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A SECURITIES FRAUD AND CORPORATE GOVERNANCE QUARTERLY

FUNDAMENTAL CAUSES OF ACCOUNTING DEBACLES: SHOW ME WHERE IT SAYS I CAN'T

by Roman L. Weil

Enron bet the farm and lost. It's OK to gamble, but shareholders should know about the size and risk of bets undertaken as well as how the nature of bets changes over time. Why didn't the accounting for Enron's activities do a better job of alerting shareholders to the risks and changes in them?

The Fundamental Problem

The fundamental problem arises when accounting *rules* trump accounting *principles*. From my historical perspective (other observers might choose a different start), accounting rule makers took the first step on the road to the Enron accounting debacle in 1980. At that time, Congress passed legislation de-regulating the granting of trucking rights, effectively giving any trucker the right to carry any commodity between any two points. Prior to that de-regulating legislation, Congress, acting through the Interstate Commerce Commission, had limited those rights. The issued rights traded in the market place and, once purchased by a trucking firm, appeared on the firm's balance sheet at cost. When Congress effectively destroyed the value of those rights

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CIVIL LITIGATION IMPACT OF THE NEW CORPORATE FRAUD LEGISLATION

by Gregory P. Joseph, Esq.

The corporate fraud legislation signed into law on July 30, 2002, is largely focused not on civil litigation but on corporate governance, disclosure and criminal law matters. The Sarbanes-Oxley Act of 2002 is, however, a telling example of the law of unintended consequences. It will have wide-ranging effects on securities, derivative and other shareholder lawsuits. This article outlines some of the more important civil litigation implications of the Act.

Statute of Limitations. The Act includes three explicit applications to civil litigation. First, section 804 extends the statute of limitations for securities fraud actions to the earlier of two years following discovery of the facts constituting the violation, or five years after the violation. The new 2-and-5 year limitations periods replace the prior 1-and-3 year periods, and apply to all proceedings commenced on or after July 30, 2002. This change will doubtless trigger a spate of lawsuits questioning the validity of applying the new periods to actions which, but for the Act, were time barred as of July 29, 2002.

Insider Trading. In response to the public outcry arising out of Enron's demise, section 306 creates a new derivative action against officers and directors who trade in their company's stock during a blackout period (*i.e.,* when participants in the company's benefits plans may not trade). This derivative action has a uniquely meaningless demand requirement. While a request must be made 60 days before suit may be filed, the company cannot preclude the action by conscientiously (or otherwise) deciding not to file suit. The derivative plaintiff may proceed unless the company has filed suit within 60 days (and may proceed later if the company commences the action but does not "diligently" prosecute it). This raises the prospect that a plaintiff may file a request under this statute but simultaneously wish to allege futility as to other, state law derivative claims. The wording of the demand letter will be critical.

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ACCOUNTING DEBACLES

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by allowing any trucker the right to carry the goods previously protected by monopoly rights, what did the accountants at trucking firms do? They wrote off the value of the trucking rights then remaining on the balance sheet, recognizing an amount of loss equal to their then-current book value.

Did the trucking company accountants need a specific accounting rule telling them to write off the book value of those trucking right assets? You wouldn't think so, would you? But the Financial Accounting Standards Board (FASB) felt compelled to pass a rule (Statement of Financial Accounting Standards No. 44, 1980) saying just that. This was the first step toward the Enron debacle.

Since the early 1980s, an aggressive company's management engages in a transaction not covered by specific accounting rules, accounts for it as it chooses, and challenges the auditor by arguing, "Show me where it says I can't." The auditor used to be able to appeal to first principles of accounting. Such principles suggest, for example, that post-deregulation trucking rights are no longer assets. Now, the aggressive management can say,"Detailed accounting rules cover so many transactions and none of them covers the current issue, so we can devise accounting of our own choosing." And they do.

Accounting rule making has become increasingly detailed as both the SEC and auditors plead with standard setters for specific rules to provide backbone: "Dear FASB or EITF (Emerging Issues Task Force, created by the SEC and the FASB), Give us a rule for this new transaction."

So, Enron transfers assets, reporting current profit and debt, then challenges its auditor to "Show me where it says I can't." The auditor can't. The auditor considers nixing the profit recognition but simultaneously considers the consequences of saying, "No" to aggressive management: "We might lose this client."

The near majority of the board members of the rule setting FASB have come from high-powered audit practices. These members bring to the Board a mindset that the accounting profession needs and wants specific guidance for specific transactions. Three of them can meet privately and can effectively, if not formally, guide, perhaps even set, the

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Inside Look

The continuing parade of corporate scandals, from Worldcom's collapse and record-setting bankruptcy to the televised handcuffing of Adelphia's chairman, expose a widespread breakdown in the quality of corporate governance. Recently, Federal Reserve Chairman Alan Greenspan attributed this breakdown to the "infectious greed that seemed to grip much of our business community." The investors' guardians, public accountants, were overwhelmed by this greed. In this issue of the *Advocate*, we look at steps that lawmakers and shareholders have taken to deter future wrongdoing and restore confidence in the markets and faith in financial reporting.

We are delighted that Roman L. Weil contributed to this issue of the *Advocate*. Dr. Weil is the V. Duane Rath Professor of Accounting at the Graduate School of Business of the University of Chicago and a frequent commentator on corporate governance and public accounting matters. In the aftermath of Enron's collapse, the House Committee on Energy and Commerce invited Dr. Weil to testify during its hearings on accounting reform. *Fundamental Causes of Accounting Debacles: Show Me Where It Says I Can't* is adapted from that testimony. In it, Dr. Weil offers his insight into the root causes of financial disasters, like the one at Enron, and proposes solutions to prevent future such scandals.

Congress adopted some of Dr. Weil's proposals when it enacted the Sarbanes-Oxley Act of 2002. That litigation is largely focused on corporate reform, including disclosure requirements and criminal penalties. But the law also affects private shareholder litigation in significant respects. Gregory P. Joseph, a preeminent litigator and the former Chair of the Litigation Section of the American Bar Association, explains the implications of the new law in *Civil Litigation Impact of the New Corporate Fraud Legislation*. Mr. Joseph also explains what the law did not do. It did not, for example, roll back important limitations on accountants' liability, which was a gift to the accounting industry when Congress passed the Private Securities Litigation Reform Act in 1995.

I also draw your attention to *Eye on The Issues*. In her regular column, Beata Gocyk-Farber synthesizes current news and events, providing updates on important developments in the areas of securities and corporate governance. In this issue, Beata monitors the efforts of the various regulatory bodies and institutional investors to curb the abuses which have recently made headlines. Beata also reports on the push by TIAA-CREF and other institutional investors to prod public companies to account for options as expenses, shares some alarming statistics on corporate graft, and much more.

We have enjoyed bringing this issue of the *Advocate* to you. We hope you enjoy reading it and, as always, we welcome your feedback and all questions.

Max W. Berger

agenda for the Board. A minority of the Board has spent careers dealing with fundamental theory. This minority, with more faith in the conceptual basis for accounting, appears to prefer to derive broadly applicable rules from first principles of accounting, which the FASB developed in the early 1980s in its conceptual framework. The majority, the members from auditing practice, less interested in deriving rules from conceptual principles, appears to win most of the battles.

The emphasis on specific rules for specific issues gets more pronounced over time. I concede that these specific rules for specific issues leads to more uniform reporting of the covered transaction — all else equal, a good thing. That uniformity comes at a cost: practicing accountants have less need for informed intelligence and judgment. Part of the pressure on standard setters for specific rules for specific transactions comes from the current litigation environment and from the SEC. Auditors, in a rational pursuit of a full purse, want unambiguous rules to stand behind in the event that accountant judgments and estimates, made in good faith, turn out to miss the target.

That some benefit results from specific rules for specific transactions doesn't make such rules a good idea. These rules have a cost: "Show me where it says I can't," demands management. "Give me more rules for these new transactions, pleads the auditor, so I can combat aggressive management or plaintiffs whose stock has dropped in value." This cycle continues: the increasing number of specific rules for specific transactions strengthens aggressive management's belief that if a rule doesn't prohibit it, then it's allowed. This, in turn, increases the auditor's dependence on specific rules.

What to Do?

I want accountants to rely on fundamental, first principles in choosing accounting methods and estimates. I want accountants not to hide behind the absence of a specific rule. Whatever the detailed rules accountants write, smart managers can construct transactions the rules don't cover.

You might now think about the parallels of the above with our tax collection system, where principles alone cannot suffice. The principle: tax income. The principle requires thousands of pages of tax code, regulations, and court decisions to implement. Can financial accounting be different? I think *yes*. The tax collector and the taxpayer play a zero-sum game — what one pays, the other gets. Financial accounting doesn't have that property and in addition has the auditor to interpret the rule book.

What else, besides more spine in the auditor, do we need to reduce the likelihood of more accounting debacles?

Congress: Keep Out of Accounting Rule Making

Several times in my professional lifetime, Congress has written rules, or taken steps to influence the rules, with bad outcomes for reported financial results. Moreover, these incidents call into question the wisdom of complaining to Congress. The first occurred in the legislation for investment tax credits in the 1960's. The most recent disaster was in the mid 1990's when Congress pressured the FASB to pull back on its proposals for the expensing of stock option costs. I can think of no offsetting, good outcomes.

Reduce Conflicts of Interest

In recent weeks, we have heard about reducing two key conflicts of interest: the opportunities of the auditor to do consulting and to go to work for the audited company. The basic conflict occurs because the audited pays the auditor and, in practice, selects the auditor. In my opinion, everything else has lesser effect.

Auditor Term Limits

Congress, in the recently enacted Sarbanes-Oxley Act of 2002, mandated the rotation of the lead partner on the audit every five years. I endorsed an even more stringent rotation — where the audit firm, not merely the auditor, must change. Firm rotation would let the auditor know that, no matter what, another auditor will take over the job in a few years and will have the incentive to expose a predecessor's carelessness (Talk about professional peer review. This will be *real* peer review, not the pap we get now.) Mandatory auditor term limits have a cost — audit costs might triple. Not just the actual audit bills, but the costs the audited company incurs to show the new auditor where the inventory records lie in the second file drawer of the cabinet two to the left of the green door in the third room on the right of the outside corridor.

I imagine that known term limits will induce the Audit Committee to begin the search for the subsequent auditor 18 months or so before the engagement will start and will be able to bring that new auditor into on-board, learn-from-observation mode early in the process. Those who argue against mandatory auditor rotation adduce large transition costs. Suddenly changing auditors does cause surprise costs that anticipated, orderly transitions will reduce.

Prod the Audit Committee

Then, we need audit committees to exercise the power Congress and the SEC has given them. Thirty years ago, Rod Hills, then Chairman of the SEC, conceived the powerful modern audit committee. He has written that the audit committee's most important job is to make the independent, attesting auditor believe that the auditor's retention depends *solely* on the decision of the audit committee. Most often, it doesn't work that way.

Most audit committees consist of independent, smart, but financially illiterate, members, with rarely more than one financial expert. (How do I know they are often illiterate? Because I teach them in Directors' College classes where I start with pop quizzes.) Audit Committees

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Eye On The Issues

LEGISLATIVE/REGULATORY UPDATES
AND RECENT DECISIONS OF INTEREST

By Beata Gocyk-Farber

Amid New Wave of Corporate Scandals, Lawmakers Reform The Securities Laws. On July 30, 2002, President Bush signed into law a corporate-oversight bill commonly referred to as the Sarbanes-Oxley Act of 2002. The majority of commentators agree that, while not perfect, the new legislation is a step in the right direction. Sarah Teslik, executive director of the Council of Institutional Investors, observed that the new law "is better than I had feared," but also added that "it will probably not make much of the difference." *The New York Times, July 25, 2002 and July 31, 2002.* ***(Gregory Joseph, a noted commentator, writes on the civil litigation impact of the Act in this issue of the Advocate.)***

Arthur Levitt Calls for Reinstatement of Liability For Aiding And Abetting Securities Fraud. Former SEC Chairman Arthur Levitt said that a key failure in the new corporate-oversight legislation is its lack of a provision for liability for aiding and abetting in private securities fraud cases. Levitt explained that "if a lawyer or accountant told the people at Enron or WorldCom that if they cooked up this scheme, private rights of action would not prevail, you couldn't sue those lawyers or accountants, that's wrong." Levitt's view is shared by some of the nation's top academics. Susan P. Koniak, a professor of Law at Boston University, and the co-author of "The Ethics of Lawyering," recently observed that most of the corporate scandals could not have happened without the enthusiastic cooperation of corporate lawyers, who under current law remain largely immune from prosecution. *National Journal, July 27, 2002 and Forbes, August 12, 2002.*

TIAA-CREF Says That Treating Stock Options As Expenses Is the Only Option. TIAA-CREF, one of the nation's largest institutional investors, is launching an unprecedented drive to persuade U.S. companies that they should treat all employee stock options as expenses. TIAA-CREF intends to send letters to the chairmen of 1,754 publicly-traded corporations, urging them to discuss the matter with their boards. Faced with growing pressure by institutional investors like TIAA-CREF, more and more large companies — including Coca Cola, General Electric, Procter & Gamble, Washington Post Co., General Motors and Citigroup — announced that they will voluntarily start accounting for option grants as expenses. According to *Fortune,* expensing of options would have reduced the earnings of the S&P 500 by 21% in 2001; at the tech companies, the bite would be much worse: Dell's 2001 earnings would have been reduced by 59%; Intel's by 79%, and Cisco's by a whopping 171%! *Fortune, August 12, 2002, The Wall Street Journal, July 24, 2002 and August 8, 2002.*

Spitzer Is Turning His Investigative Eye on Executive Compensation. Prompted by reports in the *Financial Times* that senior executives and directors reaped millions of dollars before their companies filed for bankruptcy, Eliot Spitzer, the New York State Attorney General, is investigating the legality of such compensation. According to the *Financial Times*, the total gross earnings of 52 executives, whose companies are among the country's top 25 bankruptcies, added up to $3.3 billion! Gary Winnick of Global Crossing topped the list with $512 million in compensation; Enron's Ken Lay and Lou Pai received $247 million and $270 million, respectively; and K.B. Chandrasekhar of Exodus Communications reaped $130 million. Spitzer would not identify individuals or companies under scrutiny, but he confirmed that several targets held positions at companies identified by the *Financial Times*. *Bloomberg, August 1, 2002; Financial Times, July 30, 2002.*

NASD Proposes New Rules To Prevent IPO Abuses. The National Association of Securities Dealers (NASD) has proposed new rules aimed at curtailing certain improper practices surrounding Initial Public Offerings (IPOs). The new rules emerged from regulatory probes, including the House Financial Services Committee's investigation into Salomon Smith Barney's alleged practice of allocating shares of hot IPOs to top executives in exchange for investment banking business (so called "quid pro quos"). David Chacon, a former broker at Salomon, said that Jack B. Grubman, Salomon's former telecommunications analyst, kept a running list of favorite executives for the purpose of allocating IPO shares. In response to a subpoena from the Committee, Salomon conceded that it handed out IPO allocations to WorldCom executives and directors that "were sufficiently large…to raise questions about appearance of conflicts." *The Wall Street Journal, July 29, 2002 and August 27, 2002, The New York Times, August 6, 2002 and Washington Post, July 2, 2002.*

Lawmakers Propose Asset Seizure For Executives Charged with Securities Fraud. Representative Richard H. Baker, the Louisiana Republican, intends to propose legislation that would allow the government to seize assets of executives charged with violating the securities laws. Under current law, personal holdings of executives charged by the SEC or the Justice Department are untouchable until conviction or settlement. Consequently, while the government struggles to prove its case, the charged executives may waste or hide assets that are potentially available for disgorgement if the government's case is successful. So far, in fiscal 2002, the SEC has won orders forcing executives to disgorge $632 million, but it has retrieved only $73 million, or just 12%, because most of the money was spent on legal fees or hidden. *Business Week, August 26, 2002.*

The New York Stock Exchange Pushes For Directors' Independence And Shareholders' Approval of Stock Options. The New York Stock Exchange proposed new corporate governance rules for companies whose shares trade on the exchange. The new rules would require companies to have boards with a majority of independent directors and to obtain shareholders' approval before issuing most stock options. The new independence requirement replaces the current rule, which calls for only three independent directors, regardless of the size of the board. Carl McCall, the New York State Comptroller and co-chairman of the N.Y.S.E. accountability committee, said that the group had considered requiring companies to treat stock options as expenses, but there was too much disagreement about how to value options. He added, however, that the exchange may add such a requirement in the future. *The New York Times, August 2, 2002.*

Pension Funds Demand Their Day in Court. With corporate scandals breaking out daily, the total losses by pension funds are staggering. The Spectrem Group, a Chicago-based research firm, estimates that since the beginning of 2000, public pension funds' assets have fallen by $370 billion, or about 14%. Public pension funds increasingly are seeking redress in court to recover their losses and deter future wrongdoing. Recently, U.S. District Judge Denise L. Cote in the Southern District of New York appointed the New York State Common Retirement Fund, which has assets of $112 billion, as the lead plaintiff over part of the class-action suit against Worldcom, noting that the Fund had suffered a "massive loss," estimated at $306 million, and therefore had an "extraordinary stake in the litigation." *Washington Post, July 2, 2002; Dow Jones Newswires, August 12, 2002.*

Did Merrill Lynch & Co., Citigroup and J.P. Morgan Chase Help Enron Cook Books? Recent regulatory probes into the Enron collapse revealed shocking evidence that top Wall Street firms, including Citigroup's investment banking unit, Salomon Smith Barney, J.P. Morgan Chase and Merrill Lynch & Co., may have helped Enron to inflate revenues and hide debt. Henry McVey, a Morgan Stanley analyst, estimates that the firms may pay as much as $6 billion this year to settle the legal claims relating to their "Enron connection." *Bloomberg, August 7, 2002.*

New York and North Carolina State Pension Funds Tell Wall Street To Reform Or Else. New York State Comptroller Carl McCall and North Carolina Treasurer Richard Moore, the sole trustees of their states' pension funds with combined assets of almost $200 billion, are considering a proposal that would require the brokerage firms they do business with to adopt changes in stock-research practices along the lines of the policy changes that were recently implemented by Merrill Lynch & Co. as part of its settlement with New York State Attorney General Eliot Spitzer. The changes include improvement of disclosure to investors of potential conflicts of interest between securities analysts and investment banking units; eliminating the direct tie between analysts' compensation and investment banking business, and the monitoring of analysts' activities. *The Wall Street Journal, June 7, 2002.*

The SEC Requires Executives To Attest to The Accuracy of Financial Results. In late June, the SEC ordered the top executive and finance officers of 947 public corporations with at least $1.2 billion in annual revenue to swear under oath that their financial reports are accurate. For 691 of these companies, the deadline for submitting the sworn statements passed on August 14, 2002. On August 20, 2002, the SEC announced that out of these 691 companies, only 16 failed to certify to the accuracy and completeness of their reports and instead filed explanations or other forms of certification, and only one company failed to file the certification or obtain an extension. *The New York Times, August 7, 2002 and the SEC Press Release, August 20, 2002.*

Senior Executives At The Most Troubled Companies Cashed In on Their Options. Fortune Magazine recently examined insiders' stock sales at companies that had a market cap of at least $400 million in 1999 and whose stock has fallen by at least 75%. The findings were astounding. Executives and directors of the 1,035 corporations sold approximately $66 billion worth of their companies' stock. Of that amount, a total haul of $23 billion went to 466 insiders at 25 corporations, who now comprise Fortune's "Greedy Bunch" list. According to Fortune, the enormous insider selling resulted in pure profit to the executives because they acquired the bulk of their shares through options awarded at very low prices. Philip Anschutz, a chairman of downtrodden Qwest Communications, reaped $1.57 billion. John Moores, the chairman of deeply-troubled Peregrine Systems, cashed in $646 million from stock sales before the company was forced to disclose that its revenues were overstated. *Fortune, September 2, 2002.*

Crisis of Confidence. Recent polls show that public faith in the integrity of our markets is waning. Fifty-seven percent of Americans say they don't trust corporate executives or brokerage firms to give them honest information. One third of respondents believe that what happened at Enron is typical of what goes on at most or many companies, and only one third believe that recommendations from financial advisers are "primarily motivated" by a desire to help their clients make money. *The Wall Street Journal, June 13, 2002.*

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usually depend on management to recommend the independent auditor and changes in the auditor. The auditor learns to take its guidance from management, not from the audit committee. Congress and the SEC has provided power to the audit committee; now, it can help empower the audit committee by having the audit committee report on its independent search to find the replacement and its independent contacts with the auditor after engagement.

Consulting Conflicts

Management typically views audits as adding no value, purchased merely because regulation requires them. Hence, management typically wants the most cost-effective job it can get to satisfy the regulations. This doesn't mean the cheapest audit. Capital markets will guide a company in the S&P 500 not to hire me to do its audit, but to hire one of the Big Four, because the resulting savings in the cost of funds more than offsets the higher invoice cost. Once that firm decides it needs a Big Four auditor, its Chief Financial Officer will prefer to spend less, not more, for the service. The audit committee worries less about reducing the audit bill.

The audit committee could say, "We're going to pay top dollar for a high quality audit." To the auditor it could say, "Make a decent profit on the audit; don't count on consulting fees to make up for thin margins on the audit." This will drive up the cost of both the audit and the consulting services, because the outside consultant will not have the head start in understanding the client's specifics that the auditor has. Management will not like this. The audit committee, charged to be concerned primarily with the audit, should be unconcerned about the higher cost of consulting fees. When did you last hear of an audit committee asking for a higher-priced audit? I think audit committees should ask what extra work they might get from the auditor for a 20-percent increase in fees and should consider such a purchase.

Does this require a regulation forbidding the auditor from consulting? No, we already have regulations empowering the audit committee to act, independent of management. Now, we need the audit committee to act.

In the current environment, it's heresy to suggest that we need not forbid auditors from also providing consulting services. Indeed, the new statute limits the ability of a firm to provide both auditing and consulting service. I suggest, however, that mandatory auditor rotation, with auditors chosen and beholden to the audit committee, will solve the conflict of interest problem. Forbidding the auditor from all consulting will not produce high quality audits nor deal with the problem of malleable GAAP.

While the new statute prohibits firms from providing audit services contemporaneously with many non-audit serves, the new statute also allows for limited exceptions to the prohibition on consulting. The statute would allow the audit firm to prepare tax returns, for example, if approved in advance by the audit committee. I, and others, see no need to waste resources by having firms different from the auditor do the tax return. Where to draw the line? Let's don't mandate one, but let the audit committee decide. I can imagine that the auditor will prefer shorter terms to longer because the sooner the audit is done, the sooner it can undertake consulting engagements.

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Whistleblowers. Section 806 creates a civil remedy for whistleblowers who suffer retaliation. The whistleblower protection is very broad, extending not only to employees who notify the authorities but also to those who "assist in a proceeding… relating to an alleged violation of" the securities laws. This thus applies to "assist[ing]" any securities fraud action brought against the company. Putting aside the ethical issue as to whether or when plaintiffs' counsel may contact employees during their pre-filing (or pre-amendment) investigation, this provision raises potential issues under standard-form Directors & Officers insurance policies (which often furnish an important source of funds for injured investors). The insured-vs.-insured exception in some D&O policies purports to preclude coverage if any past or present employee "assists" the plaintiff. Some carriers strain to read this exclusion very broadly, as covering mere responses by employees to telephone calls placed by plaintiffs' counsel or investigators. While companies are often loath to bar communications between employees and others (to avoid any appearance of obstruction), the Act appears to evince a public policy of fostering such communications. Will this public policy trump strained insurer attempts to limit coverage on the basis of often brief and innocuous factual conversations between employees (present or past) and those investigating possible wrongdoing?

Audit Committee Members as Target Defendants. Since enactment of the Private Securities Litigation Reform Act (PSLRA) in 1995, securities fraud plaintiffs have frequently aimed their lawsuits solely at the corporation and its most senior (and allegedly most involved) officers, commonly the CEO and the CFO. Outside directors have often not been sued, in light of the PSLRA's stringent pleading requirements. This practice will change. Both in securities and derivative litigation, Audit Committee members will become target defendants because of everything that the Act requires them to do. Under section 301 of the Act, for example, the Audit Committee is "directly responsible for the… oversight of the work of [the outside auditor]… for the purpose of preparing or issuing an audit report" (amending 15 U.S.C. §78f(m)(2)). The Audit Committee will also receive and must address signed reports from the CEO and CFO detailing "all significant deficiencies in the design or operation of internal controls" and "any fraud, *whether or not material*, that involves… employees who have a significant role in the issuer's internal controls" (§302(a)(5)). This latter provision may have the counterintuitive impact of rendering material what might otherwise be deemed immaterial, simply by virtue of its having been reported to the Audit Committee under so ambiguous a provision.

> ## Quarterly Quote
>
> *"Just as you need to prevent setting a fire to avoid getting burned, we need to prevent corporate abuse before investors get burned again."*
>
> — H. Carl McCall, State Comptroller for New York who manages the second largest state pension fund in the country, when announcing that investment banks will be asked to embrace the conflict-of-interest policies set forth in the agreement that New York State Attorney General Eliot Spitzer reached with Merrill Lynch.

As if to enhance any scienter or gross negligence allegations that a securities or derivative plaintiff must make, each Audit Committee must have "at least 1 member who is a financial expert," whose identity will be a matter of public disclosure under SEC rules to be promulgated within 180 days (§407(a)). The expertise required of this financial expert includes both "an understanding of generally accepted accounting principles" and experience in preparing or auditing financial statements (§407(b)(1)-(2)). Who better to (allegedly) know of, or recklessly disregard, accounting chicanery? Note a continuing theme of this legislation — the federalization of corporate governance matters historically determined by state law.

Attorneys as Defendants? Section 307 of the Act requires that, within 180 days, the SEC promulgate rules governing attorney conduct that may expose counsel, both in-house and outside, to third-party liability. There are several important aspects to these rules. First, they will relate to "a material violation of securities laws or breach of fiduciary duty or similar violation by the company or any agent thereof." Materiality judgments are among those most easily second-guessed, particularly in light of SEC pronouncements obscuring any objective measures. Judgments, moreover, will be judged *ex post*, after a bad outcome — an outcome that is by definition not known at the time any advice is rendered. This will counsel caution and extensive (or over-) reporting. Further, while the subject matter of securities and fiduciary violations is objectively ascertainable, just what is "a similar violation"?

Second, the SEC rules must mandate that a lawyer report any such "material violation," in the first instance, to the general counsel or CEO of the company. A potential pitfall here will be failing to report to the chief legal counsel of the company, as opposed to other in-house counsel. (Client sensibilities are not determinative when personal liability of counsel is on the line.)

Third, "if the [general] counsel or [CEO] does not appropriately respond to the evidence" presented by the lawyer, the lawyer must report the evidence to the Audit Committee or another committee of independent directors, or to the board as a whole. Failure to follow these requirements may be deemed to give rise to an inference of scienter on the part of counsel, or may later be held to constitute aiding and abetting a breach

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of fiduciary duty (or "a similar violation"). Companies would be well-advised to set up a mechanism to process and receive these reports.

A corollary of extensive (or over-) reporting is extensive knowledge on the part of the recipients of the reports. This may expose to liability — or, at least, litigation — those independent directors who receive reports concerning matters that ultimately materialize in disaster.

Intentional, Knowing & Reckless. The Supreme Court has never decided whether recklessness is sufficient to sustain liability under 10(b) of the Securities Exchange Act or SEC Rule section 10b-5, although every Circuit holds that it is. The Act does not purport to address this issue directly, but there are some passages that are potentially pertinent — namely, section 105(c) (dealing with sanctions to be visited on errant accountants by the new Public Company Accounting Oversight Board) and section 602 (which defines "improper professional conduct" before the SEC). Both of these provisions use the phrase, "intentional or knowing conduct, including reckless conduct" to describe sanctionable behavior. The appositional inclusion of "reckless" appears to be descriptive of the phrase "intentional or knowing," and not an expansion of. At least, the use of the word "including" would certainly suggest that.

Scienter & Malpractice. Much of the Act is devoted to the formation and operation of the new Public Company Accounting Oversight Board and creation of new corporate governance and reporting obligations. A number of these will translate into benchmarks against which scienter and neglect of duty can be measured or alleged. For example, under section 101(c), the Board will "establish or adopt…auditing, quality control, ethics, independence, and other standards." Under sections 104 and 105, the Board will also conduct both inspections of accounting firms and investigations into misconduct. Further, under section 406, the SEC will issue rules requiring disclosure of each issuer's "code of ethics for senior financial officers," with "ethics" being defined to include "full, fair, accurate, timely, and understandable disclosure…."

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"Real-Time" Disclosure Duty. In SAB 99 (Aug. 13, 1999), the SEC broadly defined the notion of materiality. The Act adds a timing component to this notion. Section 409 of the Act amends 15 U.S.C. section 78m(l) to require "disclos[ure] to the public *on a rapid and current basis*" of "material changes in the financial condition or operations of the issuer, in plain English…." This is clearly intended to accelerate reporting obligations. It is unclear how much faster "real-time" disclosure need be, but the courts and the SEC will doubtless fill in the blanks.

Discovery. The Act mandates that accounting firms maintain for seven years "audit work papers, and other information… in sufficient detail to support the conclusions reached" (§103(a)(2)). This obligation applies to foreign accounting firms (usually Big Four affiliates) that issue audit opinions for U.S. issuers and, if the Board so determines, will also apply to those foreign entities that are significantly involved in the audit, even if they do not sign the audit opinion (§106). For the first five years of this seven-year period, not just " sufficient" but "*all* audit or review papers" must be maintained, to avoid commission of a felony (§802).

What the Act Did Not Do. As important as the changes wrought by the Act are, those that one might have anticipated were *not* made. Among the things that Congress did not change: The PSLRA bar against pleading securities fraud as a RICO predicate act remains intact (18 U.S.C. §1964(c)). The Supreme Court's abolition of aider-and-abetter liability for securities fraud was not touched (*Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994)). And the PSLRA's introduction of proportionate liability for miscreants adjudged only reckless — a gift to the accounting industry — was not modified.

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