

## Inside:

*A speech before the National Press Club in Washington, D.C., on 5 June by Henry M. Paulson, Jr., Chairman and Chief Executive Officer of the Goldman Sachs Group, Inc.*

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## Restoring Investor Confidence: An Agenda for Change

*In a speech on 5 June, Goldman Sachs Chairman and Chief Executive Officer Henry M. Paulson, Jr., called for reform within the US financial system to restore public confidence in business principles and practices*

I come here today as the CEO of Goldman Sachs. But, perhaps even more importantly, I come here as an individual who believes passionately in the strength of our free-market system—a system which generates growth, creates jobs and wealth, rewards initiative and fosters innovation like no other in the history of the world.

Ours is an economy that has proved its resilience again and again, most recently and most dramatically as it recovered from the terrible attacks of September 11.

Today we face another challenge—what some have called a crisis of confidence in the way in which companies do business. This, coupled with the lingering sense of vulnerability and uncertainty resulting from September 11, as well as international tensions and conflict, has seriously impaired the confidence of investors, CEOs and Boards of Directors alike. It has been a drag on the economy, the performance of our capital markets and on corporate activity, including mergers and acquisitions and new investment.

This began last fall, with the collapse of Enron, at the time one of the most admired corporations in the country. That collapse rapidly became a scandal, with mounting evidence of gross mismanagement and malfeasance. One of the nation's most respected accounting firms—Arthur Andersen—was swept up in the Enron debacle, its survival still very much in the balance.

In Congress and elsewhere, new and unflattering light has been shed on the practices of other companies. My own industry has come in for criticism for, among other things, the way it conducts investment research. Just six months after Enron's bankruptcy, its collapse has led to a general and often harsh examination of how we do business in America.

In my lifetime, American business has never been under such scrutiny. And to be blunt, much of it is deserved.

Don't get me wrong. Our economy is not full of Enrons, ready to collapse when someone takes a close look at their books. And the overwhelming majority of American corporate executives are men and women of integrity who are competent and highly committed to the long-term success of the companies which they lead. But the Enron debacle and subsequent revelations have revealed major shortcomings in the way some US companies and those charged with their oversight have gone about their business. And it has, without doubt, eroded public trust.

Self-correction has already begun. And, despite the difficulties of the moment, I see the post-Enron environment as one of opportunity—a chance for all interested parties to reassess our current practices and renew our basic principles.

But we need to do so in ways that maintain the vitality of our market-driven economic system. Regulation is, of course, crucial to the proper functioning of our markets. But finding the right balance between regulation and market forces is critical. We've done so before. And I am confident that we will be able to strike such a balance yet again.

The stakes, after all, are enormous. And they transcend those of individual firms or investors. The US economy and its financial markets are, rightly, the envy of the world. Since June 1981, the economy has almost doubled, productivity is up 50%, and about 40 million jobs have been created. During this same period, the stock market has appreciated by more than two and a half times.

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But our markets are not just beneficiaries of our remarkable economic performance. They also drive it by mobilizing capital, unlocking value, encouraging entrepreneurship and rewarding good management. Our financial markets are the deepest, most efficient and fairest to be found anywhere; they are models that others, in developed and developing economies alike, strive to emulate.

But they are not perfect. And it's time that we fix them.

As part of that discussion today I would like to provide some perspective on three areas: accounting policies and practices; corporate governance; and conflicts of interest.

### Accounting

I will begin with accounting, where we have seen by far the biggest fallout from the Enron collapse. The response is simple: the Arthur Anderson-certified financial statements of Enron bore little or no relationship to economic reality. Moreover, a distressing—although relatively small—number of similar instances involving other firms have also come to light, as have a larger number of company-specific accounting problems.

How did all this happen?

Long bull markets always seem to result in laxity and complacency. Moreover, investors don't like surprises, and they have expressed a clear preference for companies that generate predictable earnings streams. Most businesses go through cycles or have business models that make this impossible.

Nonetheless, some CEOs feel obliged to defy gravity in an attempt to produce earnings increases quarter after quarter after quarter. This can create pressure on in-house financial staff and outside auditors. This problem is compounded by the fact that the overly complex rules-based approach underpinning US GAAP is ripe for manipulation.

The combination of these two factors—pressure to produce predictable earnings

and an overly complex rule set—has resulted in a few companies trying to bend the rules or circumvent them altogether. The more complex things become, the greater this temptation and the easier it is to succeed.

So how can we strengthen our system and enhance investor confidence? First and foremost: accounting is the responsibility of corporate management—plain and simple.

While the exact form needs to be crafted carefully so as not to create a tidal wave of frivolous litigation, the CEO at a minimum should be required to certify that his or her company has established reasonable procedures for assessing the accuracy and completeness of its financial results and disclosures.

Next comes the question of auditor independence. Basic, simple questions must be asked. Who does the auditing firm really believe they work for? Who hires them; who pays them; and who gives them their directions?

Of course, existing good corporate governance standards and listing rules require that the Board of Directors, acting upon the recommendation of the Audit Committee, select auditors each year. But in practice, many Boards have tended to rubber-stamp management's decision. Auditors understand that it is really management which selects them and determines their fees—a clear conflict of interest. In the post-Enron environment the system is already beginning to self-correct to the extent that Audit Committees and Boards feel compelled to do their job with much more zeal. But in my judgment they must do even more.

Audit Committees must develop policies and processes that ensure there is no doubt that the company's auditors report to them and work for them. A major step in that direction would be for Audit Committees to perform a rigorous annual review that, at a minimum, would include negotiation of audit fees and a real consideration of the factors that might cause a decision to replace the auditor. This would require an Audit Committee to evaluate an auditor's performance against clear criteria set in

advance, and it would require a practical plan to be in place if the need for replacement is determined.

On the issue of consulting services, I have a simple statement: I do not believe that auditors should provide consulting services to their audit clients because, at least in appearance, this compromises auditor independence and erodes trust.

But we must be careful in setting this rule. Some activities are so closely related to auditing that they should be permissible for audit clients because they allow the auditor to do a better job. Nothing, however, must compromise the audit firms' ability to conduct pressure-free audits.

Changes are also in order for oversight.

In recent months we have seen the results of SEC action with several high-profile restatements of earnings. Such actions are powerful, positive steps.

But we need to go further. The SEC must be responsible for setting and enforcing auditing standards, either by establishing an independent public regulatory organization, as the Commission has already suggested, or by taking more direct responsibility itself. In any event, the current 'peer review' process, which today allows audit firms to police themselves, should be replaced with an effective 'audit of the auditors.' This should include comprehensive reviews of specific audit work at randomly selected public companies.

Again, let's not lose sight of the fact that the SEC is the government entity charged with overall responsibility for ensuring the integrity of our financial markets. Whether it does this directly or, in the case of auditor oversight, through a public oversight body is a matter for fair debate, but it is also a matter for the SEC to determine in the first instance. However, it is imperative that any such oversight body be independent of the accounting industry, led by experienced and knowledgeable business people. And the SEC must be prepared to step in directly whenever and wherever it believes the oversight body is not fulfilling its role.

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Chairman Oxley of the House Financial Services Committee, among others, has proposed greater auditor oversight responsibilities for the SEC. He has also proposed strengthening the SEC with a budget increase, and this is essential if it is to fulfill its mission. The SEC must have increased resources, and that means the ability to pay market-based compensation to attract and retain talented professionals.

Now I come to the most critical area—**N**one that I believe must be addressed urgently—the US rules-based accounting system. This is where the most change is needed.

We must not lose sight of the fact that US GAAP accounts for the vast majority of global economic activity, has been held up as the model for the whole world, has served us well for many years and is generally viewed as the best accounting system in the world. There is now talk of the superiority of the ‘European system’—a less rules-based and more judgment-based approach. It is clearly different and successful in its own right. We must be willing to learn from it and to adapt our own system. The goal should be international convergence of accounting systems. To do this we need a new approach to standard setting.

I referenced earlier the phenomenal growth in the US economy over the last two decades. Indeed, the speed of innovation in the financial markets over this period has been nothing short of astonishing. This pace of change demands a nimble and practical method of ensuring that information at the core of the US economy is fairly presented. We need standard setters well versed in business complexity who understand the import of their actions and the need to address critical issues quickly. And we need a standard-setting process that is practical and efficient.

I am not an expert in the area of accounting standard setting, but it seems to me that if the outcome of all we have been through in the past six months, all the soul searching and debate, is business as usual at the FASB, then we will have missed an enormous opportunity for improvement. I

strongly encourage the SEC to take a long hard look at the way we set accounting standards in the US, including the governance of the FASB, the selection of FASB members, the FASB standard-setting process with all of its time delays and the overall resources at the FASB’s disposal, and to ask—‘are we satisfied with the results or do we need change?’

As you might expect, a number of accounting changes are being contemplated today by the FASB, some of them specifically in reaction to the Enron situation. For example, after a near 20-year debate, rules governing consolidation of special purpose entities are finally promised, and they are long overdue. But the initial proposals are complex, rules-based and lacking in underlying principle. In fact they may make financial statements even less transparent and even more divorced from economic reality. This is not the way to move US accounting standards forward.

As I said earlier, I believe that we need to focus on fundamental principles—principles, not details—that ensure all the risks and rewards of an entity are properly recorded and disclosed to shareholders. The FASB should take a big step back and refocus its efforts on what is needed to achieve financial statement transparency. In this case, simply put, less may be more.

The FASB should begin by looking at the prevailing ‘historical cost’ accounting model—which is hopelessly antiquated for companies principally engaged in the business of financial services, or for companies which have become as heavily involved in financial instruments as Enron was.

Instead of requiring such companies to record the current, fair market value of all financial assets and liabilities in their financial statements, historical cost accounting allows them to record certain financial assets and liabilities at their historic cost. Of course, the value of financial instruments varies greatly with the fluctuations of the market. Unless companies account for those fluctuations, their financial statements can conceal tremendous losses.

In today’s world a corporation’s creditworthiness can deteriorate rapidly—witness Enron, where some of the nation’s largest banks were forced to fulfill billion-dollar commitments just weeks before it collapsed. Yet banks are not required to recognize the fair market value of loan commitments or outstanding loans in their financial statements even when there has been a major erosion of economic value. Consequently, the economic cost of these outstanding liabilities is unknown to investors, regulators or the media.

I say this with the recognition that a transition to a system of fair-value accounting is not without its difficulties. I also recognize that such a transition will take time. These considerations should not, however, paralyze efforts to move towards accounting practices that will best approximate economic reality.

The discipline associated with the use of fair value accounting—or for that matter any accounting system—includes the following:

- First, we should require that any change in the methodology used to determine fair value be immediately disclosed.
- Second, and most importantly, we should require management to establish, and then to disclose, the systems and procedures necessary to ensure that fair value is properly applied. These should include the segregation and independence of financial control staff from those charged with generating revenue, and the separation of those professionals responsible for determining valuations from those responsible for verifying the valuations.

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### Corporate Governance

As someone who runs a global investment bank and spends a lot of time with clients inside and outside this country, I believe that the US system of corporate governance—though not perfect—is the best in the world.

Now, before I recommend some changes, let me clearly state that no form of corporate governance—no matter how well-designed—will guarantee that there won't be future failures. In a market-based economy, companies with bad business models will fail. The freedom to succeed must be accompanied by the corresponding freedom to fail. That we cannot change, nor should we. And, in the final analysis, the most important thing is the quality of the people involved—their competence, their experience and their integrity.

But for optimal results, competent, experienced people with integrity should be working in a corporate governance system which provides them the proper checks and balances and sufficient information for all to do their jobs. The three basic principles of such a system are:

- 1) transparency with an emphasis on financial disclosure which reflects economic reality;
- 2) competence and integrity; and
- 3) a proper alignment of interests and allocation of responsibilities among management, the Board of Directors and shareholders, recognizing potential conflicts and clearly disclosing their nature.

Working from these principles, it makes good sense that CEOs receive the largest portion of their compensation in equity.

But it is equally vital that they hold it for the long-term. That will create the proper incentives and inspire investor and employee confidence. Share sales by top management, particularly if they represent a significant portion of the individual's ownership, fly directly in the face of the intent of an equity-based compensation

program. Moreover, no matter how carefully the windows governing share sales by top management are constructed, and no matter how fulsome and transparent disclosures are, top management would have to be woefully inept not to know more about the condition of—and the prospects for—his or her company than the average shareholder.

In this regard, the business community has been given a black eye by the activities and behavior of some CEOs and other notable insiders who sold large numbers of shares just before dramatic declines in their companies' share prices. In some instances these sales preceded bankruptcy by a matter of months. Existing legal mechanisms may serve to sort out inappropriate insider selling, but given difficulties of proof, more is needed.

Executive compensation has clearly caught the public attention. There have been a few well-publicized examples of CEO over-compensation. Even when measured against a US system which pays generously relative to any other place in the world, when compensation is out of line with performance, it really stands out!

There have also been a few extraordinary loans to CEOs. Most shareholders don't view their company as a bank (unless it really is one!), and such a loan to a CEO does not inspire public confidence or properly align interests.

Given the public interest surrounding CEO pay, Board compensation committees also face increased scrutiny—as well they should. In this regard, we should focus on the compensation of independent directors from company sources other than their directors' fees. One notorious example is Enron, which compensated at least some of their so-called independent directors through consulting fees and other arrangements that in some cases greatly exceeded their directors' fees. Even if these consulting arrangements don't actually taint directors' independence, they undermine confidence in the system.

Of course, the compensation abuses I've cited are not the norm, they are the exception. The vast majority of executive and independent director compensation

stands up to scrutiny and is part of a system which has benefited this country greatly—a system that holds the Board of Directors accountable for hiring, firing and compensating CEOs—and puts the power to elect the Board of Directors in the hands of the shareholders. When CEOs are formally evaluated by competent, independent Compensation Committees and their compensation is matched with the results, the system works.

Much good work has been and is being done in the area of Corporate Governance including the May 2002 report by the Business Roundtable and an upcoming report by a NYSE committee on corporate governance. The key is to move quickly to implementation. And, of course, for public companies to take governance very seriously, devoting more time and effort to ensure that these checks and balances are rigorous and work as intended.

I would recommend the following 10-point plan, much of which already represents best practice.

- First, each public company should clearly describe to its shareholders, either in its Annual Report or Proxy Statement, how its corporate governance system, with all of its checks and balances, works.
- Second, all listed companies should have a majority of independent directors, both in substance and appearance.
- Third, the Board of Directors should be required affirmatively to determine that no 'independent' director has any relationship that the Board believes may impair, or appear to impair, the exercise of that director's independent judgment. Additionally, the nature of that director's relationships should be fully disclosed to shareholders.
- Fourth, non-management directors should be required to meet periodically without the 'insiders'—including the CEO—being present.

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- Fifth, both Audit Committees and Compensation Committees should consist entirely of independent directors.
- Sixth, executive officer compensation should be aligned closely with shareholder interests by making equity a very material portion of such compensation. And Compensation Committees should be encouraged to develop guidelines requiring that a substantial portion of that equity be held for significant periods of time.
- Seventh, all compensation plans granting stock, options or other company securities to directors or executive officers should be approved by both the Compensation Committee and by shareholders.
- Eighth, all 'compensation' or other financial relationships with the company and its executive officers or directors should be fully, fairly and promptly disclosed.
- Ninth, all transactions in company securities by executive officers or directors should be disclosed within 48 hours.
- Tenth, while 'insiders' selling in advance of public disclosure of 'bad news' is already illegal, in the case of CEOs, we should raise the bar and mandate a one-year 'claw back' in the case of bankruptcy, regardless of the reason.

### **Conflicts of Interest and Investment Research**

Let me now turn to a third area of concern: managing conflicts of interest. I have already discussed conflicts of interest involving executives, Boards, auditors, companies and shareholders which are largely addressed by clarifying roles.

Closer to home, let me say a few words about conflicts between a company and its clients which can ultimately lead to loss of franchise and, hence, shareholder value. An example of this is the potential conflict between the investment banking and investment research functions in an integrated investment bank. The controversy surrounding research conflicts in the investment banking industry has been widely reported in the media and has eroded investor confidence.

Conflicts are a fact of life in many, if not most, institutions throughout society ranging from the political arena and government, to media and businesses of all types. The key is how we manage them, the disclosures we make, the systems or 'firewalls' we put in place and the judgments that are made in balancing competing interests.

For an integrated investment bank such as Goldman Sachs, conflict management has always been a core competency because it is critical to our reputation and a key to our success. Day in and day out our business requires a proper and fair balancing of investing and issuing interests. Generally, we meet these challenges. But unfortunately, particularly in the context of the technology and telecom bubble of the late 1990s, we have not done as good a job as we might have in preserving and protecting the perception of the independence of our research analysts who play a vital role in the investing and capital allocation process.

To address this challenge, two weeks ago we at Goldman Sachs announced a number of important steps beginning with the positive reaffirmation of the principles of integrity, independent thought, analytic rigor and transparency which underpin our research. And we have codified these in a statement of Investment Research Principles. We have also appointed an Ombudsman who is available to promptly address any conflicts which may arise, and instituted new oversight responsibilities for the Audit and Compensation Committees of our Board of Directors.

And most importantly, as the major part of our effort we will continue to focus on doing better fundamental analysis. The next time something looks too good to be true, we hope to have the wisdom to see it and the courage of our conviction to act accordingly.

Integrity is the cornerstone, if not the bedrock, upon which all financial markets are based, and is also the foundation of the reputation of Goldman Sachs. In that regard, I note that the US Securities and Exchange Commission recently unanimously approved sweeping changes to the rules of the NASD and NYSE designed to address investment research analyst conflicts of interest. The Commission also emphasized that additional changes may prove appropriate; and the Merrill Lynch settlement is a further step in the right direction and should work to bolster investor confidence and reinforce the integrity of our markets.

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### **Conclusion**

My remarks here today represent my best thoughts on how to fix some of the problems facing our financial markets. They do not pretend to be comprehensive or original. In fact, many if not most of them have been suggested by others, including the Business Roundtable chaired by Franklin Raines, the NYSE under Dick Grasso's leadership and the Financial Services Forum chaired by Phil Purcell.

All my suggestions have one aim—restoring trust in our system: trust in the accuracy of financial statements; trust in the integrity of corporate management; trust in the honesty of investment analysis. Without such confidence we all lose: investors will forego gains, entrepreneurs will have less access to capital, there will be fewer and less attractive jobs, less business to be done and fewer tax dollars to support government programs. And the impact is felt most heavily on the less privileged. It is our job to see our capital markets continue to be models of fairness and efficiency.

Self-correction, I'm pleased to say, is already underway. But, without over-reacting, we need to move quickly to implementation to reduce uncertainty.

In retrospect it is perhaps not surprising that the 18-year bull market we have enjoyed was also accompanied by certain excesses. Hindsight is 20/20, and it is only natural for society to look for someone to blame whenever there is a setback.

I am confident we can move beyond second-guessing and finger pointing to attain real progress on meaningful reform. Having seen how we, as an industry and a nation, responded to the terrible attacks of September 11, how could I not be an optimist? Working together, I am certain that we can achieve our common goal of restoring investor trust and ensuring that our financial system and economy emerge even stronger than before.

Thank you. ■

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