companies were smaller high-growth high-tech or bio-tech companies where the pressure to show earnings growth is intense. Others were Dot-Com enterprises which have no earnings and were under pressure to show revenue increases - or create apparent profits by using so-called "pro forma" accounting to generate financial results which Generally Accepted Accounting Principles (GAAP) would never sanction.

An article in the Journal of Business (Francois Degeorge, Jayendu Patel, Richard Zeckhauser, Earnings Management to Exceed Thresholds, Journal of Business, 1999, Vol 72, no 1.) concluded: "executives have both the incentive and ability to manage earnings." Manipulation was most frequently present when needed to meet bright line tests, i.e. earnings estimates, and occurred most often in the fourth quarter just when the supposedly independent auditors are arriving on the scene for the annual audit. What does this conclusion suggest about the effectiveness of annual audits by so called independent accountants? Another study concludes "we have no doubt that short term earnings are being manipulated in many, if not all, companies." (W. Bruns and K. Merchant The Dangerous Morality of Managing Earnings. Management Accounting. 72. 1996)

Worth Magazine ran a story, "Taking the Lies Out of Earnings," which concluded, "earnings are becoming an increasingly less reliable tool for investors, as changes in executive compensation and accounting practices give corporate officials both a reason to bend the rules and greater leeway in doing so." (February 1997 issue)

According to Richard Walker - the former SEC enforcement chief who resigned earlier this year - "If we had nothing else to do, the accounting investigations alone would keep us busy for the next five or 10 years." ("SEC List of Accounting-Fraud Probes Grows, Stretching Agency's Resources," The Wall Street Journal, July 6, 2001.) In short, Enron was a disaster waiting to happen.

Auditor Conflicts

At the center of the erosion in accounting practices are the conflicts of interest created when "independent" auditors are also providing consulting services to their audit clients. We have seen that at Enron, according to the Powers Committee report, Arthur Andersen was actually structuring, as a consultant, the partnerships whose accounting treatment it was then approving as the independent auditor -- in effect auditing itself. Andersen then flatly denied it had done this in appearances before the Senate Commerce Committee and the House Financial Services Committee.

As a result of new regulations fought for by the SEC under former Chairman Arthur Levitt, with the support of the Council of Institutional Investors and the AFL-CIO and against fierce opposition from the accounting industry and the Congress, this year companies were forced to disclose previously secret information about their audit firms' consulting work. We now are learning how much companies pay their supposedly independent auditors for consulting services as compared to fees for "independent" audit work. The SEC had guessed consulting fees would run 25%-40% more than audit fees.
In fact, of total corporate payments to auditors only about 27 cents of every dollar is for audit work - the rest is for consulting services. ("Auditors Exposed! Cozy Deals Alleged! How 'Independent' Are These Book Checkers?" U.S. News & World Report, July 23, 2001.)
There can be no question these huge consulting fees have undermined the independence of the big accounting firms. According to The Wall Street Journal, "Study Faults Work of Auditors Who Consult" (August 1, 2001):

Auditing firms are more likely to compromise and stretch the bounds of accepted accounting practices when they are receiving substantial consulting fees from the firms they audit, according to an academic study .... The study - by professors at Massachusetts Institute of Technology, Michigan State University and Stanford University - is one of the first to pore through financial filings to answer empirically one of the key questions facing the accounting industry: How objective can an accounting firm be in an audit when it is also making millions of dollars providing the same client with other services? ... "Our study suggests that paying an accounting firm more for nonaudit services impairs auditor independence and reduces the quality of earnings," said Karen Nelson, a co-author and accounting professor at Stanford.

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We also need to recognize the obstacles preventing the SEC - the supposed "cop on the beat" - from doing its job. The resources of the SEC have long been outstripped by our surging markets. When Arthur Levitt tried to take on the accounting industry, Congress opposed him. Now the SEC is headed by a lawyer who used to represent Arthur Andersen and the other big accounting firms who fought to continue to conceal the billions in consulting fees they were pocketing from their corporate clients while certifying billions in phony profits. The White House has indicated it intends to fill two further seats on the SEC with Big Five audit firm partners -- essentially giving the Big Five control of the Commission.

Pressure to Manipulate Earnings Driven by Runaway Executive Pay
While the protections against accounting fraud have been weakened, the incentive on the part of executives to commit accounting fraud has been greatly increased by the phenomenon of runaway executive compensation. The AFL-CIO has been calling attention to this scandal since 1997 at its website www.paywatch.org. The explosion in executive pay was fueled by FASB's refusal, again under Congressional pressure in the mid-1990's, to require companies to account for the economic reality of executive option grants in their financial statements. These huge grants then became an overwhelming incentive for executives to pump up stock prices-- even when their companies' real performance was less than stellar.

According to a recent Watson Wyatt study (AStock Option Over-hang; Shareholder Boon, Shareholder Burden?@ 2001 study), an important cause of the recent devastation of tech stocks is the ill effects of enormous stock-option grants over the past several years. Stock options became an addiction of pandemic proportions in the 1990s. Companies liked them because they did not have to be counted as an expense and made earnings look better than they really were. Executives liked them because they provided easy riches as the greatest bull market of all time pushed stocks higher and higher, regardless of individual corporate performance. But this had hidden costs. It overstated real corporate earnings by billions of dollars during the past decade. And the more options there were, the less valuable the underlying stock became, creating real dilution that lowered actual earnings per share even more.
The Watson Wyatt study documents that even before the recent Nasdaq/NYSE collapse, companies giving the biggest option grants produced lower total returns to shareholders and higher stock volatility. The study, which examined option grants and stock price moves at 850 of the nation's largest companies, concluded that the heavy use of stock options had motivated executives to pursue riskier business strategies, like adding debt and making high-priced stock buy-backs. These strategies reflected the difference between an option holder, which has an upside but not a downside, and a stockholder, who paid real money for the stock and for whom the downside is very real..

Companies with a high percentage of outstanding options also suffer from option overhang. In 1998 and 1999, companies with the highest growth in option overhang produced much lower returns to shareholders. Now, the bill for all these options is coming due. The study concludes companies should encourage outright stock ownership instead of options. Companies that do so show higher returns to shareholders. As it becomes clearer that options exacerbated corporate stock declines, perhaps executives at companies with option excesses will be forced to rethink their strategy. But it is doubtful. Executives know that stock options mean having their cake and eating it too; but now comes the indigestion - unfortunately it's for their shareholders, not them.

And, it is even worse. We not only have executives getting compliant boards to re-price their options lower when the stock declines, but to keep doing it, literally chasing the stock price downward to continue to protect the insiders from either the vagaries of the market or their own mistakes. Amazon.com fell from over $120, re-priced at $23 and then again at $13. Clarent re-priced at over $50, then $26, and now $13. Excessive stock option grants and abusive re-pricing actions are clear examples of ignoring the interests of the true owners of corporations and of the need for better corporate governance procedures to make executives more accountable to the true owners of the enterprise.

Institutional Investors Vulnerable to Accounting Fraud

Now let me take a moment to explain why institutional investors are particularly vulnerable to accounting fraud. Large institutions with billions of dollars invested in the equity markets typically invest most of their assets in index funds. Index funds buy the entire market and hold each company's stock in proportion to its market capitalization. Index funds rely on the market to accurately price the securities in which they invest -- and their track record of beating the average active manager is testimony to the depth of the liquidity of our markets and the effectiveness of our system of market regulation. Index funds are also by far the cheapest way to prudently invest in the equity markets. But index funds are also the perfect victim of accounting fraud-- if corporate numbers are fraudulent, the markets will price stocks too high, and index funds cannot help but be the victims. That is why the Longview Funds have always seen good corporate governance, strong securities regulation and independent auditors, backed up by activist institutional investors ready to sue when victimized, as key to our money management strategy.

For the past ten years, Amalgamated Bank has joined other institutional investors in seeking to persuade corporate America to adopt a wide variety of governance improvements - smaller annually-elected boards dominated by independent directors; appointment of only independent directors to audit, nominating and compensation committees; and, now that there is disclosure of fees paid to auditors, the hiring of auditors unencumbered by conflicts of interest. However, even facing scrutiny from institutional investors, corporations have ignored shareholder resolutions that passed with overwhelming votes. We cannot protect our interests effectively in corporate annual meetings or in our courts when the laws and the regulators are allowing the companies in which we invest and the auditors who are supposed to be protecting us to steal from us with impunity.

Liability Limits in PSLRA Encourage Accounting Fraud

When I talk about laws that protect the misconduct we saw at Enron, I am thinking particularly of the 1995 amendments to the federal securities laws, the Private Securities Litigation Reform Act@ ("PSLRA"). While parts of this legislation had positive consequences, such as the lead plaintiff provisions that took control of litigation from the lawyers and gave it to the investors, the bulk of this legislation imposed a series of often impossible hurdles for investors seeking to hold corporate executives and accountants liable for securities fraud. To put it bluntly, congress opened the door and Enron and its ilk drove right on through. The PSLRA was enacted on December 22, 1995, when the Senate overrode a veto by one vote.

Testimony by consumer and investor groups warned that the proposed drastic cutback on investor protections against and remedies for securities fraud would reduce corporate executives' and securities professionals' accountability for misconduct. This, in turn, would result in an increase in securities fraud and investor losses and impair investor confidence, thus harming capital formation and our nation's economy. Not only was the PSLRA opposed by Arthur Levitt's SEC and vetoed by President Clinton, but virtually every major consumer, labor and investor group in America and the vast majority of America's newspapers editorialized against the PSLRA. They all warned that it would grant those best positioned to profit from stock price inflation a license to lie and result in a massive upsurge of fraudulent conduct and investor losses. Those predictions have now come true with a vengeance.

The Worker-Investor Reform Agenda: Securities Law, Bankruptcy Law, Pension Law

Now Enron has exposed to widespread public attention a whole series of conflicts of interest and inadequate regulation affecting our capital markets and our retirement savings system-- problems that the labor movement and institutional investors have been warning about for years. But with the exception of a few brave public spirited individuals like Arthur Levitt, few here in Washington heeded these warnings. But now is the time to act on a range of issues. I will begin with where this Committee has clearest jurisdiction. Congress needs to:

(1) Restore meaningful access to the courts for investors victimized by accounting fraud. We need to restore the right of investors to sue accountants and lawyers for aiding and abetting their clients' securities fraud. Every major securities fraud case since the passage of the Private Securities Litigation Reform Act has had significant involvement on the part of auditors and attorneys, but the victims of their actions cannot sue them for their role in it. We also need to restore access to victims of Enron like conspiracies to claims under civil RICO. Nothing looks more like a racketeering conspiracy than the events involving Enron, Andersen, their law firms and their political allies, yet the PSLRA immunizes these racketeers against RICO liability. Congress also needs to establish one clear and fair standard nationally for liability for securities fraud, and that standard should be recklessness. The intentionality requirement some federal courts have inferred is in the PSLRA effectively makes it impossible for investors to recover in most securities fraud cases. It requires private litigants to essentially find an informant -- a task more suited to a criminal investigation by the government. Finally, the PSLRA repealed joint and several liability, which has a particularly harmful impact in the most serious cases like Enron where the company itself, as a result of its conduct, is bankrupt. Joint and several liability should be restored.

(2) Reform the bankruptcy laws so that rich miscreants in Texas and Florida can't sit in their million dollar homes while their victims across town get thrown out of their apartments-- as is literally happening in Houston today. In this regard the bankruptcy bill this Congress passed last year is a shocking travesty -- it would punish the victims of Enron who have to file for personal bankruptcy while legitimizing the very transactions Enron used to hide its liabilities. (Prof. Elizabeth Warren and 34 Bankruptcy Law Professors letter to Chairmen Leahy and Sensenbrenner, January 23rd, 2002) It should die where it is now in conference.

(3) Put into place an effective public regulatory organization over the accounting industry and end the practice of so-called "independent" auditors collecting millions of dollars of non-audit fees from companies they are auditing. The AFL-CIO has petitioned the SEC to enact further rules ensuring auditor independence, but in light of the lack of responsiveness and the conflicts of interest potentially affecting a majority of the Commission on this issue, we believe Congress must act either by mandating rulemaking or by enacting a ban on consulting by audit firms into law.
(4) Ensure corporate directors are really independent of the CEO's they are supposed to be overseeing by ending the practice of having Enron-style independent directors who were really financially and politically dependent on Enron executives. The AFL-CIO and the Council of Institutional Investors have both petitioned the SEC to enact rules that would have this effect, but there has been no response from the Commission and we frankly believe that Congressional action is needed either to mandate rulemaking or to enact the principles of independence into law.
(5) Reform the accounting treatment of stock options given to corporate insiders and put meaningful restrictions on how those options may be exercised and sold so that we won't see again executives who are running a company into the ground simultaneously taking a billion dollars out of the company by exercising options.
(6) Reform 401(k)-type retirement savings plans to prevent employers from pushing employer stock into worker retirement accounts-- a practice which is great for employers because it is cash-free but terrible for workers whose retirement savings are bet entirely on one company. In this regard President Bush's proposals are completely inadequate to this problem, and in fact would put employees' retirement savings further at risk by repealing ERISA's current ban on conflicted investment advice by 401-k money managers trying to promote high fee and high risk investment options.

Conclusion: People Are Hurting-- Congress Must Act

The corruption of our securities markets which Enron symbolizes has hurt a lot of people. While it is too early to tell how long or severe the current recession will be, no one can deny that significant economic harm has occurred due to collapse of our securities markets. Financial and accounting scandals have plunged companies into crises leading to many bankruptcies. Investor losses have turned into a Areverse wealth effect.@ Massive layoffs abound. Capital formation has been impaired as burned investors shun the IPO market. New public offerings are sparse in today=s environment..

Baby boomers without defined benefit retirement plans are considering what to try to do next now that their 401(k)s have been hit. According to Business Week ("Retirement Gets Scary for Baby Boomers," July 30, 2001):

Lulled by recent dreams of early and easy retirement, millions of Americans are suddenly facing the harsh truth that they will have a much harder time retiring.... Those with lots of high-tech company stock in their 401(k)s may be in the worst shape.... Stripped of the illusions fed by a booming stock market, retirement is shaping up to be a nightmare of cost and complexity.

Or as an article in the New York Times puts it-- "the inevitable bottom line of a 401(k) system -- postponed retirement -- is surfacing." ("Workers Find Retirement is Receding Toward 70," New York Times, February 3, 2002, Money and Business, p. 4.) The truth is what the labor movement has been saying for decades -- 401-k plans are a good supplement to a defined pension plan and Social Security, but a disastrous replacement.
And then there are individuals like the many Enron 401-k participants who came to Washington last week -- secretaries, vice-presidents, electrical lineworkers -- people in their 50's who gave a lifetime to their employer and were rewarded with layoff notices, bounced severance checks and empty retirement accounts. Surely these people should receive the ill-gotten gains of the insiders here.

I will conclude by pointing out that the workers I represent are appalled by what happened at Enron. I wish I could say that they are shocked. But they are not. They are not shocked because what happened at Enron has exposed something that they know very well -- the reality of excess corporate power in our society. That power manifests itself daily. It is demonstrated in the stimulus bill supported by the administration that provides a windfall for the wealthiest people in our society while giving workers almost nothing. That power was also behind a multi-billion dollar bailout of the airline industry, while, again, workers received almost nothing. The story of how millionaire executives used their wealth and political clout to rig the rules and free themselves from accountability, and then used that freedom to enrich themselves while workers, consumers, and small investors pay the consequences is becoming all to commonplace in our society.

These then are the lessons of the last several years, only most dramatically demonstrated by Enron. It is now up to Congress to act, quickly and decisively to protect the American people's retirement income and prevent the Enron's of the future. The labor movement and institutional investor community stand ready to work with this Committee and this Congress to adopt true reform legislation. Thank you for considering our views.