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Statement of the Shadow Financial Regulatory Committee
On

The Responsibilities of Financial Professionals and Firms in Recent Financial Scandals

September 22, 2003

In the past few years a series of financial scandals have involved the use of financial engineering to improve reported earnings and hide indebtedness through transactions that have had little or no economic substance. Enron's use of special purpose entities and its structuring of loans to appear as commercial transactions are perhaps the most publicized examples. Such practices raise fundamental issues about the use and interpretation of generally accepted accounting principles (GAAP), especially when applied on a "check the box" basis without regard to underlying concepts.

Many of these transactions required collaboration by outside professional and financial organizations, including accounting and legal firms as well as commercial and investment banks. Belatedly, many of these firms are adopting internal rules, procedures and monitoring practices designed to eliminate collaboration in such activities with their corporate clients. This new attitude is replacing a former approval of such collaboration, which actually sought to generate new business by suggesting, and even selling, programs designed to produce misleading financial reports by client companies.

The Shadow Financial Regulatory Committee wholeheartedly approves this new focus. American financial markets depend for their vitality on the integrity of financial reporting. Professional and financial firms that contribute to misleading reporting not only undermine the confidence of the investing public in that integrity, but also do a grave disservice to their own employees, partners and investors.

The Committee is reluctant to propose further legislation and regulations at this time. The Sarbanes-Oxley Act introduced much new law, and additional new law is in the process of being made through regulatory and court decisions concerning the recent scandals. In addition, settlements of pending litigation have made major changes in financial practices. We look forward to learning more about new measures being taken internally by outside professional and financial firms. Hasty new public policy requirements could not only abort this highly desirable private sector evolution, but could further bureaucratize corporate decision-making. It could also lead to further clogging of the courts with unproductive class-action and test-case litigation.

The Committee will continue to monitor private sector developments of the kind just discussed. This is an opportunity for private-sector professional and financial leaders to take steps to improve their own ethical standards, while restoring the reputation and integrity of U.S. financial markets.