**Securities and Exchange Commission Historical Society**
**Interview with Donald Nicolaisen**
**Conducted on December 10, 2010 by Kenneth Durr**

**KD:** I notice that your father was an accountant. So you grew up with this; is that right?

**DN:** I did. He was an accountant. He was not a university graduate, so he learned it the hard way. I was convinced when I went to school that there was one thing I wasn't going to do, and that was accounting. I ended up pursuing a major in economics and psychology but saw that the job opportunities in those areas weren't great in my senior year and I rushed to take a lot of accounting credits. I actually like it.

**KD:** It sounds like economics and psychology would lead pretty clearly into that line of work.

**DN:** It does. Psychology is probably more important even than accounting when you deal with the audit practice, which is where I spent most of my career.

**KD:** Tell me a little bit about joining up with Price Waterhouse in the sixties. What was the firm like? What was your job?

**DN:** The firm was relatively small at that time, as were all of the then Big Eight firms. I interviewed with all of the Big Eight and concluded that I liked Price Waterhouse, primarily because of the people I met and the clients that they had in the office where I started, which was Milwaukee, Wisconsin. It was a great list of clients, nice people, and a good opportunity to begin a career with opportunities to do other things. My thought process was I would spend a couple of years at Price Waterhouse and then move on and do something else. As things happened, I spent a lot more time than that there.

**KD:** How about specialty? Do you become a jack-of-all-trades when you first start out? How does that work?

**DN:** You started out with a broad cross-section of clients. My first client was a public utility, followed by a mortgage bank, and then a very large manufacturing company, so a great diversity of work at that time. Today, it's a little more specialized. But at that time, you could really do a cross-section of clients. That was part of the appeal. It was always interesting. It was always something different. I began in the audit practice, thought about moving into either consulting or tax, but with the variety of things that you could do in audit, I just loved it and stayed.

**KD:** Maybe something to do with that psychology, too.

**DN:** Perhaps, perhaps.

**KD:** Tell me about moving up. Did you go from Milwaukee to another big city, a larger city, or how did that work?

**DN:** After three years in Milwaukee, I was asked if I would be interested in participating in what was then the international exchange program at P.W. It was really, as they called it, the grooming school, or to help you acquire additional polish, if you may. The opportunities were all in Europe. My first reaction was, "I like Milwaukee and probably wouldn't do it, but let me talk to my wife." She was very enthusiastic about it right away. We pursued it and ended up, after three-and-a-half years in Milwaukee, then spending the next three years in Hamburg, Germany.

**KD:** That would seem strange because you're in the U.S. and you're working according to GAAP, I guess.

**DN:** Right.

**KD:** Then all of a sudden, in order to polish you, they sent you off where things are completely different?

**DN:** They are very different. The language, of course, is the biggest difference. But accounting-wise, many of the clients were U.S.-based. I worked on companies that were today Exxons and W.R. Grace and Kellogg, and other household name U.S. companies, as well as Royal Dutch Shell. But it was primarily the German affiliates of those companies.

**KD:** They were all using GAAP?

**DN:** They were all using GAAP. They all spoke German.

**KD:** I suppose you spoke German after a while.

**DN:** All my staff spoke German. I had to learn very much on the fly how to communicate. That was a great opportunity, too. But you were exposed to cultural differences, the language differences. While my focus was primarily on U.S. GAAP for these companies, I was also deeply involved in their statutory reporting. I learned a lot about financial reporting in Germany and how it functions. It actually became a real interest to me because it was so different from U.S. GAAP.

**KD:** In what way?

**DN:** Everything in Germany at that time was driven by rules and regulations. There wasn't use of principles, which we had at that time in the U.S. The focus was instead, on compliance with laws and regulations. Disclosures were very specific. If the disclosure was required, it was provided whether the amounts were material or totally immaterial. The structure of the balance sheet was very different. The balance sheet had a long-term focus to it, contrasted to the U.S., which looked primarily at short-term influences first.

**KD:** So, you came back to the United States. Did you go back to Milwaukee?

**DN:** I did, came back to Milwaukee. We spent probably another dozen years there, and then off to New York.

**KD:** What was the move to New York about?

**DN:** I was asked to head up the national office functions, the accounting, auditing, SEC practices, all of the technical aspects of that.

**KD:** What does that entail? Unpack that a little bit.

**DN:** It's the place where ultimately partners would have to go if they had a decision that they needed help with, as far as either accounting or auditing for their clients. It's the place where the firms interface with the SEC and the FASB, so we spent a lot of time working with and discussing issues with your counterparts at the SEC, the other accounting firms, and the FASB. As part of that, I spent eight years on the Emerging Issues Task Force of the FASB.

**KD:** Let's talk a little bit about the people you worked with at the SEC along the way. I suppose you'd go to the chief accountant a good bit?

**DN:** Yes, you did. Naturally, you tried to help each other. I think that's one thing people maybe don't understand about the profession. There is no intent to surprise people or trap companies. The idea is communicate as openly as possible. Where we had client issues and there were simply no answers, I always thought it best practice to explain beforehand why we were reaching conclusions that we were reaching. As long as the client didn't disagree, that would often entail visits to the SEC, and particularly the Chief Accountant's Office, to explain the unique set of circumstances.

That dialogue sometimes would be easy, where the SEC would say, "We get it. We have no better answer." In other cases they had seen practice elsewhere; we had an opportunity then to get to the appropriate response. So, a real good exchange of ideas.

**KD:** Did the people in that position, the Chief Accountants, did that make a difference in how they handled situations like this?

**DN:** Well, I think for them, it's also the learning experience, which I learned later on when I was at the office. It provided an opportunity to see much more than they would if people didn't communicate and didn't open the kimono, if you will, and show the issues that are really current today, and that companies were troubled by.

**KD:** This was the eighties and nineties?

**DN:** This was the late eighties and nineties.

**KD:** What were some of the issues? I would assume that there were a few issues that kept coming up.

**DN:** Probably 80 percent of the issues were related to financial instruments -- how to account for complicated hedging transactions, the broad area of financial structures and spin-offs of entities and issues involving off-balance sheet and on-balance sheet transactions, e.g. securitizations. All of those things that were evolving in that time period were basically the heart of what we discussed.

**KD:** You were there when these things were really coming out?

**DN:** Yes.

**KD:** That someday everybody would know what those things were?

**DN:** That's right.

**KD:** Were you working with the SEC? Were you doing an ad hoc structuring of the body of principles, the way you would work with these things? Was the FASB involved in that discussion?

**DN:** Yes, the FASB was usually involved in the discussion. Many of the issues would end up at the Emerging Issues Task Force. All of the firms would float those things that were really new or unique to their practice, or where it wasn't clear how to account for a transaction, or where you couldn't clearly analogize to other transactions. One analogy might give you one answer, but if you analogized to some other transaction might give you a very different answer. I think it was period of time of openness, a lot of discussion, a lot of exploration as to how to deal with emerging derivatives and securitizations and other complex financial structures.

**KD:** Who did you work with on the EITF?

**DN:** EITF meetings were conducted at the FASB, so their board members and staff could participate or observe.

**KD:** Other industry people, too, right?

**DN:** Yes, members of the EITF itself were from the accounting firms—all of the large firms were represented, plus several of the regional firms, as well as a number of people from industry. Industries were not just financial industries – where most of the issues were. You would have knowledgeable people with backgrounds in accounting, but they might have been from manufacturing companies or financial institutions. So a good cross-section. Good discussions. All of that was open to the press, was open to the public, so others who wanted to comment on it were encouraged to do so, and the SEC's Chief Accountant would sit in on all of those discussions at the EITF.

**KD:** I was told that he was the power to stand up and say whatever he wanted to say, right?

**DN:** Had the power to say whatever he wanted to say. But, obviously, that power was limited in the sense that he didn't speak for the Commission itself. It was a personal expression of opinion, but needless to say, that carried great weight.

**KD:** Did people from the accounting firms to get on the EITF and stay there for long periods of time, people who tended to have that perspective?

**DN:** Yes, I would say I was probably one of the longer term members, eight years, and some people might spend four or five. Generally, the idea was continuity did matter.

**KD:** So, Price Waterhouse was probably pretty happy to have somebody that they could count on being there?

**DN:** Right, right.

**KD:** Moving up, were you involved in the merger with Coopers and Lybrand?

**DN:** Yes, at that point, I chaired the financial services practice at Price Waterhouse, insurance, brokerage, banking, and other areas, and was a member of the Price Waterhouse board, both in the U.S. and globally, and so I was deeply involved in those discussions. I chaired at both levels the human capital committees, which meant I had to deal with partnership issues, partner concerns, compensation, admission of new partners, and a lot of other things. So, yes, I was involved.

**KD:** Was this the latest in a long line of acquisitions for Price Waterhouse?

**DN:** No. Price Waterhouse, historically, did not do acquisitions. They were very rare in the time that I was in the firm. It was not at all common for P.W. to do mergers. So, this was a very big step for us as a firm. We picked our partner carefully and did a lot of work before we shook hands and agreed to move forward as a merger of equals.

**KD:** Did Coopers pick you, too? I mean, was it mutual?

**DN:** I think it was mutual. You know, like anything else, it takes a little while to get to know each other. Even though you know everything about each other and their clients, it's different to sit down across the table and reach agreement on things that matter. But clearly the fact that everyone is structured as partnerships makes it easier. You realize how important it is that you can rely upon your partners. The level of trust has to be developed very quickly. And it wasn't as difficult as I might have imagined.

**KD:** I want to get a sense of what's going on at this time. What was driving you to this merger? The other firms are doing more or less the same thing, I guess. From your perspective, how much was internal the logic of Price Waterhouse, and how much was just external, "We've got to do this because the world around us is changing"?

**DN:** I would say, if you have something that's working, it's always easier to say, "Let's leave it as it is and we'll continue our own practice," and so that obviously is the difficulty in reaching the conclusion to merge with somebody else. But when you looked at the global reach that the merger offered, the balancing of clients across industries, and the ability to develop deeper skill sets to better serve your clients, to look at the economies of scale that come with that size of a merger, the balancing within other parts of the globe of our practices was very complementary. The more we looked at it, the more I think both parties agree that this was a very good merger and well worth pursuing.

**KD:** Economies of scale is pretty clear.

**DN:** Right.

**KD:** What was Coopers bringing geographically, or in terms of practice that Price Waterhouse didn't have?

**DN:** They had a very good practice in parts of Europe. We had a very good practice, too but they had a very complementary practice that, when combined, brought deep credentials. P.W. historically had served the largest companies in the world. Coopers certainly had very large clients, but they also had a broader range of midsize and smaller clientele. Particularly within Germany and other places, they just had excellent practices that were very complementary.

**KD:** By the nineties, then, your perspective is undoubtedly a lot broader than when you were hanging around in Milwaukee. You're meeting with the FASB, the SEC. By the late nineties, Arthur Levitt is pushing some accounting reforms at the SEC.

**DN:** Right.

**KD:** What was Price Waterhouse's perspective on that? How did the industry or the profession receive those initiatives by Levitt?

**DN:** Obviously, it's always difficult when somebody from the outside critiques whatever it is you're doing. Those who are critics simply see things differently than those who are on the playing field. It doesn't matter, I don't think, whether you're a playwright or an actor or a politician or anybody else. You want to, naturally, defend your own practices. But Levitt was right and there were good reasons to address a number of areas of auditor independence, or just to better communicate with the public, particularly the investing public, what the firms were about, what they can do and can do very well, as well as what steps are in place to protect independence and objectivity and being able to assure investors that the focus is on an audit and that the audit is done right. On balance, I think that dialogue and the added pressure was very helpful. It's good to have a broader perspective.

**KD:** But my sense is that in the late nineties, the profession wasn't as open to making changes as it later became?

**DN:** No, obviously, it wasn't. We had been very successful. I think whenever that happens, there is always a certain swagger that large institutions that achieve substantial success tend to have. I don't think we were unique in that sense. We felt very strongly we were doing most things right, certainly all the big things. But the appearance side of it needed help and there were many areas where we could improve.

**KD:** Did you interface with the Public Oversight Board at any point?

**DN:** I didn't too much of the time. I did have a bit of contact with the old original Public Oversight Board, but it wasn't a big occupier of time for me. They were in the developing stage.

**KD:** Any other FASB/EITF initiatives in this period that we haven't talked about that kept you busy?

**DN:** Well, I think with the financial instruments and the consolidation questions, we were very busy. Of course, this was also a period of time where stock option accounting was proposed for change, and with enough pressure from Congress that the FASB did not act at that time. For me it was important, because later when I was at the Commission, we really did have to deal with that and had a different result.

**KD:** Right, well, you talk about the swagger, and by the early 2000s, the swagger is undoubtedly a bit less pronounced.

**DN:** A little more wobbly.

**KD:** Yes, did you and your colleagues have a sense of the public perception of the profession in the early 2000s?

**DN:** I think that obviously varied, where if you looked at the 95 percent, it was done right. There weren't really issues. If you look at the fringe areas where there was very bad accounting, very bad auditing, I think there is no excuse for that. With reasonableness, I think all of the firms recognized that this is an urgent matter. We really needed to deal with it and needed to change. There was a response that followed, some of which was overtaken by events, Sarbanes-Oxley clearly being the biggest change instrument. There was a lot that happened – it was a big change.

From a personal perspective, it was probably the first time in my career where I was deeply disappointed that our profession would be perceived as having significant failures, significant gaps in what we did, and lapses. While I was proud of our partners and our firm, just the noise around the industry was extremely disturbing.

**KD:** You talked about some initiatives that were taken prior to Sarbanes-Oxley that obviously people forgot about because there was this earthquake. What were some of those?

**DN:** There were a number of changes made in independence and objectivity and required review processes. More things moved to the national office, oversight, changes in accounting, unique transactions, the troublesome practice areas that were pretty apparent to everybody, consolidation issues, all of those things, and especially securitizations. All those things took on even more of a national office focus, and decisions tended to gather there, rather than at the individual practice partner level.

**KD:** Was this common across all the big firms?

**DN:** I think so, yes.

**KD:** Without naming names, did different firms take different approaches to this? Were some a little more intransigent and others more attuned?

**DN:** I think all of the firms—obviously Arthur Andersen was very much on their back foot and were in the papers every day. The images of the Enron situation, the destroying of documents, or shredding of documents, all of that in the eyes of the public and the press are just extremely damaging. I think they were the most vilified of the firms in that sense. But everyone, I believe, really got the message.

**KD:** Certainly when the legislation came down.

**DN:** Right, clearly.

**KD:** Let's move into the SEC period. Tell me a little bit about how you heard about being tapped for the Chief Accountant's job, why you were told the offer was made, things like that.

**DN:** I had in the past said no to the thought of going down to the Commission.

**KD:** Had the offer been made before?

**DN:** You know it's not exactly made. It's, "Will you talk to us?" is usually the way it works. This time was different. I felt very much that if I could play a part, I really wanted to. I was disappointed in our profession. I was extremely disappointed in parts of the business community. It was probably more obvious to others; I had to admit to myself that my background had really prepared me. This was the right time, that I had the right skill sets. It would be selfish on my part to simply say no.

Realize that it's extremely disruptive to your lifestyle to take an enormous cut in pay, pack up your bags, move to Washington, and put on the role of regulatory character as opposed to someone who had always been on the other side of the table. But I felt it was time, with lots of encouragement from Chairman Donaldson and others who were very influential. Alan Beller was the head of Corporation Finance at the time. Bill McDonough had joined as head of the PCAOB, and all were very encouraging to say, "Do it, please. You've got to."

**KD:** Were these people you had worked with in some way before?

**DN:** I hadn't known Alan Beller well. I had met him before that. But he's a very persistent man. He knew what he had to deal with, and he knew how important it was to have a partner in the Chief Accountant's office that could play a complementary role. Bill McDonough I had known for many years, from his time at the New York Fed. So that was a very comfortable position. I knew that I could work with him, that I could trust him, and that I could work with him.

**KD:** So, between the three of you, you're working with Corp. Fin. and you're working with the PCAOB. Did you have a sense that there was a common agenda? Or did people have different—

**DN:** Well, the objectives were the same. We were all interested in improving investor confidence and putting in place those things that enable investors to actually rely upon the work of the SEC and the PCAOB. The PCAOB, of course, was a new creation. Chairman Donaldson had asked that I be the primary liaison with the PCAOB and work with Bill McDonough in making sure that they got off the ground and providing support from the Commission perspective, wherever we possibly could. So with Bill

McDonough's stature and my knowledge of the industry, we soon knew that we could and needed to rely upon each other and conduct a number of different areas. We really worked hard in a lot of areas to get things done and done right.

**KD:** Did the legislation specify that the Chief Accountant would—

**DN:** No, the legislation was not that specific. It was that the Commission had certain responsibilities, approval of the budget of the PCAOB, as well as what essentially is a second vetting of PCAOB standards. The standards would be developed by the staff at the PCAOB, then would be exposed to the public. Then there would be a second airing of that by the SEC, so that the SEC could also gather comments and input. A somewhat complicated structure, but we figured out how we could make it work.

**KD:** What are the benefits that override the complications?

**DN:** I think the significance to the PCAOB is that the SEC is well-recognized, has the established role of investor protection, had long looked at the auditor relationships and the rules and regulations around auditing, and this provided the PCAOB to leverage that. Where they needed support, the Commission was the obvious body to provide that support. For both of us, it really provided more resources and more specialization, if you will, in drilling down on things.

**KD:** Right, the PCAOB is able to get down into the weeds a little more?

**DN:** Much more. They have a very different charter. This was the first time that the auditing profession was regulated. Their regulator is now clearly the PCAOB, and there were very specific elements of that act that the PCAOB had responsibility for, registration and inspection, and oversight of the profession.

**KD:** How about the Office of the Chief Accountant? What did you find when you came in? Was this a pretty well-functioning group, or did you see things you wanted to improve?

**DN:** Let me answer that two ways. One, what I saw, I liked. What I also saw, and this is maybe my personality, what I also saw were ways we could do things that I thought could be better. There had been a shortage of staff. I quickly set out to fill the gaps, and also created new positions. This was a time where international accounting was also very much under discussion, and so I wanted to create a separate function to deal with that, create a separate group that would deal with the PCAOB and auditing standards, so I established deputies in both of those areas. I loved the talent that was at the Commission when I came in, Scott Taub had served in filling the void for a very long, and had done it very ably.

**KD:** It was a year or so, wasn't it?

**DN:** It was at least a year. But he was really the strength of that group for longer than that. I found that he and many of the other staff that were there were just great, great talent sources. I didn't have anybody who I was disappointed by. It was a very good impression. The only thing that I found was, and this may be part of my nature, too, is that if I am part of a large organization, I want to use all the resources of that organization. I found that the Commission's economists, the international group, the various educational aspects of the Commission which address investor groups, and certainly Alan Beller and I—Alan leading Corp Fin—we were partners immediately in leveraging resources.

It was really easy. It was very easy to partner with these other groups within the Commission where we could support each other. I was just blown away by the skill sets and the depth of really quality people that were in many parts of the Commission.

**KD:** But on the other hand, you were looking at expanding the office pretty significantly?

**DN:** Yes.

**KD:** So, I assume you had to hire a lot of folks?

**DN:** I did hire a lot, right. We essentially doubled the size quickly.

**KD:** Did you get a lot of idealistic young people who wanted to get in there and help?

**DN:** A lot of those types, yes. We had lots of those, and they restore your faith in what we do, as well as an amazing number of extremely experienced high quality candidates who, when you looked at their resume, you would say, "Wow, this is just unbelievable that this person would even want to contribute at this level. They are so overqualified." It was a tremendous wealth of talent that was available. It wasn't hard to fill the slots. It was primarily, take the time to do it right, get the right people in the right places. We did that.

**KD:** Okay, so, that's the organizational stuff, the issues.

**DN:** Let me just add one comment to that, I had from day one, the full support of the Chairman. Chairman Donaldson was very clear that this was an area where he respected my years of experience, and abilities, and I really learned how to be useful to him, at the same to know when I should raise my hand and make sure that we discussed things. His support was excellent, as were the other Commissioners, but I wanted to say the Chairman stood out.

**KD:** When working with Bill Donaldson, when was it important to raise your hand?

**DN:** Well, I thought it would be important, as it is, to make sure that if I took an action that would have significant publicity, that it would be no surprise to the Commission.

**KD:** The least you could do, I guess.

**DN:** You know, it's kind of more than the least. I would make sure that we built up to that, in that there would be a good understanding as to why I would take a decision that I felt necessary.

**KD:** Right, let's talk about the issues that you were faced with. So many things are in flux at this point. Did you sit down and make a list and say, "Here are my priorities. I've got to hit this first, and then I can hit that then?"

**DN:** Yes, probably because there is nothing that's not subject to public disclosure, I kept those lists in my head. I had a hundred-day plan. I knew with real precision what I wanted to accomplish in the first hundred days, and did tick them all off. I got it done. I also had a pretty good idea of what would come along, along the way, that would have an element of urgency to it, and had, I think, a pretty good idea of what needed to be done and whether it was accomplishable and within reasonable parameters. What you can't plan for is the day-to-day happenings. They are significant at the Commission. There are always events that, as you would describe it, where the urgent takes over the important. You had to work very hard to keep the important things going forward while still dealing with the day-to-day emergencies.

**KD:** Did you do that by having two sets of staff, one to deal with the emergencies and one to keep everything else?

**DN:** No, basically a fairly common staff. But having the international group separate from the auditing function, the rest of accounting and reporting disclosure matters made it easier to do that. So it was pretty clear when something would surface where it went.

**KD:** Let's talk about that hundred day plan. Do you remember what was at the top of that list?

**DN:** Staffing was clearly at the top, was to make sure that that was commenced and in place. Part of my desire was to make sure that I established relationships on the Hill that would be important as we dealt with issues. I would take the pulse of Sarbanes-Oxley and how it was enacted. A lot of the rules had been written by the Commission, but the PCAOB had not yet developed their first standard for internal control reporting. While all of that was obvious, there was a time to take the pulse in many areas as to just what I would read as being workable measures, and how we might make that happen.

Another area that I was deeply interested in was functioning of the FASB and their standard-setting process. There were many things that the Commission had asked the FASB to deal with, and I wanted to make sure we had a plan in place to track their progress. We didn't have authority over the FASB, but they, like everyone else, were very interested in working so that things got done.

**KD:** They didn't mind you tracking their progress, I guess?

**DN:** They might have. But I think we did it reasonably cordially.

**KD:** I'm just going to run through a couple of themes that come up. We talked a little bit about relationships, relations with the PCAOB, and how this was an ongoing thing, off-balance sheets and special entities, special purpose entities, that one seemed to come early and stay late. Tell me a little bit about your experience with that.

**DN:** That was one that was well underway when I arrived at the Commission.

**KD:** Was there a study going on?

**DN:** The FASB was in the process of rewriting its standard on special purpose entities. They concluded on an approach that was different, but in my view was also different and complicated. I expressed my views to them. That was one of the areas where we perhaps didn't have unified ideas as to how to deal with it, but it was their responsibility. I provided the necessary inputs that we could, but at the end of the day, that standard ended up being like many others. It just didn't work.

**KD:** Is that FIN 46?

**DN:** It was FIN 46 and a couple of other interpretations that were provided. They were directionally right, but lacked practicality in actually making it work in the field, they're extremely complicated for everyone to understand, not just preparers, but investors. So there still needed to be more work on that. It was one of the last things when I left the Commission and left the inventory of things that were not yet done. That was on my list.

**KD:** But there was all this talk at this time about standards-based or objectives-based, and moving beyond the plethora of rules.

**DN:** Right.

**KD:** My understanding was that FIN 46 was one of these standards-based things.

**DN:** Anything that's rules-based enables a person to learn how to play the game, and once you know how to play the game, you can circumvent the intent of the rule, and that's an unfortunate thing. The business community at that time was really looking for certainty. "Tell us the rules. We'll follow the rules." I think they did that in good faith, but at the same time, if there are rigid rules, it's just pretty easy to find a way around it.

I said that earlier on, that when I moved to Germany, U.S. accounting was principles-based, and German standards were more rules-based. What we didn't have in absolute clarity in the same way that the German standards did, they went even further in requiring explanations. I'm not a fan of the U.S. movement to more rules-based standards, more details. I understand why we've had to do it, but it looks like patch-work. Someone will always find a way to circumvent rules that run hundreds of pages. On the other hand, I believe principles supported by rules works. Rules alone are a continuing problem.

**KD:** Okay, but FIN 46, was that really rules-based?

**DN:** Well, it was intended to be principles-based, with a concept behind it. But the measurements were all mechanical and FIN 46 became complicated.

**KD:** I suppose people come and ask clarification?

**DN:** They do. It is very hard to write a standard that is either principle-based or rule-based that lasts for long periods of time, unless it is extremely simple. Anything that becomes fifty or more pages is not simple. We found ourselves in that place.

**KD:** Another one that came early and stayed late was dealing with 404.

**DN:** Right.

**KD:** And can you walk me through that process, and what you were able to accomplish early. What the complications became?

**DN:** Well, from day one, we knew this would be an extremely controversial implementation process. If you were on the outside looking in and you said, "I want to implement significant change and I want to do it in all companies, and do it all at one time," you would say it's impossible. You just wouldn't do it. You would do tests and pilot studies.

You would revamp things after considering feedback before rolling out new requirements on a broad scale. That way, you can moderate it. There would be a lot of steps that you would take along the way. That wasn't really possible with the way the act was written. So, when the PCAOB began to write their rules, their standard on internal control reporting, they were starting with a fresh page, with a requirement. As a new body, you would expect that they would try to do everything possible to fully achieve the maximum in the first step. That was a difficult process.

**KD:** They did try to do that?

**DN:** They did try to do that. We did work with them. As they wrote their rules, there was some moderation along the way. But as it was exposed and dealt with, my feeling at least, that we're going to have to come back to this. We're not going to get it done. We're not going to get it completely right in the first phase. We will require companies to comply with the rule. We'll look for major departures from it. But the idea of let's get it out there, let's not go crazy with enforcement in the first year. Let's see if we can't tweak this along the way would be important.

So, the Commission held hearings along the way. Things were adjusted and moderated to a degree. And we did ask the PCAOB to consider changes. In particular, with respect to smaller companies, it was within our purview to defer implementation for them until there was enough information available from work by the larger companies, so that we would be able to say, "All right, let's draw this out across the smaller enterprises that aren't as used to this as the largest global organizations."

**KD:** And don't have the resources, either.

**DN:** Didn't have the resources.

**KD:** So, when 404 was rolled out, were small companies exempted at that point?

**DN:** Yes, we deferred implementation. We kept revising the calendar to say, not yet, not yet. During that period of time, I searched frantically for ways to simplify the process for smaller companies, to develop a guide, if you will, for a smaller company's implementation of the internal control reporting. I asked a lot of different groups to look at what might be appropriate. COSO undertook the challenge.

**KD:** COSO?

**DN:** It's the Committee of Sponsoring Organizations, I think is the title. We asked them because they were objective and generally had more experience with internal controls than any other group. They were well-positioned. And they did undertake the study. When they came back, the views of the short version were that it's very costly to maintain document and audit controls in smaller organizations, extremely costly. I'm not sure it passes the cost/benefit test for many. So, we thought of other things, like perhaps labeling or red lettering, those companies not in full compliance with the SOX requirements. By the time I left the Commission, it was still an unresolved area.

In other areas, the PCAOB did their work, and tried hard to make the revisions that were necessary and appropriate along the way. Nonetheless, many in the business community felt, and some still feel, that 404 was overkill. It didn't pass their cost/benefit test, and they believed that they had adequate controls. A lot of companies' CFOs and CEOs would later tell me that when they first went through the SOX 404 exercise, they really didn't like it. It was very costly, even if absolutely necessary. However, many said they did benefit from it. And at this point, it's pretty well-baked into the practice. It's now pretty well accepted that we need to have good controls, and that there is a need to document and audit those controls.

**KD:** But at the time, were you seeing some political capital being spent with congressmen coming in and saying, "Hey, ease up on this, because this is too much for our constituents"?

**DN:** Different people would have different views, and I think I heard from all of those at Congress who were interested in this. Most of them were conveying, and expressed it as such, conveying views that they heard from their constituents, as opposed to saying, "This is ridiculous, stop it." There were a few of those, but they were not by any means the norm. Congress, in passing and enacting the act, clearly knew this would have a lot of controversy associated with it. But it was necessary, and it was fully appropriate in responding to the public outcries of outrage. So, for the most part, there was pretty good support.

**KD:** How did you hear from Congress? Were there hearings? Did you ever sit down and testify?

**DN:** A lot of them would pick up the phone and call. Since I was the identified liaison with the PCAOB, I got the calls. I would meet often with both Sarbanes and Oxley staffs to make sure that they understood what we were doing, how we were implementing the 404 requirements, and what oversight we were providing along the way.

**KD:** Did the small business exemption remain then, through your time?

**DN:** It did, yes. We just couldn't find a magic way to deal with it.

**KD:** Well, some incidents then, or things that appear from my research of the incidents that have a place in time. One of the first things you did was held an inspection, went in and took a look at the Big Four accounting firms.

**DN:** Right.

**KD:** Tell me a little bit about that process and what you found, whether you were surprised or not.

**DN:** Well, the inspection work was new and was a function of the PCAOB. I had come from an accounting firm and I knew pretty much the other larger firms, so I can't say that I was tremendously surprised. Only a portion of the PCAOB findings are by statute public, so I wouldn't discuss it here, either. But I can't say that I was shocked or surprised significantly in their findings.

**KD:** What was the purpose of that?

**DN:** The inspection of the firms? That's required by the SOX act, and is to be conducted by the PCAOB.

**KD:** But if the findings are confidential, are you using them behind the scenes?

**DN:** Yes, well, the PCAOB do. We, obviously, would read their reports and think about things that might impact the reliability of financial reporting. But auditors are the secondary actors. The primary preparers and the primary responsibility for financial statements and disclosures rests with management.

**KD:** Another one is the contingent fees. You got into a little scuffle with KPMG about contingent fees.

**DN:** I would say it wasn't just KPMG. Contingent fees aren't permitted and never have been. So a firm couldn't say, "Our fee is this, but if this happens, it is ten times that." But there were shortcuts, I would call them shortcuts. They were well thought-out, well-lawyered, that had been looked at as ways to achieve, particularly in the tax area, where additional results would increase the bottom line for the company. There would be some sharing of that along the way with the audit firm.

**KD:** Was this new, or had this been around for a long time?

**DN:** It had been around for a while, but it was beginning to grow in size. So I, maybe perhaps dogmatically, just said, "Stop it. This doesn't pass the appearance of independence in my view." My view isn't the only view. I just couldn't, from a public standpoint, not express a view on it.

**KD:** How did you do that, through a release or something?

**DN:** I called each of the firms in and talked to them and then issued a release. A statement, I guess, is actually what it was.

**KD:** How was that received?

**DN:** It wasn't greeted with open arms, but I think the majority of people understood that it needed to be addressed, and that there were not logical ways to conclude other than "Don't do contingent fees."

**KD:** At this point, were the accounting firms making the case that, "Well, we're not doing our consulting now, we're under a lot of pressure here to make money, to survive"? Did they make that argument?

**DN:** That wouldn't be a good argument for them to make.

**KD:** Why not?

**DN:** Because it's a question of is this particular approach appropriate or not. So while there might have been some noise around that, that wasn't a primary argument. The arguments were lawyerly. They were scholarly. They had sliced and diced every word that was out there. They had looked at everything that existed. They felt, with confidence of their lawyers, that they were fully within their rights and appropriately dealing with it and had appropriately put safeguards around it.

A lot of that, I didn't disagree with. I just think the perception was so inconsistent with the independence of an auditor that for me it ended up being – I'll say again, I was dogmatic on my part, just decided that I would put my stake in the ground on it.

**KD:** Did that work?

**DN:** Yes.

**KD:** Then a big one, Fannie Mae. In late 2004 they were asked to restate.

**DN:** Yes.

**KD:** Tell me about the process leading up to that.

**DN:** Fannie Mae was not required to register with the SEC by law or by statute. It wasn't a requirement, but for other reasons Fannie Mae decided to do that. In doing so, they came to the Commission and they said, "We want to be treated like any other registrant. We want to file our financial information and statements with the Commission," and they went through various rounds of preliminary, quote, "unofficial filings." In the course of doing that, and dealing with their own regulator; we were not their regulator - they had a separate, statutory regulator. Their regulator had questioned some of their accounting. They specifically asked for my views and a decision as to what is the appropriate accounting in a couple of areas, the biggest of which was hedge accounting.

**KD:** Was Treasury their regulator?

**DN:** No, it was the Office of OFHEO, the Office of Federal Housing Enterprise Oversight, which has since been restructured and renamed FHFA, the Federal Housing Finance Agency, and it was an office that was there just for the oversight of Fannie and Freddie.

**KD:** I see. So, they asked for your opinion?

**DN:** Fannie Mae asked for my opinion, and the regulator also did. The company was clear that, "Whatever you decide, you know, we will abide by it. We want to do this right, and we will comply with it." I expressed my views after a very exhaustive exploration and study of everything that was available. In my view, it was appropriate for them to restate their financial statements, and that's what I asked them to do. They agreed to do it.

**KD:** This would be one of those things you made sure Bill Donaldson knew about in advance?

**DN:** Yes, but, very clearly this was not a Commission action and it was not an action of the Commissioners. So, all of the Commissioners I tried to keep advised of this in that there would be plenty of press. I didn't see any other answer for this. I'm a believer in what Fannie Mae does, so I like the fact that they were helping people get into homes. I thought it was good for the economy. I think it's good for stability of families and our society. I had no view other than to come up with what was right for this very large part of the mortgage economy to enable the companies to do what they wanted to do, which was to comply fully with the SEC's rules and regulations.

**KD:** It sounds to me as if this was just simply you responding to a particular incident. The way it was played up is, this is the SEC flexing its muscle, sort of taking a hard line stand, everybody stand up and pay attention. Did you know that that kind of thing was going to happen, and did that seem like something that maybe was worth happening?

**DN:** Yes, I did, and yes, it's unavoidable. And yes, there were others that should have taken note of the requirements of hedge accounting. Accounting practices often change when companies read in a newspaper about somebody else having a problem with the SEC. So I did expect that there would be others who would also have some issues.

**KD:** Did the SEC stay in touch as they went through the process?

**DN:** Oh, yes.

**KD:** How so? How did that work?

**DN:** Well, as they worked through their restatement, which took a very long time, my staff and the staff of the Division of Corporation Finance looked closely at what they did -- did they do it right, did they comply, and were the restatements and disclosures something that were now believed appropriate. We, the Commission staff, stayed with it the whole way.

**KD:** Another was lease accounting. You had lease accounting rules. This would have been toward the end of the period.

**DN:** Yes.

**KD:** This is another one that really sort of pops up.

**DN:** It does. It was one that, to me, was an extreme disappointment. My staff had been working with lease accounting. There is an annual conference that's sponsored by the AICPA at which the SEC staff often summarizes events that they have seen and areas, of accounting or disclosure, that they are concerned about. It gets a high and appropriate level of attention at that conference. In preparing for that conference, my staff came to me with a couple of leasing transactions that they had seen in a number of places where there was a lack of compliance with the existing accounting literature.

The FASB standards were absolutely clear in these areas. There was no ambiguity in it. But what had happened was that Company A deviated from the practice, and then Company B sees that, and "Well, me too." Apparently there had been some practice out there of relying upon that practice being generally accepted, as opposed to not in compliance with the specific accounting standard.

This was after we had finished the first round of SOX 404 reporting. I saw a certain amount of frustration here believing that if we went through 404, that the starting point for everybody would be, "Are we in compliance with all accounting literature?" I was extremely disappointed to learn that that was not the case. My view was that it would be best to deal with this as a statement of the Chief Accountant and provide an opportunity for companies to restate and do it collectively so that they're not the outlier. It could be understood by the investing public that compliance with accounting standards matters. So I expressed my view on that. I knew it would be extremely unpopular with those companies that didn't follow the existing accounting standard and that relied upon something other than GAAP.

It certainly was not popular with the accounting firms either, who went through lots of restatements for their clients. But if we're going to have confidence in financial reporting, we need to comply with the rules. If you choose not to, at a minimum, you should disclose, "We don't comply with GAAP, and this is the reason why."

We've always provided at the Commission the opportunity for people to report their own income measurements that management can, and is encouraged to, describe the business as they see it in the MD&A. If they don't measure those results based on GAAP, then fine. Report it another way in communicating with shareholders, but make sure that the GAAP financial statements are right, and that you comply fully with GAAP, and GAAP disclosure requirements in those statements, and that there is consistency. So, it was not a popular thing that I had required.

**KD:** It sounds like you put out a statement that essentially said, "Okay, here is our position. Everybody restate or take charges or whatever now." Essentially.

**DN:** Exactly. Exactly.

**KD:** That's what you said. Did you have any idea of the scope that this thing would be and the number of restatements?

**DN:** No, but I thought it would be quite a few. I think it ended up being more than even I had thought. I wanted to be fair in the sense of, since there had been a fairly broad practice of non-compliance, that restatements didn't come in piecemeal, with one company now, another company later. The alternative way would be to deal with that as an enforcement matter, affecting those companies who we knew didn't comply. So you have individual restatements, and the market then begins to wonder, "Well, what's going on here?" And so this was, to me, a fairly simple way to achieve compliance with GAAP.

**KD:** Having so many companies restating all at once, did that further upset the business at all, or the accounting profession? What were the ripples coming?

**DN:** Well, the ripples occurred and many didn't like it. There were other ways we could have, (in their view, should have) done this -- sort of a natural reaction. These are people who I've known for lots of years who were very upset. Restating is a big deal.

**KD:** Anything else that we should touch on?

**DN:** You've touched on a lot, I think. I would say that I really left with a love affair for the Commission, because what it does is so unique. You wake up every day thinking about the investor community, the strength of our capital markets, the integrity that they have, the fact that there is an enforcement mechanism. There is really support around providing quality information to investors so that they can make decisions and sleep well at night. It mattered a lot to me, and does today. I just have a great appreciation for the work that the Commission does.

One of the most surprising things to me was that in the summer in which Chairman Donaldson announced that I would be joining the Commission, we had a press conference. I got home that evening and played the answering machine, and was just blown away by people who had lost everything they owned in our capital markets and that that could happen.

**KD:** So, people are giving you a personal phone call?

**DN:** Personal, "Please help." When it's that personal and that deep and that pervasive, and you look at what happened to the Enron and the WorldComs, and the loss of not just capital, but retirement plans, and employees' lives and aspirations, and kids going to college, and all these other things that are impacted by it, it hits home how important it is what we do.

**KD:** I don't want to let you go without following up a little bit. A couple of years after that you were on a blue ribbon committee created by the Treasury Secretary with Arthur Levitt, I guess. This must have been a neat opportunity to come back and take a look a couple of years after the fact. Were you surprised by what you saw? Were you pleased by what you saw?

**DN:** Remember, this was not based on inspection, per se. This was just a, take a look at various aspects of the audit profession. There were a number of aspects of that. Are there enough participants, i.e. audit firms of size to meet market needs? Is there enough competition? And, all of many other things that were important, as well as the quality of the audit profession. So it was a great opportunity to dig deep in scrubbing the audit profession and to take a look at what has developed and where any of the gaps might be. Arthur Levitt and I formed a good partnership. We saw things slightly differently, but we were, at the end of the day, very much in agreement on the things that could be improved and where progress could be made. I'm happy that our report is out there. The report is being considered by the PCAOB as they take actions in developing their standards. It's one of those monitoring steps along the way. I'm quite pleased with what we did.

**KD:** My sense is your recommendations called for really transforming the audit profession pretty significantly. Is that true?

**DN:** Well, it's called for a number of actions that would strengthen the audit profession. One of the areas that isn't probably widely understood, but the auditor is selected by an audit committee. The audit committee doesn't have any financial information other than what is released on audit by the firms themselves. If you just take that little piece, and you say it's important that there be a sustainable relationship. If you're engaging a major contractor to do something important that can affect the reputation of your own organization, you ought to know quite a bit about that participant. So that's one gap.

It's things like that that we really tried to focus on. We believe the profession is acting responsibly and is dealing with many things. There are real gaps between what they do and what the investing public can understand and verify, as to what they do. As the old Reagan axiom, "Trust, but verify." And that applies to the audit profession as it does in so many other areas.

**KD:** Excellent, anything else that we should talk about that we haven't touched on?

**DN:** No, that's a lot.

**KD:** All right, well, thanks very much.

**DN:** Thank you.

[End of Interview]