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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.

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

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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.

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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 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 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.

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

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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 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" authored by Jeffrey Leibell and Adam Wierzbowski, 2nd Quarter 2007 issue.

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 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

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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, 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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