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The Battle Lines Are Drawn

Investors Square Off Against Corporate America and Its Beltway Allies

In this *Advocate*, we dedicate our entire issue to critical developments taking place in Congress and the courts that will have a profound impact on investor protections. Without a doubt, 2007 is shaping up to be a watershed year for investors in public companies.

On the one hand, anti-investor groups emphasize rolling back the investor protections obtained in the aftermath of *WorldCom* and *Enron*. These groups have conjured up a supposed "litigation crisis" in an attempt to relax corporate governance reforms and limit shareholder rights. This myth is examined in "As the Worm Turns: The Organized Effort to Insulate Corporate America from Public Accountability."

On the other hand, pro-investor advocacy groups are fighting both to defend and expand essential shareholder protections. "David vs. Goliath: The Struggle to Keep America's Capital Markets Fair and Transparent" takes a look at what's being done to protect and improve shareholder rights.

Where does the Securities and Exchange Commission come out in this debate? As explained in "The SEC: Friend or Foe?," under the direction of Chairman Christopher Cox, the SEC is taking conflicting positions in key securities cases. The SEC's increasingly laissez-faire policies appear to be only emboldening anti-investor groups to push forward with their agenda.

Most recently, in *Tellabs, Inc. v. Makor Issues & Rights Ltd.,* the Supreme Court weighed in on this debate. "A Balanced Decision in *Tellabs:* The Supreme Court Sets the Pleading Standard for Securities Fraud" analyzes the Supreme Court's decision and its impact on investors.

We hope that you find this issue of the *Advocate* to be informative. We welcome the comments, questions and input we receive from our readers.

Max W. Berger

As The Worm Turns: *The Organized Campaign To Insulate Corporate America and Investor Watchdogs From Accountability*

By Niki Mendoza and Takeo Kellar

Recently, several powerful corporate interest groups have stepped up efforts to roll-back investor rights under the guise of enhancing the competitiveness of the U.S. capital markets. These groups — including the U.S. Chamber of Commerce and the Committee on Capital Markets Regulation — claim that our capital markets have become uncompetitive compared to foreign counterparts because of increasingly restrictive legislation and the accompanying costs of compliance. The groups point out that the U.S. market share of global IPOs has declined while the number of "going private" transactions has increased since passage of the Sarbanes-Oxley Act in 2002. The groups argue that these trends are due to "overregulation, frivolous litigation, and incompatible accounting standards." Acknowledging that globalization is inevitable, they, therefore, argue that in order to remain competitive in the world market, the United States must take affirmative steps through legislation and court action to limit private securities litigation and reduce standards of corporate accountability. The most vocal of these groups have each commissioned reports to publicize their findings and recommendations.

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The Paulson Committee's "Concerns About The Competitiveness Of U.S. Capital Markets"

The Paulson Committee is perhaps the most prominent public face on the effort to diminish investor protections and corporate accountability in our capital markets. While claiming its membership consists of "23 leaders from the investor community, business, finance, law, accounting, and academia," the Paulson Committee is comprised almost exclusively of representatives of investment banks, auditors, and corporate issuers — the very entities most likely to benefit from the Committee's proposed anti-investor measures. The Committee deliberately excluded any former market regulators from its executive membership because, as the Committee's Co-Chair explained, "[t]hey may have a lack of objectivity." Also, without any apology or explanation, the Committee failed to include a single representative from even one public pension fund or other institutional investor — a startling exclusion considering that institutional investors own an estimated 75% of all publicly-traded companies. Further, as revealed in the *Washington Post,* funding for the Committee's work was provided in large part by the C.V. Starr Foundation, a charity with "longstanding ties to Maurice R. Greenberg" — the former chairman of AIG, who was embroiled in a massive securities fraud.

The Paulson Committee released its interim report on November 30, 2006, setting forth some 32 recommendations that it claimed would serve the twin goals of reducing overly burdensome regulation and litigation while enhancing shareholder rights. While serving up platitudes like "[a]s shareholders are able to take more control over companies in which they are stakeholders, regulation can be more targeted," the Committee provides little insight into how such goals can be realistically attained. However, the Committee does provide very clear recommendations on how public policy and regulations can be relaxed to benefit American businesses at the expense of shareholders. The Committee recommendations include: (i) scaling back provisions of the

The Corporate America Lobby

The Committee on Capital Markets Regulation	**Interim Report** November 2006	The Committee is also known as the "Paulson Committee" due to its close association with Treasury Secretary Henry Paulson.
McKinsey & Company, a private management consulting firm	*"Sustaining New York's and the U.S.' Global Financial Services Leadership"*	Commissioned by New York City Mayor Michael Bloomberg and Senator Charles Schumer (D. NY).
The U.S. Chamber of Commerce	*"Commission on the Regulation of U.S. Capital Markets in the 21st Century"* March 2007	The stated mission of the U.S. Chamber of Commerce is to "fight for business and free enterprise." The Chamber maintains a professional staff of more than 300 policy experts, lobbyists, lawyers, and communicators.

Sarbanes-Oxley Act of 2002 that were designed to improve internal controls; (ii) imposing affirmative limits on the ability of state Attorneys General to prosecute corporate malfeasance; and (iii) quashing shareholder litigation by imposing liability caps for auditors, more lenient standards for outside directors, "clarification" of several elements of securities fraud to favor corporate defendants, and the possibility of requiring arbitration in securities litigation.

McKinsey & Co. — Can a Private Consulting Firm Provide Unbiased Research?

The McKinsey Report was commissioned jointly by Sen. Charles Schumer (D. NY) and New York Mayor Michael Bloomberg because, they claim, New York is in danger of losing its status as the world's top financial center within ten years if the U.S. government does not undertake "a major shift in regulation and policy." The Report claims to be based on interviews with "more than 50 financial services industry CEOs and business leaders," as well as a survey of "more than 30 other leading financial services CEOs" and "275 additional global financial services senior executives." The McKinsey Report concludes that the New York financial markets have been "stifled by stringent regulations and high litigation risks" — not surprising given that McKinsey caters to large petroleum, pharmaceutical and chemical companies, and espouses the motto "we believe we will be successful if our clients are successful."

Like the Paulson Report, the McKinsey Report recommends imposing significant limitations on the ability of shareholders to pursue private securities litigation as a mechanism to restore "competitiveness" in the U.S. capital markets. The McKinsey Report parrots the Paulson Committee by endorsing a number of reforms that, taken together, would gut private securities litigation. Recommendations include: (i) closing the courthouse doors to securities lawsuits by forcing arbitration proceedings; (ii) limiting the liability of foreign companies with U.S. listings to damages proportional to their degree of exposure to United States' markets; (iii) allowing interlocutory appeals of non-final orders; and (iv) placing a "cap" on the damages recoverable against an auditor even if a jury finds that the auditor is liable for securities fraud.

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The U.S. Chamber of Commerce

The U.S. Chamber of Commerce's "Commission on the Regulation of the U.S. Capital Markets in the 21st Century" was launched in February 2006 "to evaluate the current legal and regulatory framework of the U.S. capital markets and to recommend changes designed to ensure the health of these markets through the 21st century." The Commission is co-chaired by Arthur Culvahouse, chairman of the O'Melveny & Myers law firm, former White House counsel to the Reagan administration and a current member of President Bush's Foreign Intelligence Advisory Board, and William Daley, Vice Chairman of JPMorgan Chase and Commerce Secretary in the Clinton administration.

On March 12, 2007, the U.S. Chamber of Commerce released the Report and Recommendations of its Commission on the Regulation of the U.S. Capital Markets in the 21st Century. Echoing much said in the Paulson Report and the McKinsey Report, the recommendations cover such topics as reformation of the government's regulatory approach to financial markets and market participants, Sarbanes-Oxley, limitations on auditor liability, and changes to shareholder litigation.

Those Who Do Not Learn From the Past Are Destined to Repeat it

Recognizing that Congress is unlikely to significantly curtail private securities litigation, all three Reports propose numerous reforms that the SEC — through its Chairman Christopher Cox — could enact unilaterally, by means of rule and policy changes. Corporate America has a loyal friend in Mr. Cox, a former venture capital lawyer. Cox also spent 17 years as a Republican congressman, during which time he authored the Private Securities Litigation Reform Act of 1995 ("PSLRA") which imposed heightened pleading standards on claims brought under the federal securities laws.

Some of the more controversial proposals that could potentially be adopted unilaterally by the SEC include the following:

- Require mandatory arbitration in shareholder class actions;
- Eliminate or reduce liability of outside directors and auditors;
- Reduce or abolish the effectiveness of the Sarbanes-Oxley Act of 2002; and
- Allow public companies to disregard U.S. accounting rules and instead be guided by general principles.

Echoing sentiments that presaged passage of the PSLRA, the Committees claim to be working toward eliminating "frivolous" shareholder lawsuits. The Paulson Report criticizes private securities litigation as a wasteful circular transfer of wealth from one group of innocent shareholders (the current shareholders) to another (the shareholders at the time of the fraud). The Committees also note that the average settlement size paid by

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U.S. public companies in 2005 was higher than in years past. The Paulson Report surmises that, "[a]s average settlement values climb, so too do the incentives for companies to try to evade private litigation under the U.S. securities laws by simply choosing to sell their shares elsewhere." The SEC itself has recently reversed its traditional position that private securities fraud class actions are "a necessary supplement to the Commission's efforts," and instead, has sided with anti-investor interests. For example, in the recent Supreme Court case of *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, the SEC's *amicus* brief advanced an extremely narrow interpretation of the securities laws. For a discussion regarding other anti-investor actions recently taken by the SEC under the stewardship of Chairman Cox, see "The SEC: Friend or Foe" on page 11.

Although they do not expressly recommend abolishing the private right of action, as their early press releases and public comments had led some to expect, the Committees do recommend several measures that, in effect, would do away with class-action suits and replace them with arbitration, or would otherwise severely limit liability of companies and their directors and auditors. For example, hidden in the innocuously-named "Shareholder Rights" section of the Paulson Report, the Paulson Committee recommends closing the courthouse doors to securities lawsuits by allowing companies to unilaterally force arbitration proceedings, with or without allowing for class actions. The Paulson Committee argues that this proposal — a proposal the Paulson Committee claims presently is being considered by the SEC — will reduce the high costs of litigation. The Paulson Committee explains: "The Commission should not force shareholders to accept the costs that go with class action securities litigation, particularly the substantial and unpredictable risk of large jury verdicts that effectively force settlement of what may well be non-meritorious claims, where those shareholders choose to forgo these rights."

The Committee also proposes limitations on what it refers to as "gatekeeper litigation," i.e., litigation against directors and auditors. The Committee explains its rationale thusly: "Gatekeepers such as auditors and directors play critical roles in monitoring corporate management on behalf of shareholders. Significant increases in potential liability

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for these gatekeepers in recent years can induce risk aversion behavior not in shareholders' long-term interests and possibly reduce the supply of willing and competent professionals to perform these tasks." According to the Committee's logic, unless something is done to insulate directors and auditors from liability, no one will want to serve. The Committee also recommends that the SEC revise its rules to clarify that outside directors may avoid liability under Section 11 for false statements made in a company's initial public offering by showing that they relied in good faith on the company's audited financial statements or an auditor's "comfort" letter. To further protect outside directors, the Committee urges the SEC to reverse its longstanding position and permit the indemnification of directors from damages awarded in Section 11 actions.

The Committees further seek to protect audit firms against "catastrophic loss," citing the liquidation of the auditing firm of Arthur Andersen, and complaining that investors repeatedly look to auditors to recoup their stock-market losses. Committee member William G. Parrett — also chief executive at Deloitte Touche Tohmatsu, the international arm of Deloitte & Touche — explained: "The cost of our audits was never built for insuring the capital markets... I don't think we're saying we shouldn't have any liability, but it has to be in proportion to our participation in any problem." Audit firms also complain that they can't get sufficient insurance because their liability is almost unlimited, encompassing (in a worst-case scenario) the total stock-market value of the companies they audit. So they are forced to settle lawsuits rather than risk a trial. To protect auditors from "catastrophic" threats, the Committee suggests legislation ensuring liability caps — as is the case in some European countries.

The Committees also seek to demonize the Sarbanes-Oxley Act of 2002 ("SOX") by attributing the upsurge in going-private transactions and a perceived exodus from U.S. capital markets to a perception that SOX compliance is unduly costly. Putting aside that most studies confirm that SOX compliance has been ***not*** proven to be unreasonably costly, the Committees argue that the costs to businesses of complying with Section 404 of SOX — which requires companies to adopt financial reporting controls, submit to outside auditors and report annually on the effectiveness of those controls — are too high, thus encouraging companies to flock to foreign stock exchanges. Pro-business commentators proclaim a "worrisome trend of corporate leaders focusing inordinate time on compliance minutiae rather than innovative strategies for growth,

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David vs. Goliath:

The Struggle to Keep America's Capital Markets Fair and Transparent

By Katherine McCracken Sinderson

In the wake of the largest corporate crime wave in history, shareholders achieved much-needed additional protections through the increased accountability standards contained in the Sarbanes-Oxley Act of 2002 ("SOX"). Today, however, a mere five years after WorldCom and other scandals wiped out the savings of millions of unsuspecting investors, several high profile business advocacy groups have called for scaling back these protections — generally under the guise of enhancing the "competitiveness" of U.S. capital markets. Aware of the critical importance of shareholder protections and fearful of what could occur in their absence, shareholder advocacy groups have risen to the occasion to respond to corporate America and defend their existing rights.

Ironically, at the same time that corporate America is trying to diminish shareholder rights, corporate abuses such as the options backdating scandal and the meltdown of the subprime mortgage sector have continued unfettered. These abuses have allowed shareholders to gain a foothold and successfully institute significant changes at a few companies. Such successes give hope that these gains might be extended to more firms' governance practices and that existing protections will be preserved. As the future of shareholder rights plays out, investors stand at a crossroads: will they retain the right to hold management accountable though legal action and continue to make strides in corporate governance, or will the anti-investor community succeed in eroding the long-standing right to take legal action when defrauded?

As the future of shareholder rights plays out, investors stand at a crossroads: will they retain the right to hold management accountable though legal action and continue to make strides in corporate governance, or will the anti-investor community succeed in eroding the long-standing right of shareholders to take legal action when defrauded?

Defending Shareholder Rights

Sadly, just defending their established rights has become a full-time job for investors these days. Despite record-breaking profits on Wall Street in 2006, corporate America now contends that the U.S. markets are somehow structurally flawed and significantly less competitive than markets abroad. This notion has sparked the creation of a "Committee on Capital Markets Regulation," a Report titled "Sustaining the U.S.'s Global Financial Services Leadership" published by McKinsey & Company and, most recently, a U.S. Chamber of Commerce study entitled "The Commission on the Regulation of U.S. Capital Markets in the 21st Century" (collectively referred to as the "Reports"). According to these Reports, onerous governmental regulations and securities litigation are hurting the ability of American markets to attract new listings. In making these claims, however, these Reports conveniently distort the facts and fail to mention the healthy, thriving state of the American markets. To prevent the deregulation and lack of accountability sought by corporate America, investor advocacy groups are now uniting to respond and debunk the biased assumptions and startling omissions that form the basis for these well-funded anti-investor recommendations.

In a letter sent to House and Senate leadership, a consortium of consumer rights advocacy groups, including Consumer Action, Consumer Federation of America, Consumers Union, and U.S. PIRG, Federation of State PIRGs (the "Consumer Group"—see chart on page 7) joined together to attempt to "set the record straight." The Consumer Group informed the legislators that rather than losing out to the global markets, as anti-regulatory forces claim, U.S. securities markets are thriving—"not despite, but because of, the world class investor protections they offer." For example, contrary to the Reports' claims, the number of U.S. IPOs has risen significantly since the passage of the Sarbanes-Oxley Act. Similarly, the number of foreign companies listing in U.S. markets and the amount of money foreign companies raised in the U.S. has also increased dramatically. Indeed, foreign companies accounted for almost 20% of the IPOs conducted in the U.S. last year. Notwithstanding this documented growth, proponents of deregulation claim that the U.S. share of the world IPO market declined relative to that of the United Kingdom. The Consumer Group refuted this claim by highlighting that this apparent imbalance is largely due to new listings on the London Alternative Investment Market, a market created specifically for small companies that likely cannot meet the requirements to list in the U.S.

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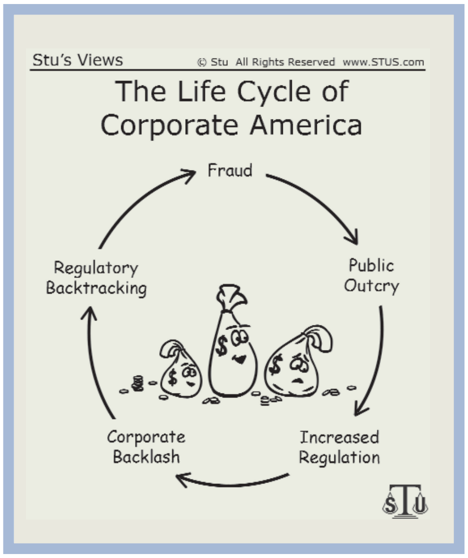
The Consumer Group also soundly dispelled the alarmist fears concerning auditor liability. This concern, the Consumer Group argued, ignores the fact that the number of lawsuits filed in recent years, particularly those against auditors, has declined dramatically. Only one of the 110 securities class actions filed in 2006 (itself a 38% decline from 2005) charged the auditor. This evidence demonstrates that fears of securities litigation bankrupting auditors through ruinous damages awards are baseless. As the Consumer Group noted, "this is hardly the picture of a litigation system run amok."

Further evidence of the flaws in the arguments put forth in the Reports lies in their complete disregard of investor trust. Bernard Wasow of the Century Foundation has argued that investor confidence is an important element to successful financial markets that seems to have been discounted by those concerned about the viability of our markets. According to Wasow, rather than rollback investor protections, our financial markets would be better served by "carry[ing] the momentum of regulatory reform into better regulation" of private benefits. The regulatory failures that were highlighted by the corporate crime scandals of Enron and WorldCom indicate the need for more, not less, accountability of publicly-held companies. Indeed, the Institute for Fraud Prevention sponsored a study of 374 companies accused of securities fraud between 1997 and 2002. The study revealed that an average of seven people were implicated in each case, illustrating what the study's author, Robert Tillman, calls "normalized corruption." According to Tillman, a professor at St. John's University, "It wasn't just a few rogue CEOs. It was a large number of people in coordinated networks of professionals, accountants, bankers, stock analysts and lawyers… Now is not the time to remove our surveillance of them."

With securities litigation filings on the wane, shareholder advocates are rightly demonstrating that the anti-investor movement's fears of litigation are baseless. As noted in communications to a Congressional committee, "this is hardly the picture of a litigation system run amok."

Recently, Senator Jim DeMint (R-SC) introduced a bill that would lower the standards of SOX Section 404 regarding internal controls for most public companies. In response, the Council for Institutional Investors (the "CII") [see chart on page 7], an association of more than 130 pension funds, with combined assets of over $3 trillion, wrote a letter to Senator Christopher Dodd (D-CT), Chairman of the Committee on Banking, Housing, and Urban Affairs. CII's opposition to the DeMint Bill emphasized that smaller public companies have a high frequency of misstatements and restatements of their financial information, which, in turn, makes Section 404's enforced internal control over financial reporting vital to investor confidence in those smaller companies. The CII recommended that, in the interests of investor protection, all public companies should fully comply with Section 404.



Shareholder advocacy groups are using all resources at their disposal to combat the misleading information dispensed by the anti-investor movement. Democratic access to Congressional representatives, combined with well-researched studies exposing the fallacies at the root of the anti-regulation arguments, appears to be effective in garnering support and effecting results. On April 24, the Senate rejected the DeMint amendment. However, notwithstanding investors' success in the halls of Congress, on May 23, 2007, the SEC agreed to roll back rules with respect to smaller companies and their compliance with SOX Section 404. In doing so, the SEC claimed that "investors will benefit from reduced compliance costs" and "companies of all sizes" will be able to focus on "what truly matters to the integrity of financial statements-risk and materiality." What benefit will be realized as result of the SEC's actions remains to be seen. One thing is certain though — shareholder advocacy groups must remain committed to protect investor rights.

Expanding Shareholder Rights

Proxy Access

Importantly, the recent high-profile efforts to roll back investor rights have not distracted investor advocates from pursuing goals that have been on their agenda for years, such as the nomination of directors. Typically, shareholders face significant barriers to directly nominating directors — they must propose their own separate slate of directors in their own proxy, a prohibitively expensive endeavor. Shareholders in Comverse Technology, Inc. recently broke new ground, obtaining unprecedented rights of control when the company adopted a proxy access bylaw. With certain limitations, shareholders may now directly nominate new directors on the company proxy card. It should be noted that the bylaw amendment occurred in the wake of the stock options backdating scandal that has engulfed Comverse.

However, regardless of its context, the Comverse shareholders' victory is particularly significant given that this is the first time a publicly-traded company has allowed such participation by shareholders. Indeed, the SEC had actually condoned the exclusion of shareholders from the company's proxy slate. (For further discussion of the SEC's role in this battle over investor protections, please see "The SEC: Friend or Foe" on page 11). In September 2006, however, the Second Circuit Court of Appeals ruled that the SEC had improperly allowed the exclusion of a proxy access proposal by the American Federation of State, County, and Municipal Employees (AFSCME). Prior to the court's ruling, the issue of shareholder proxy access had appeared dormant for years.

Since the ruling, however, labor unions have actively promoted a series of proposals at companies to allow shareholder proxy access. For example, AFSCME, along with three state pension funds, won 43 percent support for binding proxy access at Hewlett-Packard in the first proxy access proposal to ever come before shareholders for a vote. This amount of support was a significant success, given that shareholder proposals rarely achieve such numbers during the first proxy season in which they are proposed.

While a great step forward, the Comverse bylaw, the first adopted by a U.S. company, is still more restrictive than those proposed at other companies. Only time will tell whether this bylaw amendment will spread and broaden among other companies. The SEC held three roundtable discussions on proxy access during the month of May, and Chairman Cox has indicated that the SEC plans to complete work on a proxy access rule before the start of

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Investor and Consumer Rights Advocacy Organizations

Consumer Action	Consumer Action is a national non-profit consumer education and advocacy organization founded in 1971, focused on multilingual publications that help people save money and understand and enforce their consumer rights.
Consumer Federation of America	A non-profit organization founded in 1968 to advance the consumer interest through research, education and advocacy.
Consumers Union	An independent, non-profit testing and information organization, founded in 1936, serving consumers in the United States. Its mission is to test products, inform the public, and protect consumers. Its advocacy focuses on issues ranging from product safety to financial services and investing.
U.S. PIRG, Federation of State PIRGs	PIRG stands for Public Interest Research Group; U.S. PIRG is an advocacy non-profit organization in the United States and Canada, composed of self-governing affiliates at the state and province level. The PIRGs focus on the passage of legislation using professional and student/citizen lobbyists in the areas of environmental protection, consumer protection, and political reform.
Council for Institutional Investors	The CII describes itself as "the premier U.S. shareowner-rights organization." Founded in 1985, it is a not-for-profit association of 130 public, labor, and corporate pension funds with assets exceeding $3 trillion, joined together to educate members and the public about corporate governance, and to advocate for strong governance standards on issues ranging from executive compensation to the election of corporate directors.
Institutional Shareholder Services	ISS analyzes and provides information on corporate proxy votes, largely for the benefit of institutional investors. They also make recommendations as to whether it is in a shareholder's best interest to vote for or against particular proxies, and they advise businesses on how to handle corporate governance issues.
The Century Foundation	Founded in 1919 by the progressive businessman Edward A. Filene, The Century Foundation is a nonprofit public policy research institution committed to the belief that a mix of effective government, open democracy, and free markets is the most effective solution to the major challenges facing the United States.
CtW Investment Group	Founded in February 2006, the CtW Investment Group is affiliated with Change to Win (CtW), a federation of unions representing nearly six million workers in the United States. The CtW Investment group seeks to "organi[ze] workers' capital into an effective voice for corporate accountability and retirement security."

Eye on the Issues

LEGISLATIVE/REGULATORY UPDATES AND RECENT DECISIONS OF INTEREST

By Laura Gundersheim

Securities Class Action Settlements Reach Record Highs in 2006. According to surveys by both the Securities Class Action Services (SCAS) and Cornerstone Research, the dollar amounts of federal securities class action settlements reached record highs in 2006. SCAS estimates that the total was over $18 Billion, about $1 Billion higher than a finding by Cornerstone. Both numbers represent increases of approximately 300% from 2005. SCAS attributed last year's numbers to settlements in mega cases such as *Nortel Networks, McKesson Corporation* and *Enron*. According to Cornerstone, the increase was due largely to a boost in the average settlement size, as opposed to a hike in the number of cases settled. Cornerstone found that 14 cases settled last year for amounts of $100 million or more. That number far exceeded the 2004 and 2005 numbers, when there were seven and nine mega-settlements respectively. In addition, Cornerstone also concluded that institutions served as a lead plaintiff in over 50% of all cases settled last year, increases of 35% and 20% from 2005 and 2006, respectively. Cornerstone reported that the median settlement amount for 2006 when institutional investors served as lead plaintiff was $9 million. In contrast, where there was no institutional investor serving as the lead plaintiff, a median $4.3 million settlement was reached. SCAS concluded that having an institutional investor group going up against a corporation, "levels the playing field." *New York Law Journal, March 30, 2007.*

Overall Total of Restatements in 2006 Hits Record High but Restatements by Large Companies Drop Nearly 20%. Publicly traded companies filed 1,876 restatements of financial results in 2006, setting a record for corrections of financial statements and demonstrating that many companies are still struggling to get the accounting right for both simple and complex transactions. In a sign that some of the corporate governance changes enacted during this decade may be taking root, however, the number of restatements filed by large company's fell in 2006, the first such decline since 2001. Large companies-those having more than $700 million in publicly available stock-filed 196 restatements in 2006, a near 20% drop from the previous year. By contrast, companies with a public float of less than $75 million, which are not yet subject to internal control regulations, continued to have restatements climb. In 2006, U.S. companies in this category filed 1,108 restatements, a 42% jump from the previous year. *The Wall Street Journal, February 12, 2007.*

Ernst & Young Censured by SEC, Agrees to $1.5 Million Settlement. Ernst & Young was censured by the SEC and will pay $1.5 million to settle charges that it compromised its independence through work it did in 2001 for clients AIG, Inc. ("AIG") and PNC Financial Services Group, Inc. ("PNC"). The SEC claimed that Ernst & Young's professional independence was undercut because it helped AIG develop and market a financial product sold to PNC, an Ernst & Young audit client. The recovery will be placed in a fund for PNC investors allegedly victimized by the scheme. The settlement marks the second time Ernst &Young had been censured for allegedly lacking sufficient independence from its auditing clients. In 2003, the SEC suspended Ernst & Young from accepting new public-company audit clients for six months, citing its alleged lack of independence in auditing PeopleSoft. *The Wall Street Journal, March 27, 2007.*

Deferred-Compensation Rules Allow Executives to Enjoy Huge Tax Breaks. The Treasury Department recently released its deferred-compensation regulations. The new rules continue to let hundreds of thousands of executives who defer their compensation enjoy big tax breaks without facing additional restrictions beyond those in place in recent years. The new regulations make it easier for executives to collect severance without triggering the restrictions in the deferred compensation law. The regulations also let companies give departing executives more time to exercise options without triggering the deferred-compensation restrictions. Now, options can be exercised as late as 10 years after the original grant date and still be exempt from the deferred-compensation rules. *The Wall Street Journal, April 11, 2007.*

SEC Relaxes Auditing Standards for Small Companies. The SEC approved new relaxed guidelines to Section 404 of the Sarbanes-Oxley Act. The new guidelines allow smaller companies (those with a market value of less than $75 million) to focus exclusively on "areas most prone to potential fraud." The new guideline call on corporate managers to use a "risk-based" approach to identify the areas where fraud or errors are most likely and allows room to avoid testing. This contrasts with the more prescriptive approach that auditors had previously employed. Among the most concrete changes is that the SEC will now require companies to get an outside auditor's formal opinion on whether its financial controls are working. Previously, companies were required to have outside auditors evaluate the quality of the assessment process as well. The unanimous vote by the SEC's five members affects the vast majority of American businesses. Section 404, which requires public companies to assess their internal controls in order to certify that their financial reporting is reliable, was intended to discourage fraud and financial manipulation. Critics, however, say its stringent requirements impose unnecessary costs on small companies and have caused U.S. financial markets to lose ground. *The New York Times, May 24, 2007.*

SEC to Consider Allowing U.S. Companies to Use International Accounting Standards. The SEC is also considering allowing U.S. public companies to choose which type of accounting standards they use to report financial results. The Commission said it will begin soliciting comments this summer on a possible change allowing foreign companies registered with it to file financial results using international financial reports standards, or IFRS. Currently foreign companies that file with the SEC must reconcile their results to U.S. GAAP. If the Commission changes the rules to give foreign companies a choice, it would also have to consider whether U.S. companies can also choose between U.S. and international rules, according to the SEC. According to accounting experts, the rule change could spell the end for U.S.-based accounting systems. International standards, which emphasize broad-based principles over detailed rules, are seen as giving companies greater flexibility; also, many U.S. multinational companies using international standards for subsidiaries in foreign countries would rather have one accounting system globally. *The Wall Street Journal, April 25, 2007.*

Second Circuit Holds That Outside Auditors Have Duty to Correct False and Misleading Statements on Company's Financial Reporting. In *Overton v. Todman & Co., CPAs, P.C.*, the U.S. Court of Appeals for the Second Circuit addressed an issue of first impression in the circuit concerning the circumstances under which an outside auditor has a "duty to correct" false or materially misleading statements contained in its certified opinion on a company's financial statements. In that case, the Court of Appeals held that an outside auditor has a duty to correct statements it made in a certified opinion, in a limited circumstance, where (i) the statement was false or materially misleading when made, (ii) the auditor subsequently learns or was reckless in not learning that the earlier statement was false or materially misleading, and (iii) the auditor knows or should have known that potential investors are relying on its certified opinion. In such a situation, if the auditor fails to comply with its duty to correct, the auditor would be subject to a claim based on primary liability under section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. *Overton v. Todman & Co., CPAS. P.C. et al., 478 F.3d 479 (2d Cir. 2007).*

Ex-Comverse Lawyer Going to Jail in Options Backdating Plan. The former top lawyer at the software maker Comverse Technology was sentenced to a year and one day in prison for his role in a stock options backdating scheme, becoming the first corporate executive to be sentenced for options-related crimes. The company's former general counsel, William F. Sorin, pleaded guilty in New York Federal Court to conspiracy to commit securities fraud, mail fraud and wire fraud as part of a plea agreement. Mr. Sorin, 58, and two other Comverse executives were accused of reaping millions of dollars in profits by altering the grant dates of stock option awards from 1998 to 2002 to enrich to themselves and favored employees. *UUSA v. Sorin, Criminal Docket No. 06-cr-00723 (NGG-RER).SA v. Sorin, Criminal Docket No. 06-cr-00723 (NGG-RER).*

The Public Company Accounting Oversight Board Found Constitutional. A federal judge in Washington dismissed a lawsuit challenging the constitutionality of the Public Company Accounting Oversight Board ("PCAOB") created by the Sarbanes-Oxley Act. Due to the fact that portions of Sarbanes-Oxley are not severable, a successful challenge to the provision that created the PCAOB could have resulted in the entire Act being declared unconstitutional. The case was brought against the PCOAB by a small accounting firm and organizations, such as the Free Enterprise Fund, that advocate for tax reform and limited government. *Free Enterprise Fund, et al. v. The Public Company Accounting Oversight Board, et al., Civ. A. No. 06-0217 (JR), 2006 U.S. Dist. Lexis 24310 (D.C. Mar. 21, 2007).*

Directors and Officers Insurance Falls to Lowest Level in Five Years. AIG, the largest U.S. insurer of corporate boards, and rivals have cut insurance prices as the perception of risk from scandals such as Enron faded with new accountability standards. In 2006, rates to cover directors and officers who may be sued for negligence or misleading statements (referred to as "D&O insurance") fell to the lowest level in five years, according to a survey of 2,875 insurance buyers by Tillinghast, a consultant in Stamford, Connecticut. According to insurance brokers, the drop in price for D&O insurance is a result of the declining number of securities class-action lawsuits filed against U.S. companies. *Bloomberg News, April 5, 2007.*

Morgan Stanley Wins Appeal Against Ronald Perelman. Morgan Stanley won a Florida appeals court decision that overturned a $1.57 billion verdict, a defeat for billionaire Ronald Perelman, who claimed the bank defrauded him in the sale of Coleman Co. in 1998. Perelman sold Coleman to Sunbeam for cash and stock. Morgan Stanley was Sunbeam's advisor. In May 2005, jurors in West Palm Beach awarded Perelman $604 million in actual damages and $850 million in punitive damages. The trial judge added $123 million in interest. Before the trial began, however, the trial judge sanctioned Morgan Stanley for failing to turn over e-mail related to the Coleman deal by ruling that, to recover damages, Perelman had to prove only that he relied on Morgan Stanley's misstatements of Sunbeam's financial health. The Florida Court of Appeals held that the lower court erred in not making Perelman use the proper evidence to prove his damages from Morgan Stanley's concealment of the financial condition of Sunbeam Corp. Perelman will ask the full Florida Court of Appeals to review the panel's decision. *Bloomberg News, March 21, 2007.*

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KEEPING AMERICA'S CAPITAL MARKETS FREE AND TRANSPARENT

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the 2008 proxy season. This issue remains open and it remains to be seen how much access the SEC's rule will provide.

Executive Compensation

Proxy access is not the only issue on which shareholders have made progress recently. For example, executive compensation received great attention this year when Home Depot's CEO received a $210 million retirement package despite producing lackluster results duing his tenure. Over the course of this proxy season, "say on pay" proxy proposals, in which shareholders would receive an advisory vote on executive compensation, have received majority votes at Verizon, Blockbuster, and Motorola. Moreover, AFSCME is submitting proposals to more than 60 companies to give shareholders a nonbinding vote on executive pay. AFSCME, along with other shareholder advocates, is determined to have a "say on pay" and more closely link executive compensation with performance.

> ***According to a 2006 Global Institutional Investor Study prepared by Institutional Shareholder Services ("ISS"), U.S. investors, along with investors in Canada, Europe, and Australia, listed executive compensation as one of their top concerns. In response, the ISS has introduced the "Say on Pay Information Center" to provide information and advocate for investor input on executive compensation.***

According to the 2006 Global Institutional Investor Study prepared by Institutional Shareholder Services ("ISS"), U.S. investors, along with investors in Canada, Europe, and Australia, listed executive compensation as one of their top concerns. In response, the ISS has introduced the "Say on Pay Information Center" to provide information and advocate for investor input on executive compensation. According to ISS, shareholders in other markets, including the United Kingdom, the Netherlands, and Australia, have introduced shareholder votes on executive pay to address these exact problems as seen in the U.S.

Last year, the SEC introduced new rules to heighten pay disclosure. The rules provided for new clarity regarding the total amount of compensation given to executives, including pension benefits, perquisites and other personal items. However, the SEC backpedaled on these new disclosure requirements a month after they were approved, by requiring executives to report only those stock options that have vested in the prior year, rather than all options granted.

Lucian Bebchuk of Harvard Law School's Program on Corporate Governance, a dedicated advocate of executive compensation disclosure, testified before Congress, criticizing the customary practice of concealing true executive compensation. Over the last couple of years, Professor Bebchuk has introduced shareholder proxy proposals to provide additional monitoring of executive pay. This proxy season, Professor Bebchuk has introduced proposals at AIG, Bristol Myers, Exxon Mobil and Home Depot to require the approval of CEO pay by a supermajority of independent directors. Bristol Myers and Home Depot have already agreed to Professor Bebchuk's proposals. According to Stephen M. Davis, president of independent governance consulting firm Davis Global Advisors Inc., the speed of acceptance for "say on pay" proposals is unprecedented. "It's taken off like a rocket," he says. "To have the first year of a widespread campaign producing votes with 30% to 50% outcomes is unheard of."

In April, following Professor Bebchuk's testimony before Congress in March, the U.S. House of Representatives passed a bill titled the "Shareholder Vote on Executive Compensation Act." The bill was then introduced to the Senate by Senator Barack Obama. The bill calls for an annual shareholder vote on executive compensation and envisions a non-binding advisory role for investors.

Continued Vigilance in Pursuing Shareholder Protections Is Essential

While there is an organized movement to eliminate important investor protections under the misplaced argument that the U.S. capital market is losing its competitive position, shareholder advocacy groups are uniting to dispel the baseless contentions of these well-organized and well-funded anti-investor groups and are making significant strides in the areas of proxy access and executive pay disclosure. Indeed, the recent success by shareholder-rights activists is truly remarkable given the public relations efforts, political pressure, and resources expended by corporate America. That said, the willful obfuscation displayed by these anti-investor forces make it clear that shareholder advocacy groups must continue to vigilantly and vigorously protect and advance investor rights.

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The SEC: Friend or Foe?

(Hint: It's Not Looking Good For Investors)

By Adam Wierzbowski

The Securities and Exchange Commission ("SEC") and its Commissioner, Christopher Cox, have recently come under increased scrutiny from Congress, state Attorneys General and investors for taking actions that are harmful to investors and favorable to business — behavior that is contrary to the Commission's regulatory role as investor watchdog. Congress created the SEC in 1934 — in the wake of the 1929 stock market crash — to safeguard investors from the dangers of the capital markets, and to enforce the newly-passed federal securities laws. But recent events call into question whether the Commission is fully satisfying that duty.

One way the SEC has taken anti-investor positions has been by filing "friend of the court," or *amicus*, briefs with the Supreme Court and other courts. As detailed in the last edition of the *Advocate*, in the Supreme Court *amicus* brief it filed in *Tellabs v. Makor*, the SEC argued that plaintiffs should be required to plead in their complaints a "high likelihood" that defendants had an intent to deceive — thus supporting a higher standard for damaged investors to gain entry into the courthouse than to persuade a jury and win the case at trial. The position the SEC expressed in *Tellabs* was both harmful to investors and contrary to the position it had previously, and repeatedly, expressed on over a dozen occasions in the past eight years. The SEC's position was ultimately rejected by the Supreme Court, which issued its decision in *Tellabs* on June 21, 2007. The Court found that "meritorious private actions to enforce federal antifraud securities laws are an essential supplement" to actions brought by the Department of Justice and the SEC, and held that securities fraud plaintiffs need

Congress created the SEC in 1934 — in the wake of the 1929 stock market crash — to safeguard investors from the dangers of the capital markets, and to enforce the newly-passed federal securities laws. But recent events call into question whether the Commission is fully satisfying that duty.

only plead a "strong inference" of fraudulent intent that is as compelling as any opposing inference of nonfraudulent intent.

The SEC's next opportunity to weigh in on an important issue for investors is presented in *Stoneridge Investment Partners v. Scientific-Atlanta*, in which the Supreme Court is set to decide the scope of "scheme liability" under Rule 10b-5 of the Securities Exchange Act of 1934. The investors in Enron have also petitioned the Supreme Court to hear the same issue, and that petition is currently pending. These two cases involve the liability of so-called secondary actors — those who do not themselves issue false public statements but who violate the securities laws by undertaking deceptive acts in concert with those who do issue false public statements.

Stoneridge presented an excellent chance for the SEC to re-affirm the position it recently argued in support of holding secondary actors liable for their active participation in a fraudulent scheme. In *Simpson v. AOL Time Warner ("Home-Store")*, decided by the Ninth Circuit Court of Appeals in June 2006, the plaintiffs alleged that the issuer had engaged in sham transactions with certain third parties in order to fraudulently boost earnings. In that appeal, the SEC's *amicus* brief supported investors and argued that since the third parties' transactions created the false appearance of fact that misled investors, they were "deceptive acts" actionable under the securities laws. According to the SEC, no public statement by those third parties was required for a finding of liability. Although the Ninth Circuit affirmed the dismissal of the scheme liability claims against the secondary actors for other reasons, the Court largely adopted the SEC's position.

Stoneridge presents the same issues. In *Stoneridge*, investors in Charter Communications brought suit against the cable company for artificially boosting its financial results by entering into

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Quarterly Quote...

The White House View

"We think the SEC is the right entity to bring lawsuits and make sure investors are protected.... We are in a society that is overly litigious...The president believes that it's important to make certain that we reduce the unnecessary lawsuits because that's a very big burden to the economy, which adversely impacts investors."

Al Hubbard, President Bush's chief economic advisor, explaining why the White House directed the Justice Department ***not*** to file an *amicus* brief in support of investors in *Stoneridge v. Scientific-Atlanta*, an important case concerning scheme liability in securities fraud, which the Supreme Court will decide next term.

SEC: FRIEND OR FOE?

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sham transactions with two equipment vendors, Motorola and Scientific-Atlanta. The Eighth Circuit found that the claims asserted against the two vendors amounted to mere "aiding and abetting" and were barred by the Supreme Court's 1973 decision in *Central Bank,* which eliminated liability for simply aiding and abetting a fraud committed by another person. According to the Eighth Circuit's reasoning, the vendors had not made false public statements, but had simply "entered into arm's length non-securities transactions" which Charter subsequently used to improve its own financial results and thus, publish false and misleading statements to its investors. Unfortunately, the Eighth Circuit missed the SEC's point in *Homestore* since the vendors' transactions were by their very nature deceptive and clearly sufficient for finding scheme liability.

In the *Enron* class action, *Regents of the University of California v. Credit Suisse First Boston*, the Fifth Circuit recently held, following the Eighth Circuit in *Stoneridge*, that the investment banks involved in the Enron fraud were not liable under a scheme liability theory because they did not directly deceive investors. The defrauded investors have petitioned the Supreme Court to hear their appeal. When the Supreme Court hears a case like *Stoneridge* (and potentially *Enron*) that will significantly impact investors' ability to hold secondary actors liable for securities fraud, shareholders naturally expect the SEC will do everything in its power to assure that the rights of defrauded investors are protected. The SEC's will to do so, however, appears to be significantly diminished.

The Commission had a golden opportunity in *Stoneridge* to reverse course and support private enforcement of the federal securities laws. However, the SEC's reported eleventh-hour efforts to side with investors were rebuffed by others within the Bush administration, including the President himself. The SEC Commissioners, under increasingly vocal pressure from investor groups, voted 3 to 2 to request that Solicitor General Paul Clement (the SEC's advocate before the Supreme Court) file an SEC *amicus* brief supporting investors in *Stoneridge*. This request was consistent with the SEC's prior position and should have finalized the Commission's position on this important issue. However, President Bush and his Chief Economic Adviser disagreed with this view, asserting, among other things, that it is important to reduce "unnecessary lawsuits" and that "the SEC is the right entity to bring [securities] lawsuits." Accordingly, the Solicitor General declined to file the brief — despite the SEC's request — and simply let the deadline pass. Thus, even when the SEC, as the primary regulator of the securities laws, appears to support investors, Administration pressure stops it in its tracks. This public rebuff by the Administration may chill any SEC pro-investor positions in the future. The irony of this situation is that the Bush administration and Republican party have long espoused the virtues of less reliance on big government to solve social problems. Now they want to hamstring private action because, they claim, the SEC will vindicate shareholder rights.

The Commission's recent positions on other securities matters also raise substantial questions about its commitment to protecting investors going forward. For instance, in addition to the pro-business/anti-investor position it took in *Tellabs*, the SEC's anti-investor approach was seen in the antitrust lawsuit, *Credit Suisse First Boston v. Billing*. In *Billing*, the Supreme Court recently decided that certain of the largest U.S. investment banks could not be held liable for allegedly engaging in a vast conspiracy to manipulate the aftermarket prices of some 900 technology stocks sold in initial public offerings in the late 1990s under the anti-trust laws because the conduct in question was governed by the securities laws. In addition to holding that the securities laws precluded application of the anti-trust laws, the Supreme Court also stated that regulation of the underwriters' conduct should be placed with the SEC as securities experts, not in the hands of non-expert judges and juries. Surprisingly, Paul Atkins, an SEC Commissioner, urged the Supreme Court to take the case so that the Court could rule for the banks rather than for investors. Atkins stated that such lawsuits "could devastate America's process of capital formation, wreak unprecedented havoc on the underwriting business, and accelerate the marginalization of our capital markets." This stance, and the Supreme Court's ruling, ignores the devastating impact that the underwriters' misconduct has caused to capital formation and the markets in this case, and others such as *WorldCom*, and that the practices challenged by the plaintiffs, such as tying arrangements, are quintessential antitrust violations.

In *American Federation of State, County & Municipal Employees v. American International Group*, the SEC opposed investors' ability to include a shareholder proposal in AIG's proxy statement that would require the company to include in its annual meeting materials the names of shareholder-nominated director candidates. In that action, the SEC filed an *amicus* brief with the Second Circuit arguing — again contrary to prior SEC guidance — that companies are not required to include this type of shareholder proposal in their proxy materials. In ruling for the investors against the views supported by the Commission, the Second Circuit specifically found that the SEC had failed to explain why it had drastically departed from its previous interpretations of the proxy rules.

And in the bondholder class action against HealthSouth Corporation, the SEC recently submitted an *amicus* letter brief to the district court in which the Commission directly undercut plaintiffs' theory of Securities Act liability against the investment banks. Plaintiffs had alleged that those banks, which had sold over $3 billion of HealthSouth debt to their clients, claimed an exemption from the Securities Act's registration requirements even though those banks knew about the massive fraud at HealthSouth, and were using the exemption in bad faith to evade their responsibilities under the Securities Act and escape near-strict liability. The Commission, in yet another reversal from a previously espoused view, informed the district court that even if all of plaintiffs' allegations about the bank's knowledge of the fraud and their intent to use the exemption as a scheme to evade liability were true, the exemption would still apply — and no Securities Act liability may be imposed — because the banks' motive is irrelevant to the claimed exemption!

The Commission had a golden opportunity in Stoneridge to reverse course and support private enforcement of the federal securities laws. However, the SEC's reported eleventh-hour efforts to side with investors were rebuffed by others within the Bush administration, including the President himself.

Unfortunately, the SEC's recent anti-investor efforts go further than the filing of *amicus* briefs with courts. Recent months have seen disturbing trends involving the Commission's enforcement actions and changes to its own internal policies. For example, after the SEC suffered a legal setback regarding its efforts to tighten hedge fund regulation — which would have forced many of the firms in the $1 trillion hedge fund industry to register with the SEC and open their books to government inspection — the SEC inexplicably did not seek to appeal that decision to the Supreme Court. And in October 2006, the Government Accountability Office, Congress's investigative arm, initiated a broad investigation of the SEC's enforcement practices after former SEC lawyer Gary Aguirre said his superiors would not allow him to pursue an insider-trading probe at hedge fund Pequot Capital Management.

Another recent high-profile example of changes to the SEC's enforcement practices relates to the stock options backdating scandal at Apple Corporation. Last year, Apple was forced to restate its financial results by $84 million due to improper options backdating. Despite Apple's conclusions that CEO Steve Jobs knew of stock option backdating and even recommended favorable grant dates, the SEC failed to bring charges against him. This failure to bring charges is particularly shocking because Apple's former CFO Fred Anderson —

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Quarterly Quote...

The Supreme Court View

"This Court has long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission (SEC)."

Justice Ruth Bader Ginsburg delivering the Supreme Court's opinion in Tellabs v. Makor

SEC: FRIEND OR FOE?

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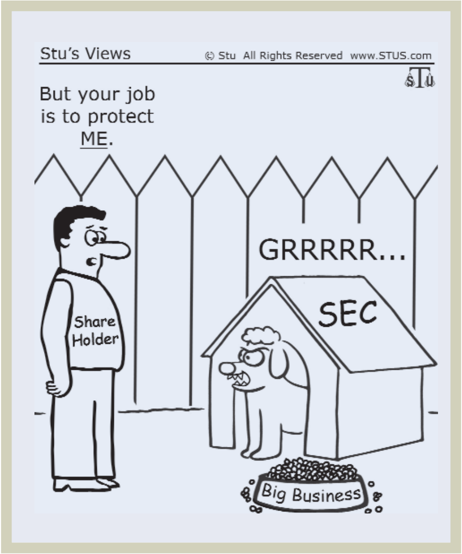
whose settlement with the SEC notably did not include a lifetime ban from serving as a corporate officer — stated publicly that he warned Jobs in 2001 that Apple might have to take an accounting charge on a large backdated grant to executives. The Commission sets a dangerous precedent and sends a clear signal to corporate America by failing to hold these executives accountable.

The Apple enforcement decisions occurred almost at the same time that the SEC announced an $81 million settlement of its claims against HealthSouth's former CEO, Richard Scrushy, in its action alleging Scrushy's responsibility for the massive accounting fraud at the healthcare company. On its face, the announced settlement suggests that the SEC still has some teeth in prosecuting corporate fraud. The catch, however, is that the SEC gave Scrushy credit for $71.5 million of the amount the SEC claimed to have obtained because Scrushy had already paid or forfeited that amount in related private civil cases, with the potential for a further credit of another $6 million in continuing private civil litigation. The SEC's settlement — which currently is no more than $9.5 million, a far cry from the proclaimed $81 million, and as little as $3.5 million — was thus nothing to brag about. And, as in the Apple enforcement actions, the SEC's settlement with Scrushy does not include the customary lifetime ban from acting as a director or officer of a



publicly-held corporation, but only prevents him from doing so for five years.

And if those enforcement actions are not disconcerting enough, the SEC is changing its policies for negotiating settlements with companies. Under the revised approach, rather than allowing SEC enforcement lawyers to reach an agreement and then obtain Commission approval, the new initiative requires enforcement lawyers to seek approval from the SEC's five commissioners before they begin settlement talks that would involve levying fines against corporations. As former SEC Chairman Arthur Levitt has said, this new policy will inject ideology into corporate penalties and undermine the enforcement division.

The SEC's conduct has not gone unnoticed by at least some members of Congress. Representative Barney Frank (D-Mass.), Chairman of the House Financial Services Committee, has scheduled an oversight hearing to air debate over the SEC's recent actions in response to criticism that its policies are increasingly favoring companies over investors. Attorneys General Marc Dann of Ohio and Mark Shurtleff of Utah have submitted a letter to Representatives Frank and Bachus (R-Ala.) of the House Committee, and to Senators Dodd (D-Conn.) and Shelby (R-Ala.) of the Senate Committee on Banking, Housing and Urban Affairs. That letter applauded the House Committee for scheduling the hearing, and urged the Senate to take similar action.

As these hearings and the Commission's failure to file an *amicus* brief in *Stoneridge* demonstrate, the SEC is at a crossroads. Over the past few years, the Commission has been leaning toward measures that would favor business interests over investor rights and corporate reform. *Stoneridge* presented an excellent opportunity for the SEC to choose the road leading to investor protection, however, a divided Commission failed to persuade the Department of Justice that a pro-investor brief was necessary. Critically for investors, and in the words of Robert Frost, the path chosen by the SEC can make "all the difference."

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A Balanced Decision in *Tellabs*?

The Supreme Court Sets the Pleading Standard for Securities Fraud

By Salvatore J. Graziano, John C. Browne and Jai K. Chandrasekhar

The Supreme Court's recognition of the vital role of institutional investors in securities litigation should encourage the trend among institutions to seek leadership of securities class actions, and among the district courts to appoint responsible institutions as lead plaintiffs to protect investors' interests.

On June 21, 2007, the United States Supreme Court issued a decision in *Tellabs, Inc. v. Makor Issues & Rights Ltd.,* which is not nearly as harmful to investor rights as early media reports have portrayed. In *Tellabs*, the Supreme Court interpreted the pleading standard that plaintiffs in securities fraud cases must satisfy under the Private Securities Litigation Reform Act of 1995 ("PSLRA") with respect to scienter, that is, defendants' fraudulent state of mind. Bernstein Litowitz Berger & Grossmann LLP filed a friend of the court brief on behalf of a number of our public pension fund clients in this case. The U.S. Chamber of Commerce and other corporate interest groups filed numerous friend of the court briefs urging the Court to set the pleading standard so high that many meritorious cases would be dismissed. The majority of the Justices declined to do so and instead preserved investors' right to bring meritorious cases.

In an opinion written by Justice Ruth Bader Ginsburg and joined by Chief Justice Roberts and Justices Kennedy, Souter, Thomas, and Breyer, the Court carefully balanced "the PSLRA's twin goals: to curb frivolous, lawyer-driven litigation, while preserving investors' ability to recover on meritorious claims." We believe that the Court's decision is favorable for investor rights in three important respects.

First, the Court adopted a reasonable interpretation of the PSLRA, which requires the complaint in every securities fraud case to "state with particularity facts giving rise to a strong inference that defendants acted with the required state of mind." The Court rejected the invitation by the Tellabs defendants and corporate interest groups, which asked the Court to rule that a securities fraud complaint must allege facts so strong that the inference of defendants' guilty state of mind is stronger than any competing inference that defendants acted innocently, or even that the alleged facts must be so strong that the inference of fraudulent intent is the strongest or most plausible inference. If the Court had accepted the defendants' and corporate interest groups' arguments, many meritorious securities fraud cases would have been vulnerable to dismissal.

Instead, the Court held that a complaint should not be dismissed "if a reasonable person would deem the inference of scienter cogent and *at least as compelling* as any opposing inference one could draw from the facts alleged" (emphasis added). In other words, if "the inference of scienter [is] *at least as strong* as any opposing inference," the complaint should not be dismissed (emphasis added). We believe that this standard will permit meritorious cases to survive motions to dismiss, while allowing dismissal of meritless cases.

Second, the Court's decision in *Tellabs* repeatedly recognizes that private securities litigation vindicates investors' rights and provides an important supplement to governmental enforcement of the securities laws by the Securities and Exchange Commission and the Justice Department. The Court wrote that "private securities litigation [i]s an indispensable tool with which defrauded investors can recover their losses — a matter crucial to the integrity of domestic capital markets." None of the Justices — not even Justices Scalia and Alito, who wrote separate opinions favoring a more pro-defendant pleading standard than the majority — echoed the anti-investor rhetoric of the business groups' briefs that portrayed private securities fraud litigation as harmful to the economy and ineffective in maintaining fair and efficient capital markets. The Court's recognition that meritorious investor lawsuits serve the legitimate purposes of deterring fraud and compensating victims of fraud is a significant check to the anti-investor campaign that special interests are currently waging.

Finally, the Court recognized that the PSLRA "aimed to increase the likelihood that institutional investors — parties more likely to balance the interests of the class with the long-term interests of the company — would serve as lead plaintiffs." The Supreme Court's recognition of the vital role of institutional investors in securities litigation should encourage the trend among institutions to seek leadership of securities class actions, and among the district courts to appoint responsible institutions as lead plaintiffs to protect investors' interests.

Some media reports about the *Tellabs* decision have portrayed it as a blow to investor rights, because the Supreme Court reversed a lower federal appeals court ruling in favor of the plaintiffs and held that plaintiffs must plead "cogent" and "compelling" facts supporting the

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INSULATING CORPORATE AMERICA

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for fear of facing personal financial penalties from overzealous regulators."

In order to combat what they perceive as an over-emphasis on compliance, the Committees suggest that Section 404 be revised to make compliance easier for companies, and/or that small companies be exempt from auditor attestation and be subject to a lesser standard for management certification, if a revised Section 404 is still too burdensome. Already, this has caused both the SEC and the Public Company Accounting Oversight Board to propose looser interpretations of how the auditing provision should be applied to smaller companies.

Consistent with their recommendations to relax requirements for complying with SOX is the Committees' recommendation that public companies be allowed to disregard the U.S. guidelines for accounting (or "GAAP") — that are described as "rule-based" — and, instead, be allowed to comply with more "principle-based" guidelines, such as international accounting standards. The commentators explain that doing away with specific rules will allow auditors and management to exercise more judgment. Alarmingly, the SEC has reportedly moved towards accepting this recommendation, announcing its intention to open the proposed policy for comments by this summer. Likewise, a new agreement between the U.S. and the European Union (recently signed by President Bush) sets the stage for a single trans-Atlantic accounting standard by 2009 — a standard that would presumably be more flexible than U.S. generally accepted accounting principles.

While new scholarship calls into serious question whether the United States truly is losing a competitive edge in the globalization of capital markets, the debate is far from resolved. In the meantime, claims of competitive loss bolster anti-investor sentiments and provide support for calls to roll back regulation and investor protections.

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A BALANCED DECISION IN TELLABS?

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inference that defendants acted with scienter. However, the Supreme Court did not dismiss the case, but rather sent it back to the lower courts to determine whether the complaint satisfies the Supreme Court's interpretation of the PSLRA's pleading standard. Furthermore, the Supreme Court expressly rejected one federal appeals court's pro-defendant interpretation of the PSLRA, which held that the inference of scienter from the facts alleged in the complaint must be the "most plausible" of all possible inferences. The Supreme Court's own interpretation of the PSLRA is more balanced and fair to both plaintiffs and defendants. The lower courts will be applying the *Tellabs* standard in every federal securities fraud case from now on, and it remains to be seen what impact it will have. On the whole, we believe that *Tellabs* could have been better for investors but, it also could have been much worse. Fortunately, for investors, the decision does not raise the barrier for securities fraud cases unreasonably high, and meritorious cases should continue to survive motions to dismiss and preserve the rights of investors to seek redress in the courts.

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