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The “Committee on Capital Markets Regulation” ... A Wolf in Sheep’s Clothing?

By Blair Nicholas and Niki Mendoza

The newly created and self-proclaimed “Committee on Capital Markets Regulation” is trumpeted as an “independent non-partisan” committee formed to study capital markets regulation and the competitiveness of the U.S. public capital markets. Although the committee has no official status, it most definitely has an agenda...an agenda of which all institutional investors should be very wary.

According to the committee’s own press release, its study, entitled innocuously enough “Capital Markets Regulation and Its Effect on U.S. Competitiveness,” will assess the degree to which U.S. public markets are losing ground to foreign and private markets, the causes of this decline, and its impact on the financial industry and the economy. But do not be fooled by the title and the purportedly objective analysis. The committee intends to make recommendations to key policy makers on the following areas which directly impact the ability of investors to protect themselves from securities fraud:

- **Liability issues** affecting public companies and gatekeepers (such as auditors and directors) with a focus on securities class action litigation, criminal enforcement and federal versus state authority;
- **The Sarbanes-Oxley Act**, with major emphasis on Section 404, which requires auditors and senior managers to certify the adequacy of internal controls;
- **Overall regulatory processes** to allow the United States to do a better job of evaluating changes of law and regulation, prospectively, initially and on an ongoing basis;
- **Shareholder rights.**



Partner Blair Nicholas, speaking at the recent Institutional Investor Forum, held in New York in October, 2006.

Although the committee said it plans to announce its recommendations soon, some of the principal members of the committee are already voicing their beliefs that the Sarbanes-Oxley Act and other securities laws and regulations hinder the competitiveness of the U.S. capital markets. It should come as no surprise if committee members conclude that investors (including large institutional investors), and state regulators (i.e., Eliot Spitzer) are unfairly persecuting American corporations, their auditors and directors, and investment banks. Indeed, many commentators expect to see recommendations for less regulation of corporations, restricted liability of auditors and others, and more restraints on investors’ abilities to recover losses caused by securities fraud.

According to news sources, in the “near future” the committee can be expected to make recom-

recommendations “to impose limits on securities class actions” and that the Securities and Exchange Commission (“SEC”) could take some steps to change the role of the “securities class action” within the next six months. Among these recommendations, is for the SEC to “dis-imply” a private cause of action against corporations under Rule 10b-5 (the crux of the enforcement of the federal securities laws). In other words, ***institutional investors and other private plaintiffs could be precluded from pursuing securities fraud claims against a corporation.***

Why would the committee want to tie the hands of institutional investors and other private plaintiffs from pursuing securities fraud actions against all corporate wrongdoers? The chart on the next page illustrates the recoveries of institutional investors and other private plaintiffs in securities class actions as compared to the SEC’s recovery in the same action.

Clearly, institutional investors have a remarkable track record of prosecuting securities fraud class actions and recovering billions of dollars for defrauded investors. Precluding these investors from pursuing securities fraud actions against all corporate wrongdoers who commit securities fraud may very well result in erasing a huge portion of investors’ recoveries in securities fraud litigation and turning back the clock to the days before the securities laws were even enacted.

News coverage has also noted that the committee may recommend securities fraud cases be moved out of the courts and into arbitration. Even if this is legally permissible, which by no means is assured, there are numerous problems with moving securities fraud cases out of the courts and into arbitration. Among other factors, in arbitration there is limited ability to pursue discovery against the wrongdoers, the rules of evidence rarely apply, and there would be ***no*** appellate review of erroneous arbitration rulings.

Therefore, the possible “reforms” percolating about the committee are not only severely misguided, but if actually proposed, will undoubtedly create a firestorm within the institutional investor community. After all, it is the institutional investor community which has stood up and taken action against corporate fraud and achieved historic corporate governance changes that have significantly altered the landscape of Wall Street, auditing firms, and boardrooms nationwide.

The timing of the committee’s formation is curious, to say the least, given the recent wave of frauds such as WorldCom and Enron; the collapse and bankruptcy of the Refco commodity firm just months after its IPO; the mutual fund late trading debacle; the recent capsizing of hedge fund Amaranth that lost \$6 billion of investor money in two weeks; and the stock option backdating scandal which has resulted in billions of dollars of past reported profits being erased, over 100 corporations under criminal investigation, and one former CEO funneling money overseas and fleeing the country to escape criminal prosecution. Clearly, securities fraud has become epic in scope and is not subsiding. Considering these significant events, investors must ask themselves: “Is now the time to propose less regulation of the securities markets?”

Do not take comfort in the purported “independence” of the committee. Although it lacks official federal endorsement, it is actively endorsed by the Secretary of the Treasury (the former chief of Goldman Sachs), Henry Paulson, and is often referred to as the “Paulson Committee.” Mr. Paulson was quoted as saying: “I am pleased to learn that the Committee on Capital Markets Regulation, an independent group of highly respected leaders in each of their fields, will examine the competitiveness of the U.S. public capital markets... This issue is important to the future of the American economy and a priority for me.” The committee will present its recommendations for reforms directly to Mr. Paulson.

Among other connections to the federal government, former Commerce Secretary Donald Evans is also a committee member. Evans is currently the CEO of the Financial Services Forum, a lobbying group for major insurers, banks and investments banks, of which Paulson is the former chairman. A Co-Chairman of the committee, R. Glenn Hubbard, is a former chairman of President Bush’s Council of Economic Advisers.

Notably, there are ***no*** current or former members of the SEC on the committee. ***No*** institutional investors or other fiduciaries. And ***no*** representatives of the securities litigation plaintiffs’ bar which is responsible for recovering over \$17 billion for investors in 2005 alone. Not surprisingly, the committee is heavy on CEOs (12 of the 20 members), including the CEOs of Dupont, Office Depot, and other top executives and/or directors of MFS Investment Management, Capital Research and Management Co., and Lehman Brothers, among others. There are also CEOs of two accounting firms, PricewaterhouseCoopers and Deloitte Touche Tohmatsu. Other members include six academics, the President and Co-COO of NYSE, and one partner in a large law firm which defends public companies against serious charges of securities fraud.

Why not invite current or former SEC members? SEC spokesman John Nester is quoted as saying that agency officials “are prepared to share their expertise with the (new) committee as appropriate and look forward to the final report.” However, committee director Hal S. Scott chose not to include any SEC representatives, claiming that people who had formulated the rules in the past “may have a lack of objectivity.” Co-Chairman Hubbard is quoted as stating that the committee would be knowledgeable about regulation. “Many of the people have SEC interaction on a regular basis.” That is true.

Many of the committee members and the companies they head are no strangers to the SEC. For example, audi-

tor PricewaterhouseCoopers agreed to pay a \$2.4 million civil penalty to settle an SEC Enforcement Action against it relating to its audit of Warnaco's annual report. In another Enforcement Action, the SEC found that PricewaterhouseCoopers violated auditor independence rules from 1996 to 2001, and that by virtue of its independence violations, the firm caused 16 of its public audit clients to file financial statements with the SEC that did not comply with the reporting provisions of the federal securities laws. The SEC further found that in connection with the improper accounting of its consulting fees, PricewaterhouseCoopers caused two of those clients to violate the reporting, recordkeeping, and/or internal controls provisions of the federal securities laws.

The other auditor represented on the committee—Deloitte—led the opposition to proposed rule changes in 2000 that would have prohibited accounting firms from offering both auditing and consulting services to clients. Deloitte, too, has had its fair share of run-ins with the SEC, including, for example, charges stemming from its audit of Adelphia Communications Corporation's fiscal year 2000 financial statements and its failed audit of Just For Feet, Inc.'s 1998 financial statements. These charges resulted in Deloitte agreeing to a monetary settlement and to undertake measures to address deficiencies in its National Risk Management Program. Given the disclosures of massive accounting frauds at major corporations audited by the large accounting firms, coupled with the CEOs of PricewaterhouseCoopers and Deloitte serving as members on the committee, it is not at all surprising that the committee may consider proposing a cap on auditor liability.

Putting aside the obvious flaws in the selection of certain committee members and the possible reforms, why not include institutional investors or other investor representatives on the committee? Could this be because institutional investors are commonly the voice for corporate governance reform and often lead the

NO WONDER the Committee wants to abolish class actions and put the SEC in charge!

Company	Securities Class Action Recovery	SEC Recovery
Enron	\$7.161 Billion	\$424.84 Million
WorldCom	\$6.156 Billion	\$750 Million
AOL Time Warner	\$2.65 Billion	\$308 Million
Lucent	\$667 Million	\$25 Million
Bristol-Myers Squibb	\$574 Million	\$150 Million

Sources: Institutional Shareholder Services; Stanford Securities Class Action Clearinghouse

prosecution of securities class actions? It is no secret that institutional investors are increasingly criticizing the excessive pay packages for executives at underperforming U.S. companies and these criticisms have led to new compensation disclosure rules for CEOs, other top executives, and Board members.

If the concern is over a need to level the playing field by deregulating the U.S. markets so as to meet the lower level of regulation in foreign markets, why not instead encourage the foreign markets to increase their regulation (and protection for investors)? In fact, that is already occurring. A 2006 Postseason Report recently issued by Institutional Shareholder Services cites several examples of international capital markets that took steps in 2006 to improve governance practices by amending best practices codes, tightening corporation or securities laws, or adopting tougher listing standards.

Clearly, the post-WorldCom era has not been "fraud-free" as class action critics had claimed it would be. Securities fraud scandals continue to steal the headlines on a weekly basis. It is not surprising that those who oppose corporate governance reform and the recovery of losses through securities class actions would attempt to formu-

late a transparent "independent" committee in an effort to undo some of the critical protections provided by state and federal securities laws, including the Sarbanes-Oxley Act.

Importantly, institutional investors, who have the most at stake, should see this committee for what it truly is: a heavily self-interested committee that is likely to recommend a dramatic rollback of investor protections — including those reforms achieved in response to the meltdowns at WorldCom and Enron, among other large publicly traded companies. Without question, institutional investors should have a voice — and a loud one — on a committee considering such critical proposals which may adversely impact investors' ability to recover assets lost as a result of securities fraud. Unfortunately, however, those with the most to lose — institutional investors — have been left out in the cold and all should view the transparent attempt by this committee to shut down the very accountability that makes our capital markets the strongest in the world as a call to arms!

Blair Nicholas is a partner in BLB&G's San Diego office. He can be reached at BlairN@blbglaw.com. Niki Mendoza is an associate in the firm's San Diego office. She can be reached at nikim@blbglaw.com.