

Securities and Exchange Commission Historical Society
Interview with Conrad Hewitt
Conducted on November 9, 2010, by Kenneth Durr

KD: Interview with Conrad Hewitt, November 9th, 2010, in San Francisco, California, by Kenneth Durr. Let's talk a little bit about your background. You're from Illinois originally?

CH: I grew up in Illinois; went to the University of Illinois. I'm hosting a luncheon here for the University of Illinois, about fifteen graduates in the College of Business, to meet the new dean of the College of Business, Larry DeBrock. I've stayed loyal many years.

KD: It looks like you worked in a bank while you were in college. Is that right?

CH: I did, the Commercial National Bank in Peoria, Illinois, in the summertime. I joined them when I graduated. I was called to active duty by the Air Force. That was an interesting experience. I wanted to be a pilot. I had contracted to be a pilot for three years.

KD: Were you in ROTC?

CH: ROTC, yes, graduated and then commissioned. Then they changed it to five years and would not let me fly. They sent about six hundred of us down to Lackland Air Force Base that were in the same boat I was. Asked me what I wanted to do, and I said, "I have

a degree in finance. I'd like to do something in banking." This fellow said, "Lieutenant, we have no banks in the Air Force, but we do need auditors." I said, "I've never taken a course in auditing." "That's no problem. We'll send you to auditing school." I went to auditing school for about three months. My duty station was SAC Headquarters, Omaha, Nebraska.

I was assigned to the Auditor General at the Pentagon. I did that for three years and really enjoyed it. It was a great experience. I had a great boss. I was supposed to get out. I had interviewed all the Big Eight firms, the Federal Reserve Bank in Chicago, Kroger, and a few other companies, and decided on Ernst & Ernst in Los Angeles. JFK was our president then, and we had the Berlin Crisis. So I was grounded for another six months. I could not get out. I did get out after three-and-a-half years and joined Ernst & Ernst in Los Angeles.

KD: So the Air Force made up your mind for you as far as becoming an auditor, is that right?

CH: In the accounting world, yes. The undergrad accounting courses I had were very easy for me. I used to tutor friends of mine who had problems in accounting courses.

KR: But you weren't looking to get into auditing or anything at that point?

CH: No, not at all.

KD: That happens quite often, I know.

CH: Didn't hurt me.

KD: Tell me a little bit about coming up in Ernst & Ernst and what became Ernst & Young.

CH: I went through two mergers. Started with Ernst & Ernst in Los Angeles and obtained my CPA certificate there. I was transferred to Orange County. When I was in the Los Angeles office, I was in charge of the mutual fund audits, trust funds, trust departments, trust companies. Banks were not audited at that time, as they are today. I went to Orange County and was involved in different clients there, high-tech companies and so forth.

I was transferred to Honolulu, because we had just obtained a new client there called Bank of Hawaii. There are two big banks in Hawaii, First Hawaiian Bank and Bank of Hawaii. They sent me there because it was a new client and they were doing an external audit. But the bank also agreed to have Ernst & Ernst do the internal auditing. Since I had a little bit of banking experience and background, they asked me to go over and head that up, which I did.

I became the managing partner in '72, left there in '79, transferred to Seattle to head up our Northwest offices there. We had offices in Spokane, Tacoma, Portland, and Anchorage. I did that. We had a good banking practice. We did eight of the ten largest banks in the State of Washington at that time.

KD: So you focused on the banking practice?

CH: I was in health care when I was in Hawaii, too. Health care and banking were my two mainstays. They decided they need some more help in San Francisco. They sent me down here to become the managing partner of the Northern California offices, because Bank of America was our client, very large client. The bank at that time was in trouble with their loan reserves throughout the world. They were blaming the auditors, us, for it.

KD: When is this?

CH: This was 1986. I came down here and brought in a new banking team, partners throughout the world. Fortunately, I was able to get the Seafirst audit up in Seattle, which was the largest bank there. They had been acquired by BofA, but they had not changed auditing firms. They were very independent.

Dick Rosenberg was brought to Seattle by Dick Cooley. Dick Cooley came from Wells Fargo here as CEO. Then he went to CEO of Seafirst in Seattle. He brought Dick Rosenberg up there. I got to know Dick, and Dick was kind of a successor to Dick Cooley. Tom Clausen became the new CEO in San Francisco. He brought Dick Rosenberg down to be his number two person. Dick became the CEO after Tom Clausen. That helped our relationships tremendously.

I had to retire at age sixty, which is a great thing. It was when I signed the partnership document, and I became a partner, I said, "That is really good; that's a good policy." To this day, I think it's a wonderful policy. I had a lot of younger partners under me throughout my career. We had a vesting program, of fully vested at age fifty-two. You could retire if you wanted to, but it was discounted up to age fifty-eight.

I had a lot of young partners that said, "You know, the profession isn't the same." It's no longer truly a profession where, in the old days, we didn't advertise and didn't have to worry about selling anything, consulting services and so forth. They were just burnt out. I would make arrangements that they would be fully vested in the retirement pay by the managing committee. We did that in most cases. Not all cases, depending on the partner.

KD: So people could retire early once they burned out, so to speak?

CH: Yes. I thought it was kind of strange, maybe it's not. When you see the partners retire, today it's the Big Four, but I think all the Big Four is the same, in terms of professionalism and high-type approach to things. I think when partners retire, they don't want to do anything except play golf and travel, in most cases. I was different; I wanted to do different things, and I did.

KD: Yes, you sure did. Just another note about Ernst & Young, you know the Big Eight and then the Big Four are all known for having had their different cultures. What kind of culture did you see coming up in Ernst & Young?

CH: Ernst & Young? That's a good question. Extremely high quality of service, and there was no shortcuts permitted of any kind in our work. We were known as a firm as doing quality work. Within the profession, we had Arthur Andersen. I always admired Andersen, because they could really market themselves. They did. They were always tough competitors when it came into proposal time. They had professionalism background in marketing behind them that really made a difference. They were the first firm to have a training center at St. Charles, Illinois, of the Big Eight.

We were the second firm to do that, at Cleveland, which was our national headquarters at that time. We always believed in a tremendous amount of training for everybody, including partners. I always liked that "continuing education" theme that our firm had. It did help quality and so forth. We merged with Arthur Young in '89. I remained the Northern California area managing partner as a result of the merger in '89. Their culture was completely different than ours. We were more nationalized in Cleveland, more like a corporation. If they told you to audit this way, you audited this way. Arthur Young did things like "consensus of committees." So there was quite a differential there in cultures.

KD: You talked a little bit about how the industry changed. You talked about marketing, of course, and the whole sort of commodification of accounting is one side. The other side is the changes in standards and practices over the years. That's going to factor a lot in your post-retirement career.

CH: You're right.

KD: Any highlights that you saw or were involved in during your time with the firm?

CH: You mentioned the standards. The standards became more numerous and more complicated. When I started in the profession, we had a busy season during the audit season. There was a tax season afterwards. Once we were done doing the audits, we would do tax returns, both corporate and personal. After about four or five years of that, the firm decided the tax code was becoming too complicated. Auditing standards and accounting standards were becoming too numerous, couldn't do both.

We had to make a decision whether we wanted to be an auditor or be a tax person. It was easy for me, because I enjoyed auditing. Some partners had to make a tough choice. The standards became more and more complicated. FASB came along after the AICPA standard setter. The standards started to become more and more complex. That was one of the reasons that a lot of the partners retired early. They just couldn't keep up with it, didn't want to keep up with it. The standards were difficult to keep up with, and work with clients, and those things. The clients had problems, too, working with the standards.

KD: It sounds like things sort of took off exponentially when FASB came in. Is that true?

CH: I would say definitely yes. Numerous pronouncements started to come. They became more complicated. The most complicated standard that came about, I'm not sure what

year that was, maybe 1995 or something. It was the 133 pronouncement on hedging and derivatives. It was almost 900 pages of detailed rules.

We changed. We said either the profession is the standard-setter or FASB changed. When I first got in the profession, things were more principle-based standards. They didn't tell you that you had to be 90 percent or less in order to qualify as a lease. Then the rules came into effect. That required the auditor to make sure that the client is following the rules. That change from principles to rules happened during my career.

KD: Was that in the seventies, something like that?

CH: I would say mid-seventies, late seventies.

KD: I think I've heard that this new focus on rules, part of that was a reaction to Penn Central, where companies that were totally out of compliance were looking for "just tell me how to get an A" kind of a thing. Let's move on into your retirement years. I want to talk a little bit about your career as a California state regulator.

CH: When I retired, I had a very good friend who was one of my big competitors in the Bay Area, Jim Gilleran. Jim was my counterpart, at that time we called it Peat Marwick and Mitchell, KPMG today. He retired about four years before I retired. He became the Superintendent of Banks for the State of California. We remained good friends after that. He was ready to move on. He called me, he said, "Con, I'm going to leave here. With

your background you'd be the ideal Superintendent of Banks for the State of California."

I said, "Thank you, Jim, I never thought of it that way. I do have to do something. I don't know what I'm going to do."

The governor, Pete Wilson, was calling me for contributions and I said, "By the way, Governor," I called him Pete, "I'm going to retire, and I would be interested in the position of Superintendent of Banks." He said, "Oh, that's terrific." He sent me the application; or his office did it. I filled it out, and I didn't hear anything for almost four months. All of a sudden, I received a phone call from his office concerning the press release announcing I'm going to be the Superintendent. I said, "Now wait a minute. I have to retire first." I managed to do that, and I became the Superintendent of Banks. At that time, the banking industry was still struggling with the closing of banks.

I was involved in half of a dozen closings. We had a number of problem banks, like they do today. They need more capital. I had an interesting staff. I had three unions to work with. I had seventeen attorneys, and they were one union. My chief counsel wasn't in it. I had my examination staff, and that was another union. Then, I had my administrative staff, and they were another union.

I went out, and I knew some of the CEOs of banks. I would be invited to speak, of course. I would ask them, "What could we do better in our banking department?" The small banks would ask, "Why do you send out fifteen people, when we're just a small

bank? I said, "I don't know what all your people do, but that does not make sense to have so many people at this small bank."

So I went back to my executive committee and asked my deputies "What is going on?" At that time, I decided I'm going to take a look at our working papers and see what examination steps we're performing. I didn't like what I saw. We weren't focusing on risk. We were focusing on everything but risk.

KD: What do you mean, "Everything but?"

CH: Well, for example, they were testing the interest in Fed funds, back and forth. They would find a \$2 error and write it up. There's no risk there. When someone opened a branch, say you're the owner of the branch, you would have to provide us with the list of all your new furniture, all your new leasehold improvements. We had to approve all that. I asked as I started to get into it, "Well, do we have somebody, an architect, on our staff that understands all of this?" "No." "Well, then why are we doing it?" They said, "Well, that's the old banking law."

I did three things during that period of time, big things. I got my executive committee to admit that we were way overstaffed. We staffed up for all the bank closures that happened, and now we're down to two or three. I said, "I think we're overstaffed by 30 percent." They wouldn't agree with me on that. So we ended up at a number of 23 percent reduction of force. Three unions battled me. We had no early retirement

packages. The problem at that time in doing it was I lost all my young people, because of union seniority, "The oldest stay; the youngest go," regardless of how good they are. It had nothing to do with performance, and that was very unfortunate. When I left, to get to that point, I still had too much staff four years later.

But anyway, because I decided to change the organization, I noticed that there were savings and loans and a number of financial institutions scattered throughout the state. These institutions were industrial loan companies, credit unions, savings and loan associations, money transmitters, and others. I also noticed that other states would have a department of financial institutions, which was an "umbrella." It covered all kinds of financial institutions. In the meantime, I decided to go through the banking law and change it, so it's principle-based because the old banking law was old. Once I did that, I was able to go into regulations and get rid of all the requirements to open a branch, for example.

KD: Did you have a team? Did you hire consultants to do this?

CH: Let me tell you how I got to that point. My counterpart, the Federal Reserve, got interested in my approach to examinations. The FDIC did, too. I went back to Washington, DC, and met with the supervisor Richard Spillenkothen, Federal Reserve. He thought it was a great idea. So we organized a taskforce. I represented the fifty states' bank supervisors, Conference of State Bank Supervisors. We had two people from the

Federal Reserve and the FDIC. Our mission was to work together to come up with a risk-based, computerized examination program that we all could use and understand together.

That took a lot of work, but we did it in about two years. We also did a number of other tasks. One thing I noticed, every bank, and it's true today, you have two regulatory examinations. You have either the state or national, and then you have either the FDIC or the Federal Reserve. My staff would go in to a state bank in July. Then, the Federal Reserve staff, if they're a member bank, would go in October. It's a very disruptive thing. I came up with the idea to do joint examinations, together with the FDIC and the Federal Reserve. Again, the union gave me grievance notices, "Why are you doing this?"

KD: What's their problem with joint examinations?

CH: They thought it would be a reduction of more staff.

KD: Because there are people who are sort of doing this for a living, dealing with examinations?

CH: Right, right, there was concern. As I found out, the Federal Reserve paid more than my staff. My staff didn't like the idea of working with somebody making more money doing the same work. The unions were afraid that the FDIC and the Federal Reserve would control my staff. I had agreed with both the FDIC and the Federal Reserve that every other year we'd switch senior examiner in charge. We did that. It worked very well. We

did it on the larger banks; couldn't do it on the smaller banks, it just didn't seem to work that well, but big banks it really worked. They still do it today.

KD: So this for all the states then?

CH: No, just California.

KD: Just California. Okay, and working with the federal government?

CH: On the joint examinations.

KD: Okay.

CH: I think after I did it, some of the other states picked up on it. States are very independent people. I've never been independent. I don't believe in silos or anything else. I went through the banking law changes and the regulation changes. Then I decided to create a new department, Department of Financial Institutions within the State of California. That was a tremendous task. The credit unions did not like the commercial banks. The commercial banks did not like the credit unions.

I had to go and diplomatically tell all the bankers, "It's going to be more efficient; it's going to cost you less in your examination fees." I would do the same with the credit unions and so forth. I had a Democratic legislature to work with. I had a Republican

administration to convince that this was a good thing for the state. They all agreed with me. We did create a new department of financial institutions. I became the first commissioner.

KD: The other group was merged into that?

CH: Everybody came. I had my staff and executive committee help me, of course. I couldn't do all this. There's two departments that we did not bring into the umbrella. One was the mortgage brokers, and the other was mortgage companies. We looked at those, and we said, "We don't think they're regulated and supervised enough. We don't want to supervise or regulate them." That became a problem, many years later, with the subprime crisis that we had. There was really no regulator of mortgage brokers or mortgage companies in the United States except some states' departments.

KD: You're dealing with FDIC-covered institutions, mostly, is that right?

CH: Yes, just commercial banks, and then I had all the other ancillary stuff, like money transmitters, which were a state function, and issuers of travelers' checks, and industrial loan companies. There are some savings and loan associations. They were all state-chartered institutions, as opposed to a federal charter.

KD: Can you compare and contrast the kind of regulation you're doing in California, as opposed to what you got into with the SEC?

CH: Completely different, there are so many layers of regulations at the federal level. I did not encounter that at the state level. Our DFI-State of California department was almost autonomous. We just did what we want. We had our own funds. We had to go through the budget process, but the banks and the financial institutions had to pay us a fee. It went into a special fund, not the general fund of the State. But at the SEC in the federal level, I ran into an instant problem when I arrived on the scene.

KD: Let's get you to the SEC before we jump into it.

CH: After my term finished as the Commissioner, I was asked to go on several boards of directors and to be their chairman of the audit committee. I had always seen it from being an auditor, because I always dealt with audit committees and their chairmen. I did this, and I really enjoyed it, because every board I went on, I became chairman. Some of the companies were acquired. A couple of them went bankrupt. At the time that I was asked to be interviewed for the position of the Chief Accountant, I was interviewed first by the staff of the chairman, Chris Cox. I did not know him. I was on three public boards, two private boards, and a charitable foundation that I really enjoyed working with, because we gave money to hospitals and universities.

KD: You've watched Sarbanes-Oxley come in from the perspective of an audit committee?

CH: Correct.

KD: Tell me about that.

CH: I didn't like it. I was on the one large board, Varian, Inc., down in Silicon Valley. We had PricewaterhouseCoopers as our auditing firm. The company had been advised by PwC that there was going to be extensive auditing done because of Sarbanes-Oxley. It really pertained to what we call Section 404(b) of Sarbanes-Oxley. 404(a) says that management, CEO and CFO, must certify to the SEC that they had evaluated their internal control system and that it's effective. (b) says that a company must be audited as to the effectiveness of its internal control system.

That was part of my experience before I got the SEC. Sarbanes-Oxley created a monster, PCAOB, and they created Auditing Standard 2. Auditing Standard No. 2 was how you audit internal control systems, extremely rule-based. Part of the standard was that you had to have large coverage within the company's internal control system. This was interpreted that the external auditor had to audit about 80-90% of the internal control system – an expensive undertaking.

KD: Now you're looking at this from the boardroom and are you wondering where you're going to come up with the money to do this?

CH: Yes, of the three public companies, I'll tell you what we did. I'll start with the smallest one first. Our public float was about \$40 million. We had an owner of a company who

was the majority stockholder. It was in the organic, culinary oil business. We were reinvesting money in research and development for organic products to maintain quality. Quality was very important.

We were not making much money. I was chairman of the audit committee. We had Grant Thornton as our external auditor. I asked the CFO, "Find out what this SOX requirement is going to cost us to have the audit of our internal controls. We have to get it documented by our internal people first. It's a big job." When they came back it was three or four times our annual audit fee. The fees would wipe out the profit of the company.

I advised the board we should consider going private, because we could not afford it, and we could not borrow any more money. The board agreed, and we interviewed investment banking firms. We decided on one, and they helped to take us private. In doing so, they said, "You also should consider selling your company, because of your product line and your customer base. You really would get a good price for your stock." So, "Okay, let's try that." We ended up being acquired by Haines Celestial Foods, a New York Stock Exchange company. We made substantial money for our shareholders. Had we gone the route of Sarbanes-Oxley, I think we would have been bankrupt.

KD: Going private seems like a pretty extreme reaction. Did that happen fairly often, do you know?

CH: I don't think it did. One of the things that helped small companies like us was that they never had to do 404(b). 404(b) required public companies to have the external auditor opine on the internal control system. The small companies were exempt by the SEC. The small companies finally were deferred by Congress in the Dodd-Frank Act.

One of the companies, for which I served on the board, had an annual audit bill of \$1 million. We ended up spending \$3 million, at least, because of Sarbanes-Oxley. When the SEC did their release on SOX, telling companies that they had to do it, they estimated that the cost was going to be – an average registrant was going to pay another additional \$92,000, in addition to their annual audit fee. The estimate was greatly understated. You asked me about Sarbanes-Oxley. SOX was a big effect upon all types of registrants.

KD: Any other challenges, things that you saw come along in that period, the early two-thousands?

CH: In California and especially Silicon Valley, you receive much of your compensation through stock options. FASB came along with their stock-based compensation standard. That created problems for companies. You had to expense it. You could never reverse the expense. You could never adjust the expense. It was based on Black-Scholes model, which was a number of assumptions. It was a bad standard. I told Bob Herz, "You need to get rid of that and use a fair-value approach. When the grant becomes exercisable, then we would measure the grant based upon the market price of the stock. If it gets below the exercisable price, then you have no expense."

KD: About when was that?

CH: That happened right before I went to the SEC, so that would have been 2005. That was another standard that created problems.

KD: So you're looking at all of these things from one perspective, and then get to how you got to the other side – how you got tapped to come into the SEC.

CH: A friend of mine, Mike Halloran, used to be the general counsel at Bank of America. He and I worked very closely together in investigations and acquisitions. I didn't know he was a good friend of Chairman Cox. Chairman Cox had called him and said, "Do you know anybody who could be Chief Accountant? I need to get a Chief Accountant." "Yes, I know a fellow who could be your Chief Accountant." Chris Cox called me and said, "Are you interested?" I said, "It depends, I would have to know what's involved, what you want, and so forth." I interviewed his staff. The staff says, "Chairman, you should interview him." So I did. He came to speak at Stanford University. I went and met with him there.

KD: What did he want to talk to you about?

CH: He wanted to know, why am I interested in being the Chief Accountant? How I could help him? I told him I had three or four basic reasons: I wanted to change Auditing

Standard 2 so it's not such a burden on companies, the cost of it. Not only the cost, it's the time of management to implement AS2 and internal control systems. So I wanted to do that.

I wanted to change the thrust of the Financial Accounting Standard Board with all the detailed rules. I wanted to change the stock option standard. I felt that we were just getting too many complicated accounting standards. I kept watching management trying to keep up with it. I watched auditing partners trying to keep up with it. They had to go back to the national office for the answers all the time. They couldn't decide themselves anymore. I wanted to do something about that.

I said, "Chris, the other thing I really would like to do is make our financial reporting system more understandable, simpler, not so complex as it is today." He said, "That's great." That's exactly what I want to do." Then he said, "There's a couple other things I want you to do." He told me, "You know you're in charge of FASB; you're in charge of PCAOB." I said, "Really, that's great."

He said, "Two other projects I want to get done before I leave." He said they were IFRS, the International Finance Reporting Standard adoption, and the other was XBRL, Extensible Business Reporting Language. I told him on the international side, I wasn't up to date on what's happening, because IASB had started about 2000. I had not paid much attention to IFRS, but I told him I would be interested.

I had always enjoyed international business; I'd had international clients, and I enjoyed the international world. Regarding the Extensible Business Reporting Language, I told him I knew nothing about that. I had not heard much about it. I said, "By the way, I don't think companies are aware of XBRL." He said, "Yes, that's a problem." He said, "I want you to be in charge of it."

KD: Why did he care about it?

CH: The old EDGAR system was obsolete, had been obsolete, very difficult to get company information through that old system, very difficult to compare one company against another. He was somewhat of a visionary in helping investors. This should have been done fifteen years ago, and he wanted that done. I was in charge of it. I recruited David Blaszkowsky, from Standard & Poor's, to be our director. I created a new office of interactive data within the Office of the Chief Accountant.

The Commission to voted to implement XBRL, and it was not easy. We created a corporation outside of the SEC, a nonprofit called US XBRL, to develop the tags. The tags are the definition of a generally-accepted accounting standard. Then I got FASB to get involved with it to check the quality of the tags, to make sure that they are, by definition, generally-accepted accounting standards.

As a final quality check, when FASB was done with it, then my staff and the Corp Fin staff checked the tags for quality. We developed approximately fifteen thousand tags, I

think, for financial statements. XBRL was implemented last year for the largest five hundred companies, very successfully, just financial statements, not the footnotes. The footnotes are a problem because everyone has different footnotes.

KD: That's in a gray area.

CH: Yes, it's gray. They'll get that done. This year, about five thousand registrants will go to the second phase. Then, about four thousand small cap companies will file using XBRL. XBRL has been around for a while. The FDIC used XBRL about ten years ago, after I left as commissioner, for call reports.

KD: Was there any push-back from anywhere, to adopting this?

CH: I'm trying to recall. There's always a push-back from somebody. On XBRL, we had about forty voluntary companies; we asked them if they'd be interested. We asked them all to volunteer, and forty showed up, like Microsoft. They used the tags on a very preliminary basis. The volunteers helped the SEC to frame the defining tags and information.

In the meantime, software companies became interested in helping, too. When you're a small company, you need outside help, just like they did in the EDGAR system. They use these software companies to process the tags – the general ledger information and so forth – into the format that the SEC wants. It's the same thing here, except it's the new

format. You can analyze the numbers. You can compare companies. Companies can compare against the competitors. Like Microsoft, they use XBRL throughout their whole company worldwide. XBRL was a big project and it was implemented successfully.

I have just been asked by the IFRS Foundation, which governs the IASB, last week, to begin a two-year term on the XBRL Advisory Council. Then there's another three years after that of the IFRS XBRL Advisory Council. I said I would, because I believe I can really help them. They're behind at least a couple years from us, because in the U.S., we had the SEC. The SEC called the shots on XBRL. Over there, you don't have an SEC to work with. You have maybe fifty big regulators to work with, every country in Europe, for example. There are twenty-seven of them to work within the EU.

KD: IASB can't do something like that? They can't ride herd on something like that?

CH: No, it's not easy for them. There's more politics involved than we have.

KD: Well, it sounds like this XBRL was one of the smoothest things that you had when you were in the commission. Let's talk about some of the other ones. You'd started talking about options.

CH: Backdated stock options.

KD: Backdated stock options jumped right out at the very beginning.

CH: It did. One of the problems we had, my staff was being swamped with registrants calling for accounting assistance. You know, "Okay, we found this." I, fortunately, had done three backdating of stock options investigations myself on the other side before all this happened. I knew what was going on in the world, in terms of backdated stock options. The enforcement division had about over a hundred cases that they had identified that they wanted pursued.

My staff came to me and said, "We have to get something out to the registrants, on how to account for backdating of stock options, because we're getting different situations. There's different applications of the standard." We worked on it and came up with a letter to the registrants saying, "Here are seven ways to account for backdating stock options." Had nothing to do with the legal aspect of it, just the accounting of it.

Enforcement didn't want me to send out the letter. They thought it might prejudice their current cases that they had. The Chairman backed me and said, "No, this is very important. We need to get this out." Then enforcement said, "Well, we talked to the Justice Department. They don't want it sent out, either." We shared cases with the Justice Department.

The Chairman gets on the phone to the U.S. Deputy Attorney to obtain his help with my letter, and the U.S. Deputy Attorney said, "Have Con send the letter over. I'll have my deputy work on it." We gave them a deadline. I think it was four days. We said, "We

can't wait any longer, because this backdating is building up throughout the U.S." That Friday, we made a compromise, and some of the wording changed in the letter. But we issued the letter that Friday. The letter saved enormous amounts of work for everybody, including those people that had the problem.

Here's how you account for it. It had nothing to do with whether or not it was legal. Our big first case on it was in the Silicon Valley, Brocade. We had charged the CEO and the VP of human resources with illegally backdating the stock options. That was the illegal side of it. The defendants asked for a mistrial because "We just relied upon our accounting for it. The accounting was not well-defined. We did what we thought was right."

The judge says, "No, I'll rule on the mistrial at the end." It went through a long trial. The jury decided that it was illegal backdating, and they were sentenced. I didn't follow it afterwards. I do know that the judge, at the end of the case, said, "There's no mistrial because the Chief Accountant of the SEC in his letter laid out the scenario for proper accounting and so forth." He used my letter as his basis for not declaring a mistrial.

KD: You're drawing the distinction between proper accounting and whether it's legal or illegal? I'm having a hard time. It seems as if you're doing the accounting right, then it must be legal.

CH: No, not really, because it depends on why you backdated the options. Say you were a new recruit coming into my company. You had a competing offer from another company. "They're going to give you 10,000 option shares. They're going to give you at the lowest price possible during the last three months." That's illegal. It has nothing to do with accounting; it's just illegal.

KD: So it gets to intent?

CH: Yes, there's a distinction there.

KD: Yes, okay. How about turning back to Sarbanes-Oxley? Obviously, the SEC had a lot of work to integrate this earthquake that had happened. How much had been accomplished, and what were the big things that remained to be done?

CH: As a result of Sarbanes-Oxley? In 2002, Sarbanes-Oxley required the SEC to be the standard-setter for accounting in the United States. The SEC has never done that. They decided to look at FASB and say, "Okay, there are five or six different criteria for a standard setter, it's spelled out, in Sarbanes-Oxley." So my predecessor, Don Nicolaisen, sent a letter to FASB saying, "Here are the criteria that qualify you to be the designated standard setter in Sarbanes-Oxley." That groundwork was already done. I didn't have to do anything with that.

I did have to get involved with the nomination process of the FASB foundation and the FASB board, because the Commissioners wanted to have a say-so, since we approved their budget. My staff and I were involved in the FASB proposed standards. If FASB would not agree with us, we told them that we could suspend the standards. The SEC's Chief Accountant has much influence in the accounting world, beyond public companies.

I worked with Mike Halloran, who came to the SEC after I did. He was an Assistant Counsel to Chairman Cox. We worked up a procedure, a process with FASB as to when an opening occurred, either in the foundation or in the board of FASB. We would be notified, and we would go to the Commissioners for nominations. We didn't have to approve anybody, because we didn't want someone going on the FASB board that we're investigating. It'd be embarrassing to them; it'd be embarrassing to the SEC. I ended up getting that done.

Sarbanes-Oxley created the PCAOB, and so I got really involved with PCAOB. We changed the Standard AS2 into a principle-based Standard AS5. That took a lot of work. The old standard was rules-based and complex. Because of AS2, I thought the auditing firms were telling the management of companies how to establish their internal control system, how to evaluate their internal control system. Management had no say-so. I thought that was wrong.

KD: Back to 404, here.

CH: Yes, so that was one of the reasons I felt something had to be done. I came up with the idea that the SEC would come out with some kind of guidance for management to evaluate their internal control system. We did that, interpretative guidance, to evaluate your internal control system. We mandated it. We had about forty-some pages of guidance, all principle-based. No rules. If you or the company had already done something differently, and it did work, that was fine. If not, then you had to use this approach to guidance. That worked pretty well. That was a lot of work to get done, but we did do that. To this day, companies and investors are benefiting from that.

KD: How do you keep principles from becoming rules?

CH: Well, if you start doing detailed add-ons to a principle, then it becomes a rule. The problem today is on principles. That was one of the items I wanted FASB and PCAOB to do. I told them that I would not accept any standard unless it's principle-based. Sarbanes-Oxley mandated SEC to do a study on that point. The staff did a study; published it in 2003, that all standards should be principle based or objectively based.

The problem you have with principle-based standards is that everybody wants detailed guidance. But you're supposed to use your professional judgment, reasonable judgment, to make the decision. Other items in Sarbanes-Oxley came out of it. PCAOB took much of my time trying to make sure that they conform to principle-based standards. I was the one that decided to go ahead with IFRS. My predecessor had written a white paper

concerning lifting the reconciliation for foreign private issuers. They would no longer have to recreate their financial statements from IFRS to U.S. GAAP.

I looked at his paper a couple times. I could have killed the whole concept right there. But I said, "You know, this is really important." I proceeded to get my staff to work on that. We got that done. We lifted the reconciliation. We said, "You know, you're a foreign issuer. You can file your financial statements with us at the SEC, using IFRS, only in English, IFRS, English, as promulgated by the International Accounting Standard Board. You couldn't go to Germany and use a local or carved-out IFRS,. It had to be IASB, that was it.

KD: But this was only for larger companies, right?

CH: Basically we had about three or four hundred, and I think they're down to two hundred now.

KD: This, of course, is all part of something bigger, the whole idea of convergence?

CH: From that point on, I said, "We've have to move on this." Each year, IASB was growing and getting more and more countries adopting IFRS. A number of those countries had used U.S. GAAP. We did a concept release, just to float the idea out, to get more information, because we didn't know much about it. From the concept release, we received two to three hundred comment letters to study and analyze.

The next step was the proposing release. We went to the Commission with a proposing release in August 2008, but it never got published until a couple months later. Things happened internally. It had to be published in the *Federal Register*. It was published, in September, I think, saying that here's proposing, at least, what the SEC is thinking and finalizing it. Five years from now, we're going to adopt IFRS as an accounting standard and so forth.

The new Chairman, Mary Schapiro, came in January 2009. That's when I left. She had a number of things on her plate. Most of them dealt with enforcement, Ponzi schemes, and Congress was saying "What's going on with the SEC?" When I left, Jim Kroeker was named as acting Chief Accountant. I recruited him, hired him, and he is outstanding. She did not name him as Chief Accountant until August of last year. In the meantime, any momentum in IFRS got lost, because the Commissioners were so wrapped up with enforcement problems and trying to reorganize the enforcement division and so forth. They didn't have time to focus on IFRS.

When I was there, I worked with the Commissioners on several projects. I spent a lot of time with them on accounting and auditing matters, independence, and enforcement matters. But they would spend most of their time analyzing the cases that enforcement was bringing to them, stacks and stacks of files, emails, and items to examine. That's where they'd spend most of their time.

KD: Yes, everybody got waylaid in 2008, off in a different direction. For IFRS, what were the pros and cons here? Was it just simply, "This is something that we're going to go to eventually, and it's a matter of when?" Or were there people who were saying, "Well, let's not get rid of GAAP so quickly?"

CH: There are two sides to it. I believe the majority of the people – I worked with the Dow 30 companies – want IFRS. They all wanted to go with it. Some of them had 80 percent of their operations overseas. They were using IFRS overseas. They were maintaining two expensive accounting systems. They were ready to adopt IFRS. They had had some problems with their contracts, their compensation arrangements, and bonuses. They were really charged up to go.

Then you had small companies which said, "We don't need it. We have no problems with U.S. GAAP," small company, private company. "Why do we need that?" I kept promoting IFRS in all my speeches. I kept saying, "You know, if the U.S. is going to maintain being the competitive in the capital market world, we have to go to IFRS, because we're going to be the last one standing.

If our companies have to go overseas for capital and so forth, they're going to have a tough time producing IFRS statements that are understandable to foreign investors, because everybody's used to IFRS standard financial statements." That will continue. I am really amazed by how fast IASB has grown over the last ten years. They're still growing. Supposedly, by next year, there will be over 150 countries that have adopted it.

They may not have adopted it 100 percent. They may have carved out a little special thing they don't like, but basically the world is going to IFRS.

KD: But there are questions about the IASB and if it's going to be robust enough to handle this.

CH: Yes, they are very robust because of their growth. That's why they've been very successful to date. When I was at the SEC, we decided with the international affairs office and my chief deputy of international, Julie Erhardt, to help the IFRS Foundation with their governance. There is a monitoring board that was created. It was seven countries at the time I was there. Just initially started, and this board was going to eventually oversee the IFRS Foundation, just as the SEC oversees, we call it FAF, Financial Accounting Foundation, in the U.S.

This monitoring board was going to do the same thing the SEC does, only it's going to be made up of the largest countries and regulators. Then they will oversee the governance of the foundation and the funding of it. That's moving in the right direction. That's already happening. People don't even really understand that, but that's in place.

KD: Is funding?

CH: The funding is still a problem. The funding is moving along fairly well. Some foreign countries are doing the same thing we're doing. You get the registrants to provide the

revenue for IFRS. That's what we do. That's what other countries are adopting. I think it's going to take time. It took us maybe forty years to get our independent funding straightened around for FASB. They're in the same sequence of events.

KD: You moved over the relationships of the PCAOB pretty quickly. I want to spend a little bit of time on that. It seems that bringing this new entity in would have confused the situation greatly. I remain confused as to just exactly where the PCAOB stops, FASB starts, the SEC, what its relationship is? How do you deal with that triangle?

CH: Fortunately, the Chief Accountant has the oversight of all three of those functions. There is a distinction between FASB and PCAOB, in the fact that PCAOB really supervises and regulates the auditing firms and the auditing standards. FASB deals with only the accounting. They're fairly distinct entities as standard setters.

The PCAOB inspects the auditing firms. That's been a problem. I hear back from the auditing firms, "Our partners are afraid to do anything." The PCAOB says, "This is wrong." So the auditing fees went up because the PCAOB says, "Well, you didn't do enough sampling. You didn't examine the alternatives. Why didn't you do this?" It got pretty bad. Now there is a check and balance in all this, with the PCAOB and the auditing firms. The Chief Accountant of the SEC inspects PCAOB annually.

When I was there, I wanted to make sure there was a good balance of oversight by PCAOB by the auditing firms and that they were not creating extra work and fees to the

companies because of the PCAOB demands. We always had an interesting challenge there. But we would go in there and see what the PCAOB program was, what their future standards would be, because we had to approve any standards that came out. That's another check and balance; the SEC has to approve every auditing standard.

One of the things I wanted to do, because I'd started in on the IFRS convergence of major accounting standards, which I really felt was necessary and still do to this day. Five or six years from now, everybody will say, "Well, we have to convert to IFRS now." I said, "Yes, and by the way, five or six years from now, the standards will hardly be any different at all, because of this convergence effort that's been going on for four or five, six years now."

I pushed PCAOB to look at the international convergence of auditing standards. They didn't like that. I felt in the long run, it's necessary, so every standard that they propose today, they have to say what the international standards are in contrast.

KD: Why didn't they like that?

CH: They just thought it impugns their independence, and that their standards were better than the rest of the world's. There is a big movement in the rest of the world on auditing standards to be the same, convergence.

KD: PCAOB was set up by Congress, so there's only so much you could do. Did you run into points where there was something that you wanted to do that you couldn't because of that?

CH: No, the SEC has complete authority in terms of the PCAOB oversight. If you remember, there was a lawsuit questioning the appointment of PCAOB chairman and board, and the way they charged the registrants, which is approved by the SEC. Mark Olson became the chairman of the PCAOB. He was a fellow Ernst & Young partner. He and I had known each other before, and so it really turned into a nice working relationship. There were some tough issues that we accomplished together.

KD: We touched on backdating options. Something else that's interesting that came up during your time is the idea of valuing options. We talked about Black-Scholes, and there were various attempts to come up with a market solution. Tell me a little bit about that one.

CH: I felt that the stock-based compensation standard itself was a bad standard, because you had to record what I call a fictitious expense on the books when the grant was made. Regardless of the value, you could not change that once you had established that the stock was granted, the model would establish the value. That was your expense for the term of the option. I felt that was wrong. I said, "Well, what if the grant terminates at the end of ten years, if that's the term, and it's all underwater? Then you've got this expense sitting on your books that you cannot reverse." That's the way it's set up. Bob Herz, Chairman of FASB, agreed that it's wrong.

I told my staff. I said, "I don't like this; here's my thinking on it." My staff agreed with me on it, that what it should be. When you issue the stock to an employee at the time of grant, that employee does not have any vested interest in it. He or she cannot do anything with it. Therefore, to me there's no expense incurred at that time of the grant.

As that employee vests, over time, maybe at the end of five years they're fully vested, but it has a term of ten years to exercise it. As they vest, say over five years, each quarter, and you have an exercise price. Let's say it's \$10, if they can exercise it. The first quarter that they're vested, if it's under \$10, there's no expense, because they can't do anything with it. They still get the same amount of compensation they did before. Next quarter, if it's \$11 a share, a dollar over, then you take that one dollar times whatever, and that would be the expense recorded in that quarter. If it goes under \$10 again the next quarter, reverse it until it's exercised and so forth. The expense is based upon the fair value of the stock at the end of each quarter.

Everybody agreed with me. But FASB, in their exposure draft on fair value for banks, concerning financial assets and liabilities, made that one an exclusion. In my comment letter to FASB, I said, "You know, you ought to address it. It should not be excluded from the fair value. If you're going to believe in fair value, then you should use fair value for stock options."

KD: What about the Zions Bancorp solution to the problem? They came up with this market idea? There were a number of companies trying to come up with ways to get away from Black-Scholes and actually put a market price.

CH: A group of people from Silicon Valley called on us, because they would like to see the entire standard reversed. They'll never get it reversed, but Zions Bank came up with an idea. I call it "market auction option." Under the standard you can use a different value than the Black-Scholes model, but you have to justify it. Is the method workable and does it fairly value? They came up with it and approached me on it. I liked it. My staff liked it. So we issued them a "no objection" letter to do it. It's almost a fair value approach to their method.

KD: Is that something that has caught on?

CH: No, it did not. I think part of the problem was, I'm not sure what happened, but there just was not enough market out there to make it work. It did not catch on, but it was a good approach.

KD: Something else that came in near the end, CIFR.

CH: Oh, yes, that was my idea to address the complexity I mentioned in our financial reporting system.

KD: Okay. What was the full name of that again?

CH: The Federal Advisory Committee on Improvements to Financial Reporting (CIFR). I came up with that idea. It took me six months to get the committee established through the legal barriers within the federal government. I had to go to the OMB, the Office of Budget and Management and get their approval. It was just a legal nightmare.

KD: Why is that?

CH: It's just the way our laws are written at the federal government. You won't see very many federal advisory committees for that reason, because of the complexity of establishing one.

KD: What was so important that you went through all this to create it?

CH: I really felt that our finance reporting system needed to be changed. That includes auditing. It includes accounting, income statement presentation, those types of things. I really felt we were way overdue. The committee did, too. One of the problems with establishing a committee is to obtain a Chairman who is acceptable to the SEC. These advisory committees are established for one year, and it has to be funded and everything else by that agency. You see very few federal advisory committees for the bureaucracy involved and difficulties of funding and obtaining members.

But if I or any of the members I wanted to be on it, we had a seventeen-member committee, we had to run them through our ethics and enforcement. There were two or three people that I wanted on that were being investigated. They may have been innocent, but they were disqualified. That's true of FASB nominees, too.

KD: So as chairman, you put in your counterpart from Ernst & Young, is that right?

CH: No, for the CIFR committee?

KD: Yes.

CH: No, Bob Pozen. Bob was the vice-chair of Fidelity, then became Chairman of AFS Investment Management in Boston. He became the chairman of CIFR. He was an excellent chairman. He came out with a wonderful report. There were a number of recommendations covering improvements. We had four subcommittees, so it was a big task that produced meaningful recommendations.

I had nine professional accounting fellows working for me; they were really top-notch, bright people. They serve a two-year term; I had three academic fellows working for me. I had to add four more professional accounting fellows to handle the workload of this committee. It produced a wonderful document; some of the recommendations have been adopted. Others just got lost, as typical in committee recommendations.

KD: Was the idea that these recommendations would be taken up by the SEC?

CH: Some of them pertained to the SEC directly. Some of them pertained to SEC working with FASB. Some of them pertained to PCAOB. One of the recommendations was, "FASB should not immediately embrace fair value as a concept or a standard." Unfortunately, they just did. I think they're going to retract.

Fair value was a big problem when I was Chief Accountant, because we were going through a financial crisis with AIG, Lehman, Bear Stearns, and all the banks. They wanted me to suspend the fair value standards 157 and 159. I refused to, because I didn't see any other way of accounting for the securities for investors, to protect investors. We call it Level 3 investments; there's no observable market. They would say, "We want to just keep them at our amortized cost, 100 percent."

I said, "Wait a minute, if you were an investor, would you invest in a bank that did that instead of marking it down to 50 percent, where it belonged, 50 percent?" "Oh, that's all right, it's no big thing. We'll disclose it." It was always a battle. The lobbyists would go to Congress. Congress would call the chairman. Chairman would, "Con, are you going to change your position?" I said, "No, I'm not changing. I'm not going to suspend them, the fair value application." I did issue guidance on it. I also issued joint guidance with FASB.

KD: Is this the mark-to-market issue?

CH: Yes, big time, big time. Still is today. Not as bad, but that was partially the cause of subprime mortgage downfall.

KD: Did the SEC take a formal position, or did you just simply weigh in on the discussion?

CH: We took an "in-house" position. We're not going to change the accounting standard on it.

KD: Yes, because you could have leaned on FASB or something, right?

CH: Exactly, I did lean on FASB for the off-balance sheet entities, the securitized trust entities, because I felt that was part of the problem. They had all of these subprime trusts off balance sheet. Nobody audited, no one regulated, and all these securitized trusts, and there were more off-balance sheet entities. They had auction-rate securities. You had two or three other different types of new investment vehicles. One was SIV, they called it structured investment vehicle. All of these investment vehicles were not regulated.

KD: Kind of like in the Enron days, where you just said, "I'll let you take it and put it over here."

CH: No, that's exactly what it was.

KD: In a slightly different form, I guess. So as far as CIFR is concerned, that seemed like a pretty big landmark. I know you had a twelve-step situation; it comes up when you're talking about this principles versus?

CH: Yes, and they endorsed the principle approach, too. They looked at that and said they recommended the future standards be principle-based. That led to another recommendation that I liked, and I was behind that one. At the SEC, my staff would tell everybody that, "If you do make a reasonable judgment on a decision, an accounting decision, and you come to us with it, and we look at it, we basically would accept it."

That was not true; we did not accept it. I said, "We need to come up with a professional, reasonable judgment framework for the SEC, for the PCAOB, for the registrants when they're trying to make a decision on what to do with a difficult accounting decision." We developed a reasonable judgment framework in-house, within the SEC, at the time I left. Enforcement didn't quite like it, because they felt that it could damage some of their existing cases. But I think internally now at the SEC, they're using that approach. I would like to see it published someday, but I don't think it ever will. That was one of the recommendations that came out of a committee which was an excellent recommendation.

KD: When you would talk to registrants and they would say, "What about this?" Historically, would that set precedent for other people?

CH: Not at all. The Chief Accountant's office doubled in size because of Sarbanes-Oxley. Internally, when we have a registrant issue, it might be a revenue recognition software issue. For example, we have two sides internally. One side will take the position of the registrant; one side will take the position of the SEC. We have an internal debate on an issue. Sometimes I'm involved in those meetings. Most of the time they'd come to me and say, "Here are the results. What do you think?"

One of the big issues I had was the General Electric restatement, in December 2006, of five years of financial statements. I inherited that problem, and it had been in Corp Fin, and in enforcement for six or seven months. I became involved in it because I had to make the final decision on what to do. Do I make General Electric restate five years of financial statements or not? It took a lot of my time to go through all the working papers, emails, and everything, and look at a very technical part of 133, hedging and derivatives standard, especially cash flow effectiveness.

I decided that General Electric was wrong, and it was material enough. They didn't like that. But they restated five years, and then we had some other things going on with GE. One of the public things that came out was the "bill and hold" of locomotive engines and so forth that make their quarters look better. There are many problems like that with the registrants that the Chief Accountant and his or her staff deals with all the time. It takes time. Many of these problems go on for three or four years.

KD: You would have come in on the tail end of all the – there was that point where everybody was restating?

CH: Yes, there was, and that was something that the CIFR committee wanted to try and stop - restatements. One of their items was materiality. Materiality is a problem within the SEC and outside the SEC. What's material and what's not? Sometimes it's a bright line test, 5 percent of net earnings, that means it material? No, it doesn't mean, but that's the standard that's used. You could have a statement of cash flows, for example. It's a misclassification; it might be 10 percent off, 15 percent off. But it's disclosed. It's right there. To me, that's not material. Other people would say it's material, but it's not, because it's right there, and it just got misclassified.

KD: Again, we're looking at judgments, right?

CH: Yes, very much so. Concerning materiality, the CIFR committee said, "Take a look at, try and do something about it." I was trying to do that when I left. But internally, in practice, we probably look at the qualitative much more now than the old quantitative method used internally by the SEC staff.

KD: My understanding is that one of the things that was driving this accretion of rules over the years was the possibility of litigation and the fact that corporations and accounting firms wanted to be sure that they were covered. I think that's a good place to wrap up. What kinds of steps did you take in that direction during your years?

CH: On the legal side of the things, I'm a firm believer in principles and professional judgment, because I came up when we had principles. I evolved into the rule-base environment from being an auditor. I think it's much easier to justify, I should say, maybe "easier" is not the right word. You can justify your position on a principle more so than you can a bright line, rule-based thing. You might unintentionally do something wrong under a rule-based standard, just unintentionally, but you're going to get charged with that offense.

Whereas if they had a professional judgment situation on a principle, and you document it, this is what I did, I went out and looked at "Is there any other example out there like that?" I talked to the national office. I looked at the alternative. I said, "What's the alternative to this economic transaction?" I really believe that accounting standards should be based upon economic transactions, the substance of it, as opposed to a bright line, rule-based thing. Fortunately, IASB is very principle-based, otherwise I'd be against them.

KD: As we move toward principles, is there going to be a way to create a safe harbor for management, for accountants, whether they can do that?

CH: I don't think there should ever be a safe harbor for anything or anybody, although there are safe harbors within the SEC. For example, when I mentioned we had the forty-some voluntary companies working on XBRL, the filings. Well, we gave them a safe harbor, because they were filing their normal financial statements, using the EDGAR system. So we had to give them safe harbor for XBRL to make it work.

There are cases where you want safe harbor. You don't want to create a situation of a rule thing that said, "If you break this rule, enforcement will fine you, find you guilty." That's wrong. As we move into the principle world and start learning how to use judgment, reasonable judgment, it'll be a lot easier and more meaningful for everybody. As long as the judgment is disclosed in the footnotes or in MD&A, that's really important to me, if the disclosure's there. If the disclosure's there, then on a very complicated transaction, the economics of it, that's fine.

KD: That should be sufficient?

CH: Yes.

KD: Okay. Well, is there anything that we haven't touched on that we should have?

CH: I can't think of anything; I had an interesting career at the SEC. We accomplished much in a number of different situations that were not there before. I enjoyed it.

KD: Well, I've enjoyed talking to you. Thanks a lot.

CH: Okay, thank you.

[End of Interview]

