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INSTITUTIONAL INVESTOR

Advocate

A SECURITIES FRAUD AND CORPORATE GOVERNANCE QUARTERLY

AS THE INK DRIES, WALL STREET FOLLIES CONTINUE

By Andrew Gschwind

NOTE TO ADVOCATE READERS: in the next issue of the Advocate we will examine and critique the IPO settlement in greater detail. This article encapsulates the settlement and briefly explores several interesting developments after its announcement.

Under the terms of the global investment banking settlement announced on April 28th, ten investment banks (Salomon Smith Barney, Merrill Lynch, Morgan Stanley, Goldman Sachs, Bear Stearns, J.P. Morgan, Credit Suisse First Boston, Lehman Brothers, UBS Warburg and Piper Jaffray) will pay regulators $1.4 billion and physically and economically separate their research departments from their investment banking, or underwriting, departments. (*The fines and penalties for each bank are shown in the chart on page 3.*)

The deal ends an embarrassing stretch for an industry accused of deceiving investors with tainted stock market research designed to win lucrative investment banking deals. Or does it?

No sooner had the ink dried on the global IPO settlement, than several Wall Street firms began to either minimize it, ignore it, or violate it. The early indications are that Wall Street is an incorrigible offender.

Settlement Highlights

The $1.4 billion settlement resolves allegations concerning conflicts of interest between banks' underwriting departments and research departments, in which bankers essentially forced analysts to issue favorable research reports on companies they wanted to do business with. The settlement also resolves allegations concerning the improper allocation of IPO shares to corporate executives with whom bankers wanted to do future business ("spinning"). Under the settlement, not only must banks physically separate their research departments from their banking departments, but compensation paid to research analysts cannot, in any way, be tied to the firm's investment banking business. Research reports must also explicitly disclose any potential conflicts of interest.

Under the settlement, former star stock analysts Henry Blodgett (Internet sector) and Jack

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THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD: OFF AND RUNNING (FINALLY!)

By Jeffrey N. Leibell and Eitan Misulovin

One of the most important provisions of last summer's Sarbanes-Oxley Act, enacted by Congress to address the spate of recent corporate scandals and restore faith in America's capital markets, was the establishment of a Public Company Accounting Oversight Board ("Accounting Board"). After a slow start, the Accounting Board is finally off and running. New SEC Chairman William Donaldson recently named retiring New York Federal Reserve Bank President William J. McDonough to become Chairman of the

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WALL STREET FOLLIES

Continued from page 1.

Grubman (telecom sector) will pay $4 million and $15 million, respectively, to settle allegations concerning fraudulent research reports they authored. Both are permanently banned from working in the securities field again.

Finally, under the settlement, regulators are publicly disclosing a large number of damaging documents, including e-mails, and plaintiffs' attorneys may attempt to use the documents in private lawsuits against the banks.

Perhaps the most interesting fact to emerge from the settlement is that five investment banks, including Morgan Stanley and Bear Stearns, paid their competitors to issue favorable research reports on stock or bond offerings they underwrote. These payments—euphemistically titled "special research check" or "guaranteed economics for research"—created the appearance that the company was widely followed by independent Wall Street analysts and that all or most analysts were bullish on the company. In short, the payments were bribes, and this practice appears to have been widespread.

> *No sooner had the ink dried on the global IPO settlement, than several Wall Street firms began to either minimize it, ignore it, or violate it.*

What Settlement?

It didn't take long for Wall Streeters to ignore the "historic" settlement they signed. Indeed, several prime offenders appear quite unrepentant.

The first sign of trouble came from Merrill Lynch's CEO Stan O'Neal. Commenting on the settlement in a *Wall Street Journal* column shortly after its announcement, he said that the settlement allowed Merrill Lynch to move forward with its business and avoid protracted litigation over minor matters. His comments drew an immediate, stern rebuke from Eliot Spitzer, who said, "So, Mr. CEO, and I read your article carefully, if I were you I would reflect. What your company did, and what we have alleged about your company, is that you committed fraud."

The attitude of Morgan Stanley's CEO, Phillip Purcell, was no better. In speaking about the settlement, he told reporters that he didn't see anything in it that should worry retail investors about Morgan Stanley. His comments prompted an unusually harsh and prompt public rebuke by new SEC Chairman William Donaldson, who wrote a letter to Mr. Purcell (immediately provided to the press), saying, "your statements reflect a disturbing and misguided perspective on Morgan Stanley's alleged misconduct. The allegations in the Commission's complaint against Morgan Stanley are extremely serious...[Y]our reported comments evidence a troubling lack of contrition and lead me to wonder about Morgan Stanley's commitment to compliance with the letter and spirit of the law."

The angry, public responses from Spitzer and Donaldson achieved their desired effect. Mr. O'Neal publicly apologized and later sent a company memo to employees, saying that he takes the settlement seriously: "I get it, and I believe

Inside Look

In this issue of the *Advocate*, we focus on two important issues: the newly-established Public Company Accounting Oversight Board and the recent global IPO settlement.

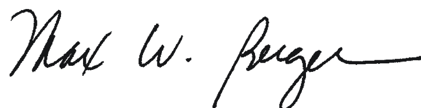
In "As The Ink Dries, Wall Street Follies Continue," Andrew Gschwind provides a brief overview of the recent global IPO settlement, in which 10 investment banks will pay regulators $1.4 billion and separate their research departments from their investment banking departments. The article also briefly explores several interesting developments after the settlement which show clearly that Wall Street has a long way to go before seriously reforming its ways.

In our article on the Accounting Board, senior counsel Jeff Leibell and associate Eitan Misulovin examine the events that led to the creation of the Accounting Board, its functions and responsibilities, recent appointees to the Board, initial Board actions and key issues confronting the Board. In short, the Accounting Board looks ready to overhaul our nation's lax auditing standards and restore confidence in companies' audited financial statements.

In a departure from the past, we have included two "Quarterly Quotes" in this issue. When you read the quotes, I think you'll see why we chose to include both (they're juicy). Also, there is a cartoon in this issue. Your feedback confirmed what we already thought: everyone likes cartoons! So now we're going to make them a regular feature of our newsletter.

Again, in this issue, Tim DeLange highlights recent securities developments in his regular *Eye on the Issues* column. As a quick review of the *Eye* reveals, developments continue at break-neck speed.

I enjoy hearing from our *Advocate* readers. As always, please feel free to contact me if you have any comments, questions or input on our publication.



MONETARY TERMS OF GLOBAL SETTLEMENT

Firm	Penalty	Disgorgement	Independent Research	Investor Education	Total
			$ in millions		
SSB	$ 150	$ 150	$ 75	$ 25	$ 400
CSFB	75	75	50	0	200
Merrill Lynch	100*	0	75	25	200
Morgan Stanley	25	25	75	0	125
Goldman Sachs	25	25	50	10	110
Bear Stearns	25	25	25	5	80
J.P. Morgan	25	25	25	5	80
Lehman Bros.	25	25	25	5	80
UBS	25	25	25	5	80
Piper Jaffray	12.5	12.5	7.5	0	32.5
Total	**$ 487.5**	**$ 387.5**	**$ 432.5**	**$ 80**	**$1,387.5**

** payment made in prior settlement*

all of us at Merrill Lynch get it." Mr. Purcell wrote a letter of apology to Chairman Donaldson, assuring him that Morgan Stanley took the settlement seriously.

The next shoe to drop involves Bear Stearns. The settlement expressly prohibits research analysts from attending or participating in IPO roadshows in any way. Yet less than one week after the settlement was announced, Bear Stearns Managing Director and research analyst James Kissane appeared in a "net roadshow" promoting the IPO of online credit card processing company iPayment, Inc. In the video, Kissane praised iPayment and touted its stock as a smart investment. Bear Stearns apologized for the incident and barred Mr. Kissane from covering the company.

Only one day later, news leaked out that Lehman Brothers put a last minute stop to a golf boondoggle in Scotland in which three key research analysts were to be flown out to play golf with company bankers and their clients at the elite Gleneagles golf course in an effort to win business. Although Lehman's clients had been told the week before that the three analysts would be attending the trip, Lehman's compliance department nixed the trip at the last minute — perhaps due to the public outrage directed at post-settlement missteps committed by the other banks. The trip would have violated the recent settlement.

The culture of cozy back-scratching and conflicts of interest runs so deep on Wall Street that even regulatory bodies are not immune. In discussing the settlement, New York Stock Exchange Chairman Richard Grasso commented, "The quality and integrity of Wall Street research will be beyond reproach. An analyst is an analyst. A banker is a banker. The two shall never cross." Fine remarks, but perhaps Mr. Grasso should focus his attention closer to home. First, Mr. Grasso was rightly criticized for recently nominating disgraced Citigroup Chairman Sandy Weill to become a director on the NYSE. Second, more importantly, Mr. Grasso currently sits on the board of Home Depot, a company traded on the NYSE, and a co-founder of Home Depot currently sits on the NYSE's board (which determines Mr. Grasso's salary). Mr. Grasso, who regards himself as a reformer, earns $10 million per year serving as Chairman of the NYSE, and there is no good reason why he should also be sitting on the board of a company he regulates.

You see, conflicts run deep on Wall Street — one of America's oldest and most cherished clubs. Only time will tell how much change the recent settlement will bring.

Andrew Gschwind is a former associate of BLB&G.

Quarterly Quote

From an April 30, 2003 letter from SEC Chairman William H. Donaldson to Morgan Stanley CEO Philip J. Purcell, responding to public comments by Mr. Purcell that he "did not see anything" in the global IPO settlement that should concern investors about Morgan Stanley's conduct:

"Dear Mr. Purcell,

. . . [Y]our statements reflect a disturbing and misguided perspective on Morgan Stanley's alleged misconduct. The allegations in the Commission's complaint against Morgan Stanley are extremely serious . . . [Y]our reported comments evidence a troubling lack of contrition and lead me to wonder about Morgan Stanley's commitment to compliance with the letter and spirit of the law. . . . I wish to remind you that among the terms of the settlement . . . is a requirement that the firm, and those speaking on its behalf, do not deny the Commission's allegations."

Eye On The Issues

LEGISLATIVE/REGULATORY UPDATES
AND RECENT DECISIONS OF INTEREST

By Timothy DeLange

Quattrone Indicted for Obstruction of Justice. On Monday, May 12, 2003, former star investment banker Frank Quattrone of Credit Suisse First Boston was indicted on charges of obstruction of justice and witness tampering, according to federal officials. The indictment charges Quattrone with allegedly directing CSFB employees to destroy documents that had been subpoenaed by a federal grand jury and the U.S. Securities and Exchange Commission in an investigation of how CSFB allocated shares of hot stock offerings in the late 1990s. The charges allege that he had directed the destruction of evidence in December 2000 by endorsing a recommendation made by a banker in his department to destroy files. The approval was made by e-mail. Quattrone, 47, of Menlo Park, California, led one of the most lucrative operations in the history of Wall Street and was at the center of CSFB's technology stock underwriting business. He resigned under intense pressure on March 4. *Reuters, May 12, 2003.*

Corporate Fraud Remains Widespread. U.S. prosecutors are investigating possible fraud by executives at approximately 130 public companies. According to U.S. Justice Department officials, the government is likely to file new criminal charges in dozens of those cases. Keith Slotter, chief of the FBI's financial-crimes section, remarked, "We had thought that maybe this corporate fraud crisis had reached a peak, but we continue to have new investigations and new allegations on companies on a regular basis." The FBI has doubled the number of agents probing corporate corruption and hopes to soon have 260 agents pursuing such cases. The FBI is opening three to five investigations a month and is actively involved in about 100 cases of suspected fraud at companies. The FBI assists the SEC on three types of crimes: accounting fraud and insider trading; self-dealing transactions that enrich employees; and obstructing justice by lying under oath, destroying documents or coercing others to do so. Currently, the SEC has about 2,200 ongoing investigations. *Bloomberg, April 23, 2003; Boston Globe, May 6, 2003.*

Stock Analysts Still Favoring Banking Clients. According to statistics, investment banking firms remain likely to give clients' stocks favorable ratings. For example, 79% of all stocks with Goldman Sachs' highest rating of "outperform" were also investment banking clients of the firm. In comparison, only 61% of the stocks with the lowest rating of "underperform" were clients. At Morgan Stanley, 40% of all stocks assigned the highest rating of "overweight" were investment banking clients, whereas only 27% of stocks rated "underweight" were clients. The statistics appear on the back of all Wall Street research reports. In reviewing the statistics, some market watchers have criticized the results, noting that it appears to be "business as usual" despite the recent scrutiny over stock-research bias. Investment banking firms refute the existence of any impropriety. They claim the results stem from their practice of underwriting only sound companies. *Wall Street Journal, April 7, 2003.*

Creative Compensation. Despite falling stock prices, CEO compensation continues to rise. In 2002, a year in which the Dow Jones industrials fell by 16.8%, total compensation for the average CEO rose by 15%. How? The latest trend in CEO compensation is the granting of restricted stock instead of options. Like options, restricted shares provide an economic incentive that increases along with share value. Unlike options, however, there is generally no strike price that must be reached to exercise; instead, restricted stock simply vests over time. Historically, restricted stock has been used as a tool to retain executives and reward longevity. Options were developed explicitly to reward performance — the stock price must hit certain targets in order for them to be worth anything. Tying the award of restricted stock to performance is essential, experts say. Otherwise, switching from options to restricted shares amounts to an unwarranted freebie for executives. *CNN/Money, April 24, 2003.*

Carl McCall To Head Corporate Governance Committee Of NYSE. The New York Stock Exchange has appointed a special committee, chaired by former New York State Comptroller, Carl McCall, to study the NYSE's own corporate governance. The announcement follows the public uproar over the NYSE's decision to appoint Citigroup Chair and CEO Sandy Weil as a director. Citigroup's Weil has received considerable criticism for his activities with former telecom analyst Jack Grubman. *Council of Institutional Investors Alerts, April 14, 2003.*

Merger Lockups Invalid. The Delaware Supreme Court has given the thumbs-down to "lockups," a mechanism in which corporate buyers receive guaranteed support from majority shareholders of a target company. The mechanism is used when one or two investors hold large blocks of stock, and it is aimed at ensuring that a rival bidder won't emerge because the majority shareholders have already committed to the initial deal. The Delaware Supreme Court, however, described lockups as "both preclusive and coercive" and "invalid and unenforceable." Deal makers say the inability to lock up key shareholders could actually result in lower prices being paid because prospective buyers will not put their best offer on the table if they cannot be guaranteed the transaction will be completed. However, the ruling may benefit shareholders, who stand to receive more money when a second bidder makes a higher purchase offer. *The Wall Street Journal, April 7, 2003.*

The $75 Million Defense – And Counting. The cost of defending a company and its corporate executives under investigation for accounting fraud is rising. Qwest Communications International Inc. spent a stunning $75 million last year for outside attorneys alone. Qwest continues to spend more than $7 million a month on outside lawyers to defend its accounting practices, including Qwest's recording of more than $1 billion in revenue for "swaps" of unneeded telecommunications capacity. *The Wall Street Journal, March 10, 2003.*

McDonough To Head SEC Accounting Oversight Board. William McDonough, the outgoing head of the New York branch of the Federal Reserve, was named head of the Public Company Accounting Oversight Board. McDonough will leave his post as president of the New York Fed in July. The Accounting Board, under pressure from the SEC, amended its proposed bylaws to give McDonough the title of chief executive officer and greater authority in hiring and firing staff. *CNN/Money, April 15, 2003; The Wall Street Journal, April 28, 2003.*

Foreign Auditors To Face Registration. Both the SEC and the new Public Company Accounting Oversight Board agree that foreign firms auditing U.S.-traded companies should register with the Accounting Board. Registration would cover foreign firms that audit U.S.-listed companies as well as overseas subsidiaries of U.S. companies. Despite a wave of protest from overseas firms, the SEC and the Accounting Board held firm, requiring foreign firms to register. "A great deal of the U.S. markets now involve companies and auditors that are not in the United States...We believe registration is extremely important for us to be able to fulfill our mandate," said Charles D. Niemeier, acting Chairman of the Accounting Board. *The Wall Street Journal, March 3, 2003; The Washington Post, April 2, 2003.*

Securities Class Settlements Continue To Rise. A volatile stock market and a rise in financial restatements have led to an increase in the cost to settle securities class actions. Last year, the average price of settling a securities fraud case rose 68% to $24.3 million, compared with $16.6 million in 2001. In 2002, there was a total of about $2.4 billion in settlements in 98 cases. The numbers are expected to rise again this year. Class-action suits typically take an average of two to three years to settle, so many of the cases filed in 2001 and 2002 are still being negotiated. *The Wall Street Journal, April 10, 2003; New York Law Journal, April 21, 2003.*

California Supreme Court Opens Doors For Holder Actions. Refusing to close the doors to its state courthouses, the California Supreme Court allowed investors who only hold, rather than purchase, stock that declines in value during the relevant time period to sue for fraud. Despite a 1975 U.S. Supreme Court decision eliminating "holder's actions," federal courts have long noted the availability of state law remedies. In the opinion, Justice Joyce Kennard wrote, "Denying a cause of action to persons who hold stock in reliance upon corporate misrepresentations reduces substantially the number of persons who can enforce corporate honesty." The California Supreme Court's unanimous decision clears the way for so-called holder's actions. The court did, however, erect significant hurdles. In particular, investors must plead with specificity their reliance on public statements made by company executives. The onus on the individual shareholder to demonstrate reliance may make class actions an impossibility since groups of investors with different showings of reliance may not qualify for class certification. *The Recorder, April 9, 2003.*

Carmichael Named Chief Auditor of Accounting Board. The new Public Company Accounting Oversight Board named industry critic Douglas R. Carmichael its Chief Auditor. Carmichael, a professor and director of the Center for Financial Integrity at the City University of New York's Baruch College, will lead the Accounting Board's efforts to develop new professional and quality-control standards for accountants. "There hasn't been anyone in the process representing investors," said Carmichael. "That's one of the main things I will attempt to instill in the staff that works on the standards." Carmichael's top priority will be developing standards to address how companies should move to detect financial fraud and requirements that auditors review their clients' internal controls. *The Washington Post, April 18, 2003.*

SEC Adopts Rules Requiring Audit Committee Compliance. The SEC voted to adopt rules requiring the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements established by the Sarbanes-Oxley Act. Under the new rules, (1) each member of the audit committee must be independent, (2) the audit committee must be directly responsible for the appointment, compensation and oversight of any public accounting firm and (3) the public accounting firm must report directly to the audit committee. To satisfy the new rules, the audit committee must establish procedures for the receipt and treatment of complaints regarding accounting and internal controls and must have the authority to engage independent counsel and other advisors. *Federal Securities Law Reports, April 9, 2003.*

Xerox Tops CalPERS's Bad Governance Hit-List. The California Public Employees' Retirement System ("CalPERS") berated Xerox for having "one of the most ineffective boards" in America, lumping the copier and printer company with five others on its annual list of worst-governed companies. CalPERS criticized Xerox for not yet adding three additional independent directors and for not splitting the positions of Chairman and Chief Executive Officer. Joining Xerox on CalPERS's closely watched "focus list" are: Gemstar-TV Guide International, JDS Uniphase, Manugistics Group, Midway Games and Parametric Technology. *Financial Times, March 28, 2003.*

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ACCOUNTING BOARD

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Accounting Board and Baruch College accounting professor Douglas Carmichael was just named its chief auditor. With these key appointments and encouraging early action, it appears the Accounting Board is finally poised to fulfill its mandate of establishing new, strong auditing standards and regulating our nation's auditors.

Background

The Sarbanes-Oxley Act established the five-member Accounting Board to regulate the auditing of companies that are publicly-traded on America's securities exchanges. Under the Act, the Accounting Board's core duties include: establishing auditing standards and auditor independence and ethics standards; registering public accounting firms; and conducting inspections, investigations and disciplinary proceedings of registered accounting firms. The SEC oversees the operations of the Accounting Board by its power to appoint and remove members of the Board, approve the Board's budget, approve or reject proposed rules and regulations, and hear appeals of adverse rulings and disciplinary action. By law, only two of the Accounting Board's five members can be certified public accountants, which means that for the first time since the passage of the Securities Act of 1933, the rules for the auditing profession will be set by outsiders instead of auditors themselves.

When the SEC was first created in 1934, it had full power and authority to set auditing standards, and President Franklin Delano Roosevelt wanted the SEC's first Commissioner, Joseph P. Kennedy, to shore up investor confidence by setting strong, binding auditing standards. However, vigorous lobbying by America's leading accountants, including George Oliver May and Arthur Andersen, persuaded the SEC that mandating a uniform set of auditing standards for all U.S. companies would be unworkable and that only accountants who labored in the trenches every day could successfully set auditing standards. Thus, in a 3-2 vote in 1939, the SEC decided to let auditors set their own accounting and auditing standards, i.e., regulate themselves.

Until recently, auditing standards were set by the American Institute of Certified Public Accountants ("AICPA"), the leading accounting trade group. In 1973, public pressure following a spree of corporate corruption caused a new, independent private organization—the Financial Accounting Standards Board ("FASB")—to come into being to define general corporate accounting principles. Then, in 1977, the AICPA established the Public Oversight Board ("POB") to monitor the integrity of the audit process. The original POB was funded by the accounting profession and was—by all accounts—a failure. On January 20, 2002, the embarrassed POB voted to voluntarily disband. In addition, prior to Sarbanes-Oxley and the Accounting Board, accounting firms were subject to review and investigation only through a "peer review" process, whereby member firms periodically inspected one another. Because the accounting profession was unwilling to be critical of its members' practices, no major accounting firm ever failed a peer review. Indeed, even after the Enron scandal erupted, on December 21, 2001, Deloitte & Touche gave Arthur Andersen a glowing peer review, and the AICPA sent the soon-to-be-dead accounting firm a letter congratulating it on its review.

With the passage of Sarbanes-Oxley and the creation of the new Accounting Board, FDR will finally get his wish: government regulation of auditing standards.

Off to a Rough Start

Under the Sarbanes-Oxley Act, the chair of the Accounting Board is required to be a "prominent individual of integrity and reputation who has a demonstrated commitment to the interests of investors and the public" and a good understanding of the securities laws. Former SEC Chairman Harvey Pitt nominated former CIA Director William Webster to chair the Accounting Board. However, Webster soon resigned over revelations that he headed the audit committee of a company currently under federal investigation for falsifying its financial results (a fact he apparently mentioned to Pitt). Indeed, Pitt's selection of Webster to head the Accounting Board helped seal his own resignation.

Then, the Accounting Board caused more than a few heads in Congress to turn when it announced that four of its board members would be paid $452,000 per year and its Chairman would earn $556,000 per year (amounts deliberately set equal to those earned by members of the Financial Accounting Standards Board). Angry Congressmen and women pointed out that the SEC Chairman earned only $138,500 and the President of the United States only $400,000. However, recognizing the Accounting Board's need to attract top talent and the symbolic importance of matching salaries paid to their counterparts at the private FASB, Congress relented and the Accounting Board's salaries have been approved.

"Now from accounting, sir. Two and two is four again."

Key Appointments Meet With Praise

Recognizing the need to stabilize a rudderless ship, new SEC Chairman William Donaldson, a Republican, made the selection of a new Accounting Board chairperson his top priority. On April 15th of this year, the SEC nominated retiring New York Reserve Bank President William McDonough, a Democrat, to chair the Board, and this appointment has been met with widespread praise. Prior to his appointment, McDonough was slated to join the New York Stock Exchange's Board of Directors. He was often mentioned as a potential successor to Federal Reserve Chairman Alan Greenspan and played a significant role in coordinating the government's response to Wall Street after the September 11th tragedy.

A couple of days later, the Accounting Board named accounting professor and frequent critic of the big accounting firms Douglas R. Carmichael to become its chief auditor. Mr. Carmichael was vice president of auditing at the AICPA before becoming a professor at Baruch College, and he has published several books on auditing and accounting. In recent years he has been a leading critic of current auditing standards, criticizing the AICPA for writing weak auditing standards in order to protect accountants from liability in lawsuits at the public's expense, and he has repeatedly warned about the conflicts of interest that auditors face when they also provide consulting services to their clients.

Accepting his new job, Mr. Carmichael said, "Auditing standards are now going to be set in the public interest. The public interest has not been the primary interest in the past, and from now on it will be." He told one reporter that, "I've seen things happen in the auditing profession that have disturbed me, that I thought went in the wrong direction." The appeal of his new job: "The chance to put things in the right direction."

Quarterly Quote

From a January 13, 2001 e-mail from Salomon Smith Barney analyst Jack Grubman to a friend, explaining how he upgraded AT&T to get his kids into pre-school and help Citigroup CEO and Co-Chairman Sandy Weill get the backing of AT&T's CEO, a board member, in a power struggle with Citigroup Co-Chairman John Reed:

"You know everyone thinks I upgraded [AT&T] to get lead for [AT&T Wireless]. Nope. I used Sandy to get my kids in 92nd St Y pre-school (which is harder than Harvard) and Sandy needed [the] vote [of AT&T's CEO] on our board to nuke Reed in showdown. Once coast was clear for both of us (i.e. Sandy clear victory and my kids confirmed) I went back to my normal negative self on [AT&T]. [AT&T's CEO] never knew that we both (Sandy and I) played him like a fiddle."

First Actions of the Accounting Board

The Accounting Board has already begun to assume its proper watchdog role.

On April 17, 2003 the Accounting Board voted unanimously to set auditing standards itself rather than continuing to rely on the AICPA or the FASB to set standards. By law, the Accounting Board could have delegated its standards-setting job to these industry groups.

In a March, 2003 press release, the AICPA announced that its Auditing Standards Board "will continue to work closely with the SEC and the [Accounting Board] to finalize... new auditing standards." One of William McDonough's first acts as Chairman of the Accounting Board was to send a terse letter to the AICPA reminding it that only the Accounting Board has the power to set auditing standards and that the AICPA should not mislead people.

In one of his first actions, Chief Auditor Carmichael has indicated that the Accounting Board will establish an advisory council with as many as 30 auditors, investors and other interested parties to assist the Accounting Board in establishing new auditing standards. Mr. Carmichael will spearhead the creation of new auditing standards.

Continued on back page.

Bernstein Litowitz Berger & Grossmann LLP prosecutes class and private actions, nationwide, on behalf of institutions and individuals. Founded in 1983, the firm's practice concentrates in the litigation of securities fraud; corporate governance; antitrust; employment discrimination; and consumer fraud actions. The firm also handles, on behalf of major institutional clients and lenders, more general complex commercial litigation. The firm's client base in securities fraud and corporate governance litigation includes large public pension funds and other institutional investors.

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Equally important, the Accounting Board voted to reopen the issue of whether accounting firms should be allowed to provide tax consulting services to their clients—a practice okayed by the SEC only three months earlier. It is thought by many that these dual functions create an irreconcilable conflict of interest.

Finally, the Accounting Board voted to fund itself through mandatory fees collected from publicly-traded companies with a market capitalization greater than $25 million and investment companies with more than $250 million in assets. The Accounting Board currently has an office in Washington, D.C. and will soon open an office in New York City, where all "Big Four" accounting firms are headquartered. By the end of 2003, the Accounting Board should have approximately 200 employees and will eventually expand to have roughly 300 employees.

These important votes hold out great promise that the Accounting Board is poised to assume an activist role in reforming our nation's accounting profession.

Key Issues, Concerns and Challenges

To be sure, the Accounting Board faces many challenges. Although the Accounting Board will certainly be more autonomous than the disbanded private-sector POB due to the fact that it is an independently-funded governmental body, the Accounting Board's budget is nonetheless subject to SEC approval. Should the SEC disagree with the Accounting Board's actions or policies, the SEC may simply reject or drastically reduce the Accounting Board's proposed budget. Again, the SEC has the power to appoint and remove Board members and even "censure or impose limitations upon the activities, functions, and operations of the Board." More importantly, each and every auditing standard and rule proposed by the Accounting Board is subject to SEC approval. Under the Sarbanes-Oxley Act, the ultimate power to make rules, carry out investigations, and enforce discipline resides in the SEC, not the Accounting Board. And the Board's ability to discipline member firms and individual accountants is limited, as any disciplinary action taken by the Accounting Board is subject to review and revision by the SEC. Such limitations may erode the Board's ability to quickly respond to violations because any application for review by the SEC operates as a stay of any disciplinary action ordered by the Board. Such review could take years.

In short, the success of the Accounting Board depends upon a cooperative SEC. Some SEC chairmen, like former Chairman Arthur Levitt, would obviously welcome an activist Board; others would clearly not. (So far, Chairman Donaldson is off to a good start.)

The Accounting Board's budget, and, therefore, its autonomy, is also subject to Congressional interference. Indeed, Congress already nearly torpedoed the Accounting Board's proposed salaries, threatening a budget amendment that barred any federal salaries greater than the $400,000 annual compensation paid to the President. Future Accounting Board budget requests and decisions will undoubtedly receive tremendous Congressional scrutiny.

Finally, even though the Accounting Board was created to provide public trust in audits conducted by independent accountants, the public is not informed of some crucial Accounting Board activities that impact that trust. When the Accounting Board uncovers deficiencies in the quality control systems of an auditing firm, the Board cannot disclose its findings to the public so long as the firm "addresses" the issue within a year. Putting aside that the Sarbanes-Oxley Act does not define what sort of action is sufficient to "address" an issue, the year-long reporting delay arguably undermines the very purpose of the Board, which is to force greater public accountability on accountants and auditors.

Nonetheless, although off to a slow start, the Accounting Board is finally poised to reform our nation's auditing standards and restore public faith in companies' audited financial statements.

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