February 4, 2002

Harvey L. Pitt
Chairman
Securities and Exchange Commission
450 Fifth Street N.W.
Washington, DC 20549

Dear Chairman Pitt:

The spectacular collapse of Enron has significantly and painfully affected millions—from the thousands of Enron employees who have lost their jobs and in some cases, their nest eggs, to the institutional investors and pension funds that invested in Enron on behalf of other individuals. It has also highlighted the painful failure of some safety nets intended to protect investors.

The Council of Institutional Investors, an organization of more than 120 public, corporate and union pension funds and nearly 120 money managers and investment and securities professionals, represents nearly $2 trillion dollars of pension assets. Council members are responsible for investing and safeguarding assets used to fund pension benefits of millions of participants and beneficiaries throughout the United States, and they have been directly impacted by Enron's collapse. A list of Council members is attached.

The Council is concerned that the escalating congressional frenzy surrounding the Enron meltdown—while generating voluminous media coverage—may fail to result in any meaningful reforms to a system clearly in need of improvements. Enron is just the latest in a long line of fraudulent accounting cases in recent years. But the unprecedented magnitude of the Enron debacle gives heightened urgency to the need for regulators and legislators to take a close look at the current safety nets and to propose meaningful reforms designed to ensure that another "Enron" won't happen.

We believe that there are a few solutions that would go a long way toward improving current investor safeguards.

First, we believe it's time for the SEC to reform auditor independence standards.

Arthur Andersen, Enron's auditor, appears to have failed miserably in ensuring that the reported financials were a fair presentation of Enron's financial condition. We believe this firm's independence was tainted by its provision of non-audit consulting services to Enron. According to Enron's 2001 proxy statement, the company paid Arthur Andersen more for consulting services ($27 million) than for its audit services ($25 million) in 2000.

While a $52 million relationship may not be material to Arthur Andersen as an accounting firm, there can be no doubt that this relationship was material to the partners of the Houston office responsible for the Enron relationship. As the SEC learned in its civil fraud case against Arthur Andersen regarding its 1992-1997 audits of Waste Management, audit partners assigned to lead audits may be responsible for coordinating non-audit services, and their compensation may be influenced by the volume of non-audit fees. Indeed, according to *The Wall Street Journal* (Jan. 17, 2002), the Arthur Andersen partners responsible for Enron were concerned about the size of the firm's non-audit consulting relationship with Enron.

To resolve this conflict, Council members believe that auditors should be prohibited from providing any non-audit services to their audit clients. Such a prohibition would ensure that auditors would not be reluctant to challenge management due to concerns over the possible loss of profitable consulting business.

Over a year ago, the Commission considered toughening the auditor independence standards to prohibit outside auditors from providing many types of non-audit consulting services to audit clients. The Council and several members urged the Commission to toughen its proposal to impose a bright line test prohibiting auditors from providing non-audit-related services to audit clients.

Unfortunately, rather than toughening its proposal, the SEC backed off in response to strong pressure from the corporate community and from Capitol Hill. The Council believes this was a mistake.

We urge the Commission to revisit this issue and toughen the rules to ban outside accountants from providing non-audit services to audit clients. We also urge the Commission to consider other auditor-related issues, including:

- Should companies be required to rotate their outside auditors every few years, as proposed by the AFL-CIO, a Council member, in a recent rulemaking petition (copy attached) to the SEC?
- Should the SEC impose "cooling off" periods before audit firm employees may work for audit clients?
- Should the SEC prohibit outside accountants from providing any internal audit services to audit clients?

Second, we believe that it is time to radically reform the oversight of auditors. It's clear that the accounting profession's current system of self-oversight is not working. We are pleased that the SEC recognizes that the accounting profession is in need of a more effective governance model.

However, we ask that the opinions of *all* interested parties—not simply the Big Five accounting firms—be considered before any oversight model is proposed. New ideas—such as the creation of an independent auditing entity—should be considered and publicly debated.

Third, we believe it's time for the SEC to require enhanced disclosure of director links to companies. All too often shareholders aren't aware of significant links between directors and companies and executives until it's too late and the companies are embroiled in a scandal.

Director independence is an issue of fundamental importance to Council members and other investors. We think it's meaningful to know if a CEO's personal attorney sits on the board or if the director works for a nonprofit that receives significant contributions from the company, for example. These relationships may impact a director's independence.

But unfortunately, the current disclosure rules are inadequate. Some very basic, yet material information, about director relationships doesn't have to be disclosed under current rules. And companies aren't volunteering to provide those details.

More than four years ago, the Council submitted a rulemaking petition to the SEC to toughen the disclosure rules so that investors would have ready access to the critical information necessary to evaluate the potential for relationships that could interfere with a director's independent judgment.

This October 1997 proposal and an October 1998 amended proposal (copies attached) have languished at the Commission. Most recently the AFL-CIO has submitted a petition (copy attached) calling for reform in this area. It's time for the Commission to act on this important disclosure issue.

Fourth, we request that the Commission press the stock exchanges to toughen their listing standards addressing board independence and board composition. More than two years ago, the exchanges, at the SEC's request, adopted new standards for the composition of listed companies' audit committees. The NASD and AMEX also refined their standards for determining director independence.

Unfortunately, the exchanges' definitions and standards—approved by the SEC—fall far short of the standards proposed by a blue ribbon commission on audit committee effectiveness or ones endorsed by the Council, its members and even the Business Roundtable.

We believe the exchanges should toughen their definitions of independent director to more closely match the definition endorsed by the Council members or comparable definitions adopted by TIAA-CREF, the California Public Employees' Retirement System or other major investors. (A copy of the Council's definition and its corporate governance standards is attached.)

It's also time for the exchanges to update their standards for board and board committee independence. Current standards for board independence are inadequate, with the NYSE only requiring two outside directors and the Nasdaq and AMEX only requiring a sufficient number of independent directors to satisfy the audit committee requirements. As endorsed by the Council, other institutional investors and the Business Roundtable, a substantial majority of directors should qualify as independent.

We also believe listing standards should be amended to require companies to have audit, compensation and nominating committees that consist solely of independent directors.

Fifth, we believe that the Commission should not soften its stance on enforcement. Companies or audit firms that violate the laws should be penalized. We believe tough enforcement efforts—and criminal prosecutions, whenever possible—are the most effective deterrents.

We are concerned about your recommendation that the SEC take a "kinder, gentler" approach with the accounting profession and other possible wrongdoers. This softening is distressing and suggests that the Commission won't take appropriate, and admittedly difficult, actions to penalize and prosecute wrongdoers.

The SEC's primary job as an enforcement agency is to protect investors and maintain the integrity of the securities market. We believe that to carry out this role, the SEC must remain vigilant about enforcing the laws. Behind-closed-doors discussions and settlements set no examples for others nor offer any deterrent benefits.

Sixth, we believe that it's time to restore integrity to the proxy voting system and to eliminate the stock exchanges' "broker may vote" policies. Current NYSE and AMEX rules allow brokers to vote on "routine" proposals—including the uncontested election of directors and the ratification of auditors. As Enron has shown, these proposals are not "routine." In fact, they may be two of the most important votes cast by shareholders.

The exchanges claim the purpose of the 70-year-old "broker may vote" rule is to ensure that companies meet quorum requirements. But recent studies have concluded that this argument is a red herring, and that nearly all U.S. companies satisfy quorum requirements without the broker votes.

This rule amounts to ballot stuffing for management. Council members urge the SEC to work with the exchanges to prohibit brokers from voting on any ballot items without express instructions from the beneficial owners.

Finally, we agree that it's time to meaningfully update the disclosure requirements and accounting rules for financial and other critical information and to speed up the way accounting and auditing standards are set. However, we do not believe that a switch to "current" disclosure of unquestionably material information—while laudable—is sufficient to solve the many problems facing the accounting profession. We urge you to consider views from all interested parties, including investors, corporations and accounting firms, as you move forward with reforming the disclosure requirements and with considering other reforms, including changes to accounting standards.

The Council welcomes initiatives that strengthen these safety nets. We look forward to discussing these critical issues with you and the other members of the Commission.

Sincerely,

Sarah A.B. Teslik
Executive Director

Enclosures