Report

Of

Roundtable Discussions

On

Class Action Reform

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Duke University

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This report summarizes the discussions among over fifty participants in the February 2, 2007 roundtable convened by the Institute for Law and Economic Policy ("ILEP")[1] and the Duke University School of Law that focused on important issues raised by various studies that have called for significant reforms in the conduct of securities class actions. The invited participants were selected because of their broad experience as practitioners, academics, and policy makers to assure as wide a spectrum of views on the future direction of regulation. Participants included past and current SEC Commissioners; a past SEC Director of Enforcement; a former SEC Chief Accountant; the past Chairman of PCOAB; Chief Counsel to the Congressional Committee that wrote the Sarbanes-Oxley Act; and the Director of the Committee on Capital Markets. A list of the roundtable participants and their affiliations appears in the appendix to this report.

The roundtable by itself was not intended to create policy positions with regard to any of the subjects discussed. Instead, its purpose was to explore the issues raised in "Interim Report of the Committee on Capital Markets" and "McKinsey & Company Sustaining New York's and US' Global Financial Services Leadership." This summary is therefore not intended to represent a consensus, or even all views expressed. Rather, it summarizes positions expressed.

Impact of SOX

Financial reporting practices have improved since 2001, due to a variety of initiatives ranging from improved corporate governance introduced by heightened listing requirements; the positive impact of the Sarbanes-Oxley Act of 2002 ("SOX"); and

[1] ILEP is a non profit entity that formulates policy questions on issues involving the administration of civil justice within the American legal system. Its focus includes the legal protection of consumers and the protection of the public interest.

strengthening of the SEC by expanding its legislative mandate and staff. The volume of restatements in recent years is further testament to not just the deferred maintenance in financial reporting that needed to be, and is being, addressed, but also the greater independence in financial reporting today due to improvements in audit committees and SOX's severing the ties between management and the firm's accountants. The decline in restatements in the years after firms became SOX compliant is indicative of the legislation's positive impact.

Real issues continue with independence, such as the propriety of auditors providing significant tax consulting advice to their audit clients. Also, smaller firms that are still exempt from the internal control attestation requirements of SOX nonetheless account for a significant portion of current restatements. Although SOX has raised reporting costs for public companies which are measurable, the benefits of SOX and other regulatory developments are less easy to calculate. However, the volume of restatements, mergers and acquisitions, initial public offerings and the buoyancy of the stock market are all consistent with the thesis that SOX and other developments have had a positive impact on U.S. capital markets.

Moreover, data indicates that companies with poor reporting practices as gauged by, among other factors, restatements and qualifications of their financial reports related to weak internal controls are systematically weaker performing companies when compared to a matched sample.

In the last two years, there has been a dramatic decline in the number of securities class action filings (as well as class actions focused on auditors). This data contradicts the widely-publicized reports of a securities class action epidemic, and the notion that

further contraction of the Big Four audit firms is likely threatened by securities class action litigation against auditors. Indeed, in 2006, only one class action had been filed against an auditing firm.

<u>SOX Related Costs</u>

Reporting costs have increased significantly since the enactment of SOX. Higher reporting costs must be placed in context. Enron's and Worldcom's collapse caused nearly 26,000 workers to lose their jobs and caused investor losses approaching one-quarter of a trillion dollars. Add to this a virtual multitude of other financial failures all linked to fraudulent reporting practices. We should therefore appreciate the confidence investors can have in our markets as a result of SOX.

A non-trivial portion of the cost increase relates to poor implementation of the new internal controls requirements by regulators and the auditing profession. Much of the cost increase also relates to issuers installing internal control features that good business practices would have counseled, but the firms failed to previously maintain.

In sum, the costs are observable, but the benefits are less visible so that the political debate, as usual, appears to focus on only one half of the cost-benefit divide. Moreover, there has been a good deal of misinformation, both in the U.S. and abroad, about the requirements of SOX and U.S. securities laws to build the case for "reforms" to prevent erosion of U.S. capital markets.

We now seem to have moved past these various implementation problems so that we might take a more reflective and positive view toward SOX and particularly the once infamous § 404. As we move forward, there is some serious unfinished business. Clear and coherent regulation of analysts and related conflict of interest issues is needed.

Shareholder rights remain an important, but unaddressed, component of trustworthy financial reporting. Moreover, thorny issues regarding regulation of small and micro-cap firms must be addressed, since such firms tend to have the weakest internal control systems, and a greater likelihood of financial fraud.

It was suggested that SOX related audit costs could be reduced if quantitative materiality guidelines were issued. In response, it was contended that many frauds start out small, perhaps well within the objectively determined materiality standard, so that qualitative, even risk-based, criteria are more likely to discourage fraud. Moreover, quantitative measures of materiality, once understood by the unscrupulous managers, could provide a roadmap by which to fly below the radar screen. And, in some areas, such as the integrity of management, the dollar amount involved is at most a secondary consideration in assessing the likely importance of reporting the event to shareholders.

At the same time, most financial frauds are not the product of managerial indiscretion but rather end-of-the-quarter pressures to meet analysts' expectations. Internal controls are thus arguably better directed towards conditions at the firm that can facilitate financial reporting abuses, and therefore should not be preoccupied with conflict of interest issues involving trivial sums that though small, nonetheless impugn management's integrity.

US Markets Compared to Foreign Markets

The U.S. share of IPOs relative to that of foreign markets has declined in the last few years. It is uncertain whether this is the result of disincentives to U.S. listing due to foreign firms' fears of SOX related costs and expenses to class actions; or is the continuation of a pre-SOX trend that accompanied the maturation of foreign markets; or

reflects the unsuitability of certain companies for U.S. listing; or is a result of a desire to issue securities in home-related markets.

There is a glaring difference between the U.S. and other countries in terms of the frequency and magnitude of both private and public enforcement (and their related sanctions). One explanation for this difference is the stronger shareholder rights that exist in many markets, such as the U.K., than exist in the U.S. But the relative attractiveness of foreign markets compared to U.S. markets can be attributed to factors other than the greater litigation exposure in the U.S. The quality of those foreign markets have markedly improved, and their liquidity, efficiencies and inherent risks have become, in some instances, comparable to U.S markets. (Though this is not the case with the much ballyhooed London Alternative Investment Market (AIM) which even from a relatively short-term analysis has yielded abysmal returns for its investors.)

A note of caution was voiced regarding how to consider these issues: one needs to take a longer view than a shorter one or two year review of market developments. That is, before considering whether a decline in IPO's or cross listings in recent years is the "canary in the mine" signaling a dire warning, a longer and broader view may suggest that the canary has just nodded off briefly. The SEC is in a strategically located position to exercise such a long view and has ample rulemaking power to grapple with changes that it believes appropriate and necessary.

Federal v. State Enforcement of Securities Laws

A central focus in moving toward the optimal level of deterrence of fraudulent market practices and efficient compensatory mechanisms for investors is vigorous public enforcement by the SEC. In appropriate cases, this public enforcement can be a criminal

prosecution by the Department of Justice. Historically, there had been lax Department of Justice enforcement outside of New York City. This pattern changed after Enron.

There is a question whether state blue sky administrators and attorneys general should be preempted from bringing securities enforcement actions altogether. There is a problem when multiple regulators pursue enforcement actions against the same respondent. The problem transcends enforcement and reaches every aspect of the regulatory enterprise. The U.S. is long overdue for a sweeping consolidation of financial market regulators. Greater coordination and cooperation is called for and perhaps some mechanism can be developed to "referee" competing enforcement agencies to prevent harmful piling on that can occur. Moreover, it may not be wise for the regulatory policy of our national capital markets to be set through enforcement actions by State Attorney Generals.

The problems with multiple agencies engaged with enforcement is more likely to manifest themselves at the settlement-sanction stage than in either the detection or investigation stage.

At the same time, redundancy in enforcement authority and effort has many positive benefits and reflects the political reality that the primary regulator, the SEC, historically and even presently is insufficiently funded. Earlier in the decade the SEC was initially prodded to consider regulations on possible abuses by stock analysts only after the 2004 global settlement with investment banking firms where the New York Attorney General played a central and public role. To date, however, the SEC has not proposed the promised rules. The regulatory competition debate and history may yield support for strong and even active state enforcement. With broad preemption, the

anointed regulator enjoys a monopoly which may cause suboptimal performance, particularly when the SEC and DOJ are beholden to Congressional budgeting constraints.

<u>Government v. Private Enforcement of Securities Laws</u>

On the civil side, there are multiple bases for complaint that securities class action suits do not efficiently deter or compensate. Consideration of how SOX's Fair Fund Provision is performing as an alternative is warranted.

A suggestion was made that recoveries in private cases be limited to disgorgement unless investors can prove reliance on the specific misrepresentation (thereby limiting recovery in fraud on the market cases). This was met by several objections, including the adverse impact on indexed investors; erosion of the well-perceived view that investors of all types should be able to rely on the integrity of the market price; the abundance of legitimate indirect reliance (upon financial columnists and analysts); and the likely reduction of private enforcement incentives due to the small amounts recoverable in relation to the large costs of litigation.

The measure of damages in private actions otherwise warrants examination. There are issues of circularity, *i.e.*, whether there is a zero-sum if diversified investors find themselves to be both winners (*e.g.*, able to sell a security at an inflated price due to earlier fraudulent reporting) and losers (*e.g.*, suffering a decline in a held security due to fraudulent reporting). (See further discussion of circularity in afternoon session at pp 11-13.)

On the other hand, the existence of private actions, as a supplement to SEC enforcement actions, provides a measure of reassurance to investors akin to an insurance policy that should fraud arise there will be some recompense. The contemporary

arguments calling for curtailing the scope of private suits do not address the long-stated position of the SEC and Congress that private suits are necessary supplements to SEC enforcement actions.

Accountability Of Individual Officers For Securities Violations

There is also a need to place responsibility on the very actors who designed the fraudulent scheme and benefited, directly or indirectly, from it. To this extent, unwavering obeisance to entity liability (*i.e.*, that corporations should be held accountable for wrongdoing by senior officers) is unlikely to lead to optimal deterrence or sensible compensation of injured investors. At the same time, many entities are unlikely to adopt steps to enhance their compliance with the law and improve the quality of their financial reporting procedures without a serious threat of entity responsibility.

One step toward this goal is for the SEC to develop a strong and coherent policy for enforcing its "claw back" authority (*i.e*., repayment of compensation received as a result of inflated results) under SOX § 304. There needs as well to be some greater use of criminal enforcement against individuals responsible for fraudulent reporting and, at the same time, serious reconsideration of the scope of respondeat superior criminal liability and collateral effects on the entity should it be held vicariously responsible in a criminal action. At the same time, it is often difficult to isolate the culpable manager.

Afternoon Session

Analysis of Settlements

The conference received data from a series of papers that provided important empirical insights regarding securities class actions. Not surprisingly, settlements are sensitive to the size, scope and complexity of the underlying fraud. Although companies on average that are the target of securities class actions have been larger post-SOX, the number of such actions has been dramatically declining. The decline of the number of such actions may suggest that enhanced SEC enforcement sanctions have become a more suitable deterrent than private class actions.

There continues to be unease whether federal judges are providing adequate oversight to securities class actions. There are settlements that are approved that are inappropriately lax both in their failure to recover for injured investors ample sums and, more particularly, to hold individuals as opposed to the entity or its insurer responsible for a substantial or any portion of the settlement amount.

Analysis of Post Corrective Statement Price Drops

One study presented found that when a company disclosed its need to restate its historic results, about 25% of the resulting stock price decline was attributable to the market correcting for the misrepresented results, and nearly 66% due to "reputational loss", *i.e.*, loss of management integrity and the likelihood that the company's ability to do business in the future would suffer as a result thereof. *See* Jonathan M. Karpoff, D. Scott Lee & Gerald S. Martin, The Cost of Cooking the Books, U. Wash. Working Paper (Dec. 31, 2006).

Circularity Thesis

Another study examined the magnitude of the "circularity" issue. *See* Anjan V. Thakor, Jeffrey S. Nielsen & David A. Gulley, The Economic Reality of Securities Class Action Litigation, Working Paper U.S. Chamber Institute for Legal Reform (Oct. 26, 2005). Theoretically large institutional investors who hold broad diversified portfolios are likely to have sold shares in companies that inflated financial results before disclosure thereof, as often as they hold shares in other companies when the truth is revealed. According to the theory, the well-diversified investors' losses in the latter will be netted out by the gains in the former. The paper's data reflects that this is partially true. About 20% of estimated losses are not netted out by gains. This difference was attributable to companies issuing new securities while reporting inflated results.

The circularity thesis was challenged on several levels. Is it appropriate to net losses incurred against gains that holders are not required to give up? For example, assume Institution A purchased Security X at $10 and that price was inflated by $3 due to fraudulent reporting. Six months later Institution A sells Security X to Institution B for $10. Subsequent to the sale, Security X declines $3 after a corrective disclosure. Why as a matter of public policy would we conclude that Institution B has not suffered recoverable damages? Similarly, if in a parallel trading situation in which we reverse the positions of Institutions A and B trading security Y, why would we not conclude that both have suffered recoverable damages of $3 per share regardless of any profit they may have inadvertently received on the other investment?

The circularity issue for securities fraud cases may not be any different for other types of litigation. Much commercial litigation moves money from one set of stockholders to another so that the diversified shareholder of companies locked in

antitrust, patent infringement, or contract disputes pose the same sort of netting issues. But there we see the issue as one of affirming principles that underlie our commercial system. We might well find this is the case with private securities litigation as well. Arguably, reforms based on fears of our competitive position *vis-à-vis* other markets have the wrong focus. Reforms should be judged by their inherent merits in addressing the social calculus of more trustworthy reporting versus the incremental cost. If reforms are adopted to bring our markets more in line with those of foreign markets, this social calculus is at risk. More generally, the circularity argument may merely restate the proposition that, in terms of price inflation caused by false reporting, fraud on the market as a whole isa zero sum game. If, in the preceding illustration, there were only Institution A and Institution B, then collectively we could conclude that neither suffered a loss since each was able to sell to the other a security that was inflated by $3. The reality though would appear to be quite different from a zero-sum, given that settlements compensate for only a portion, not entirely, for losses sustained. By way of example, one of the nation's largest public pension funds annually received from settlements $5-10 million. This was dwarfed by the annual losses due to securities fraud of nearly $200 million.

While this suggests that the compensatory justification for securities class actions is greatly weakened in the case of institutional investors, it was countered that one problem is that the damage model used in such empirical studies systematically overstates damages. Thus, settlements appear to be proportionally small relative to potential recovery. Moreover, aggregation of numerous settlements runs the risk of lumping together less meritorious cases or resource starved defendants with cases producing substantially higher recoveries relative to provable losses.

The deterrent effects of private suits need to be kept in mind, particularly as one considers reforms that may erode their effects. It is difficult though to capture the deterrent value of private suits. It might help to examine what happens to those responsible for the fraudulent reporting. Of the 2207 executives named as respondents in SEC enforcement actions through September 2006, 25% were also criminally indicted; 40% were barred from serving as officers or directors of public companies; and 93% lost their jobs. *See* Jonathan M. Karpoff, D. Scott Lee & Gerald S. Martin, The Consequences to Managers for Cooking the Books, U. Wash. Working Paper (Jan. 29, 2007).

As for foreign issuers, we might well take an approach of accommodations for foreign issuers on points where we believe their home country has a greater stake than we in the outcome. At the same time, improving corporate governance needs to be in the front of any public debate about improving the trustworthiness of financial reporting. One area needing improvement in the current system is speeding up the process to settlement and reducing the costs of the process.

Arbitration

Several recent studies have urged that shareholders should be able to approve via a charter amendment, procedures such as class action arbitration for resolving any dispute against the issuer for false reporting. The presumption is that this would reduce the costs of court-based litigation. It was questioned whether such a clause could be binding against an investor who purchased shares *after* the clause had been inserted into the issuer's charter. IPO investors' waiver would arguably be problematic. Equally problematic is whether shareholders or their shares that vote against the adopted charter

provision should, for purposes of the securities laws anti-waiver provision, be deemed to have consented in any legal sense to the provision adopted by the majority of their fellow shareholders.

Moreover, before securities class actions could be adapted to arbitration, additional methods would have to be developed for discovery disputes in that forum given the imbalance of information between the plaintiffs and defendants. It also remains to be seen how motions to dismiss will be addressed.

Also, corporate governance would need to improve to assure shareholder rather than managerial self-interest drives a board's recommendations regarding charter amendments providing for an alternative dispute resolution mechanism. Improvements would be directed toward strengthening director independence via a meaningful shareholder nomination process and allowing shareholders to initiate a charter provision that would repeal or amend the charter's existing ADR provision.

Auditor Exposure

The disappearance of Arthur Andersen has triggered a public debate focused on the fragility of the accounting profession, or at least the Big Four who dominate the audits for Fortune 500 firms. This concern runs the risk of breeding moral hazard on the part of the Big Four by either creating the false hope they are too big to fail, or introducing legislative protections such as liability caps. As for caps, it bears remembering that accountants already enjoy protection (for non-knowing violations) via proportionate liability that was introduced in 1995 by the PSLRA. Moreover, Arthur Andersen shows that the greatest exposure national accounting firms face is not civil liability but rather criminal indictment.

The general sense is that post-SOX, accounting firms have been doing a much better job, as reflected in the extremely small number of cases filed recently against accounting firms, as well as the decline in securities fraud cases overall. Moreover, an important contribution of SOX is the systematic review of internal controls which provides a much stronger prophylactic for deterring fraud and a richer tapestry by which the auditor can assess the risks of fraudulent reporting.

At the same time, there remains the fact that accountants continue to face horrendous liability for their large market cap clients, and have virtually no choice but to settle if their motion to dismiss fails. Thus, absent a meaningful *ex ante* limit on liability, accountants, and others, cannot realistically avail themselves to the central feature of our justice system, a trial on the merits. A case with provable losses approaching $8 billion in which the accountants believe they have a ninety percent chance of success still yields a threat of $800 million, which would be devastating to the firm.

Moreover, the frequency with which accountants get sued may not turn on the quality of the audit but on the vagaries and viability of the client. An auditor whose client is experiencing financial distress may do better to sever the relationship, not do a better audit. At the same time, numerous financial reporting failures involving accountants occurred when there was indisputable evidence the auditors at the highest level of the auditing firm were fully aware of the reporting violation but nonetheless certified the financial statements. Is a cap politically acceptable or socially justified in such instances?

In any case, continuing to improve the quality of the audit team and the auditors being increasingly more sensitive to signs of reporting abuses via various risk-based

measurements, are likely to produce a good deal of protection for auditors while advancing the public interest more than a cap on liability. As seen earlier, other steps to reduce auditor risk is improving corporate governance and good practices should call for audit firm rotation at least once a decade.

End of Program