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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.

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.

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

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COMMITTEE ON CAPITAL MARKETS REGULATION

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(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 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

Inside Look

This quarter, the *Advocate* focuses on the most pressing issue imaginable to investors seeking to recoup losses due to securities fraud: the newly formed and supposedly independent Committee on Capital Markets Regulation.

In "The Committee On Capital Markets Regulation — A Wolf In Sheep's Clothing?," firm partner Blair Nicholas and firm associate Niki Mendoza challenge the purported independence of the newly created and self-proclaimed "Committee on Capital Markets Regulation." As Blair and Niki explain, this new committee is trumpeted as an "independent, non-partisan" committee formed to study capital markets regulation and the competitiveness of the U.S. public capital markets. However, before even getting off the ground, the committee is expected to make recommendations to regulators and lawmakers for less regulation of public corporations, restricted liability of auditors and others, and severe restraints on investors' abilities to recover losses caused by securities fraud. Perhaps it is because this "independent" committee includes no current or former members of the SEC, no institutional investors or other fiduciaries, and no representatives of the securities litigation plaintiffs' bar. Clearly, given the recent and continuing wave of corporate fraud, now is not the time for less regulation of the securities markets, and now is not the time to roll back the critical protections provided by state and federal securities laws.

Max Berger

I also direct your attention to the regular "Eye on the Issues" column. This quarter, Benjamin Galdston has again provided a perceptive compilation of the most significant developments in the areas of securities and corporate governance for your quick perusal.

On October 5 and 6, 2006, we hosted our 12th Institutional Investor Forum in New York City. We had a record number of attendees from all over the globe and would like to again thank everyone who attended. We are told that the attendees found the Forum to be informative and enjoyable. If you would like to attend our next Forum on October 11th and 12th, 2007, please contact us. Remember, space is limited so it is best to register early.

We hope that you will enjoy this issue of the *Advocate*. As always, we strive to make it worth reading and we welcome the comments, questions and input we receive from our readers. On behalf of everyone at BLB&G, we wish you and your families all the joys of the holiday season and a happy and healthy New Year.

Max W. Berger

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.

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

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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

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Eye on the Issues

LEGISLATIVE/REGULATORY UPDATES AND RECENT DECISIONS OF INTEREST

By Benjamin Galdston

Court Ruling Favors Shareholder Proxy Access. In a decision that should pave the way for increased shareholder access to the proxy process, the Second Circuit Court of Appeals recently reversed a 2005 decision denying the American Federation of State, County & Municipal Employees ("AFSCME") access to American International Group's ("AIG") proxy statement. The case arose from an AFSCME proposal that would have amended AIG's bylaws to require the company, under certain circumstances, to publish the names of shareholder-nominated director candidates together with any candidates nominated by AIG's board. AIG opposed the proposal and excluded it from its proxy. AFSCME sued in federal court. The dispute turned on SEC Rule 14a-8(i)(8), also known as the "town meeting rule." Under the Rule, if a shareholder seeking to submit a proposal meets certain eligibility and procedural requirements, the corporation must include the proposal in its proxy statement unless it can prove to the SEC that an exclusion applies. One such exclusion concerns proposals that "relate to an election for membership on the company's board of directors or analogous governing body." AIG interpreted the phrase "an election" to mean proposals that concern any election, while AFSCME believed the rule targets proposals that concern a particular seat in a particular election. The Second Circuit agreed with AFSCME, overturned the district court's decision and remanded the case for entry of judgment in favor of AFSCME. *The New York Times, Oct. 1, 2006.*

Amaranth Hedge Fund Implodes Under $6 Billion Loss. In September, Connecticut-based hedge fund Amaranth Advisors LLC lost over $6 billion on high-risk natural-gas bets made by a "star" energy trader. The loss wiped out approximately two-thirds of the fund's value and is the biggest loss since the collapse of Long-Term Capital Management in 1998. Amaranth was warned only a month earlier by the New York Mercantile Exchange that it was holding too many natural-gas contracts. Amaranth has since sold its entire energy-trading portfolio at a loss. The debacle comes just months after a federal appeals court invalidated a new rule designed to better regulate hedge funds by requiring them to register with the SEC and open their books to periodic SEC inspections. *Bloomberg, Sept. 27, 2006; Associated Press, Sept. 28, 2006.*

Study Finds Boards Asserting Better Control Over CEO Pay. A joint study by the World Bank and Cornell University finds that the Sarbanes-Oxley Act of 2002 and new regulations adopted by the major exchanges have significantly improved Board oversight in monitoring management and reigned in CEO compensation, primarily in the grants of incentive stock options. The rules change the director nomination process to ensure more independent directors and require director independence on the compensation and audit committees. The study focused on 940 public U.S. companies and found that those companies that made the most extensive changes to their boards after the new rules came into effect also significantly decreased CEO compensation by as much as 25%. *"CEO Compensation And Board Oversight" by Vidhi Chhaochharia and Yaniv Grinstein, May 2006.*

HP Chairwoman Charged In Cloak-And-Dagger Investigation. California's attorney general filed criminal charges against former Hewlett Packard Board Chairwoman Patricia Dunn and four others involved in the corporate spying scandal at the computer and printer company. The criminal complaints charge Dunn, former HP chief ethics officer Kevin Hunsacker and three investigators with felony charges of using false or fraudulent pretenses to obtain confidential information from a public utility, unauthorized access to computer data, identity theft, and conspiracy. HP's CEO and current Board Chairman Mark Hurd and former HP general counsel Ann Baskins avoided indictment. The investigation at HP purportedly was intended to ferret out a Board member who was believed to be leaking company information to the press. News of the HP scandal first broke in September with revelations that investigators used "pretexting" and impersonation tactics to obtain Board members' phone records and other personal information. Meanwhile, three major public pension funds that collectively own more than 30 million HP shares have filed a proposal seeking access to the HP proxy. The funds, which include the New York State Common Retirement Fund, seek better access to nominate at least one candidate for the HP Board. *Associated Press, Sept. 28, 2006; The New York Times, Oct. 1, 2006; Yahoo Finance, Oct. 4, 2006.*

SEC Issues Guidance On Stock Options Practices. The SEC's chief accountant has issued a letter clarifying the SEC staff's views on the proper accounting treatment for stock option grants in historical financial statements of public companies. The guidance is intended to help differentiate between companies that granted stock options in good faith in accordance with the provisions of their applicable stock option plans and those that violated rules to artificially inflate the value of the options. The guidance comes amidst increasing litigation and criminal investigations over allegations that many U.S. companies manipulated the dates of option grants for key executives and board members to coincide with particularly favorable stock prices. While the SEC letter spells out several scenarios that constitute improper practices, the guidance also addresses many of the explanations that have been offered to explain apparently improper backdating, such as administrative delays, lost or incomplete documentation and other innocent mistakes. *Associated Press, Sept. 19, 2006.*

Apple CEO Publicly Apologizes For Back-Dating Stock Option Grants. A three-month internal investigation at computer-maker Apple, Inc. revealed that the company back-dated at least 15 stock option grants to more favorable dates and that Apple CEO Steve Jobs was aware of the practice "in a few instances." In a rare public apology, Jobs acknowledged the incidents, but claimed he did not personally benefit from the grants and was not aware of the accounting implications. Apple, which makes the popular iPod MP3 player, also announced the resignation of its former Chief Financial Officer Fred Anderson from its board of directors. Apple will have to restate its historic earnings as a result and expects to reduce some of the $3.1 billion profits generated during the company's most profitable period. *Associated Press, Oct. 4, 2006.*

New Studies Show White Collar Prosecutions And Securities Class Action Filings Down. Two recent studies report that government prosecutions of white-collar crime and private actions seeking enforcement of the federal securities laws have both declined over the first half of 2006. Commentators cite the shift in government priorities from prosecuting white collar crime to homeland security issues and the impact of new legislation, such as the Sarbanes-Oxley Act of 2002. The Justice Department's Office of the Inspector General released statistics showing that prosecutions for white-collar crimes including financial fraud are down 28 percent from five years ago. The number of private securities fraud class actions also dropped during the first half of 2006, falling 45 percent from the number of filings during the first half of 2005. The magnitude of the fraud cases also declined. Total market capitalization losses associated with filings in the first half of 2006 declined 44 percent as compared to the first half of 2005. *Christian Science Monitor, Aug. 31, 2006; Cornerstone Research: 2006 Mid-Year Assessment.*

Fannie Mae and Freddie Mac Avoid Criminal Charges. The U.S. Justice Department has announced that it will not seek criminal charges against either Fannie Mae or Freddie Mac in connection with the accounting improprieties that rocked the two mortgage finance giants. Fannie Mae, the government-sponsored mortgage lender which helps finance one of every five home loans in the United States, has admitted that its earnings were overstated by $11 billion between 1998 and 2004. In May, the company agreed to settle an SEC civil enforcement action and pay a $400 million penalty. Separately, Freddie Mac disclosed in June 2003 that it had misstated earnings by over $5 billion — mostly underreported — between 2000 and 2002. Congress created Freddie Mac and Fannie Mae to infuse capital into the home mortgage market by buying and securitizing home loans from banks and other lenders, to keep interest rates low and make home ownership affordable for more Americans. *The Wall Street Journal, Aug. 24, 2006; Associated Press, Sept. 12, 2006.*

Quarterly Quote...

"Powerful people have studies that prove their points, and then they lobby Congress, federal regulators and state legislatures to get what they want...**But is it really right for prominent American executives,** amid a host of scandals involving other executives looting their shareholders blind, **to have the best and the brightest of academe and the Street lobbying for less accountability to shareholders?"**

Ben Stein, columnist, discussing the new Committee on Capital Markets Regulation (*The New York Times,* October 30, 2006)

Former NYSE Chief Could Be Forced To Repay Up To $100 Million. Richard Grasso, the former President and Chairman of the Board of the New York Stock Exchange, suffered a huge set-back in litigation over the controversial $187.5 million retirement package he received when he resigned from the not-for-profit Exchange in 2003. On October 18, 2006, a New York State Judge ruled that Grasso must disgorge up to $100 million in payments and interest that he improperly received from executive savings and retirement plans. Grasso began his career with the Exchange in 1968 and served as CEO and Chairman from 1995 until 2003, when he was asked to resign amidst controversy. In August 2003, Grasso and the Exchange inked a new employment contract that would extend his term as Chairman and CEO to 2007 and provided for a lump sum payment of $139.5 million and $48 million in future payments. When the terms of the agreement became public one month before his departure, institutional investors, the SEC and other public officials called for Grasso's resignation, questioning the effectiveness of the not-for-profit board and its oversight of executive compensation. *The Wall Street Journal, October 21-22, 2006.*

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The Corporate End Run

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Corporate profits are at record levels. The Dow, too, has climbed past its high-water mark from the dot-com era. Executives reap bigger and bigger paydays, even as wages have stagnated. Meanwhile, the widening investigation into stock-option backdating reminds us that the corporate malfeasance era was much more than just a couple of bad apples like Enron and WorldCom.

It seems almost unbelievable, then, that corporate America would pick this moment to beg for relaxed regulation and enforcement, as well as more protection from investors' lawsuits. But as Stephen Labaton reported recently in *The Times*, industry groups are seeking broad new protections for corporations and accounting firms, not through legislation but from the Bush administration through agency rule changes.

The rationale is that the high cost of complying with the corporate governance law, the Sarbanes-Oxley Act, along with runaway lawsuits have scared foreign companies away from American stock exchanges. The timing is particularly odd given that the compliance costs associated with the much-reviled Section 404 of Sarbanes-Oxley — which requires audits of companies' internal financial controls — fell last year, as did the number of investor lawsuits, for the second year in a row.

What has actually happened is that opponents of regulation believe that the coast is clear. The law's namesakes, Paul Sarbanes and Michael Oxley, are retiring. Kenneth Lay of Enron is dead. The time appears ripe for rollbacks.

It seems almost unbelievable... that corporate America would pick this moment to beg for relaxed regulation and enforcement, as well as more protection from investors' lawsuits.

Advocates of big business like to point to a sharp decline in the United States' share of global initial stock offerings between 2000 and 2005, hoping that everyone will infer that the cause was the passage of Sarbanes-Oxley in 2002. In fact, that share had been declining since 1996, even before the Asian financial crisis. It hit bottom in 2001 and has risen since.

United States markets lost their dominance of initial stock offerings for numerous reasons that had little to do with regulation. Some of last year's biggest deals were Chinese and French privatizations. Markets elsewhere are bigger and more liquid than they once were. There are also intangibles, such as America's recent unpopularity, increased barriers for visa seekers and extraordinary budget and trade deficits, which might make an issuer think twice about a dollar-denominated stock.

The London Stock Exchange, one of the leading beneficiaries of the American decline, commissioned a study showing that underwriting fees in London are just 3 percent to 4 percent of a transaction, compared with an average of 6.5 percent to 7 percent in the United States.

When workers confront globalization, they are told to adapt, take their pink slips and go to night school. It is the harsh downside of an integrated world economy that has on balance significantly enriched the country. When financiers feel the pinch from competition in Hong Kong and London, they run to the Bush administration for rule changes.

America's investor protections and corporate regulations have made it a nation of share owners, with almost 57 million American households owning stocks either directly or through mutual funds. The Securities and Exchange Commission has already signaled that it will smooth the implementation of Sarbanes-Oxley, especially for smaller companies. And abuses of the private litigation system like pay-to-play should be stopped. There is room for reform. But over all, the system is working. It may need tweaks, but it does not need a revamping.

By The Numbers...

Over $1 trillion:
Market capitalization lost to securites fraud since 1995.

Over 80 percent:
Percentage of publicly traded companies owned by institutional investors.

0:
Number of institutional investors on 20-member "independent" Committee on Capital Markets Regulation.

COMMITTEE ON CAPITAL MARKETS REGULATION

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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, auditor 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 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

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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 formulate 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!

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Bernstein Litowitz Berger & Grossmann LLP wishes you and your families a happy, healthy and peaceful 2007.

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