Submission to the Securities and Exchange Commission's
<u>Advisory Committee on Improvements to Financial Reporting</u>

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Thank you for inviting me to appear before the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission (the "Advisory Committee") at its March 13, 2008 public meeting at the University of California - San Francisco, and for the opportunity to submit this written statement in advance of that meeting. I am hopeful that my views will be helpful to the Advisory Committee in further considering the proposals set forth in its February 14, 2008 progress report (the "Progress Report").

I. BACKGROUND / INTRODUCTION

I am a partner at Bernstein Litowitz Berger & Grossmann LLP, a fifty lawyer firm with its principal offices in New York City and San Diego. Our firm serves as securities litigation counsel for numerous institutional investors, large and small, public and private, with total invested assets approaching one trillion dollars. Our clients' beneficiaries include active and retired school teachers, policemen, firemen, and other public servants, as well as carpenters, iron workers and operating engineers. Many of our clients are active in bringing litigation when they believe they have been victimized by fraud in the capital markets; others are close observers of the markets and the litigation landscape. All are keenly interested in ensuring that the capital markets in which they invest their beneficiaries' money operate with integrity, and they view the role filled by accountants – both those employed internally by issuers and those outside auditors that serve the role as public gatekeeper – as critical in furthering accurate and reliable financial reporting which is crucial to fostering the trust and confidence that underpins our capital markets.

To give the Advisory Committee some sense of my standing to comment on such matters, let me say briefly that I have been litigating cases involving alleged violations of the securities laws for over twelve years. I am currently prosecuting several private securities class actions that revolve around the alleged misapplication of accounting standards, and the alleged failure of the outside auditors to prevent these accounting manipulations. Two of my current matters concern bankrupt issuers Refco, Inc., involving auditor Grant Thornton LLP, and New Century Financial Corp., involving KPMG LLP. I have also taken a leading role in past private securities class actions involving alleged accounting fraud resulting in significant shareholder recoveries in cases against: (i) Raytheon Company and PricewaterhouseCoopers LLP, with total recoveries of $460 million; (ii) MicroStrategy, Inc. and PricewaterhouseCoopers LLP, with total recoveries valued in excess of $150 million; and (iii) i2 Technologies, Inc. and Arthur Andersen LLP, with total recovery of $87.75 million. In addition to holding auditors accountable for their alleged malfeasance, these cases involve other market actors such as issuers, corporate officers and directors, investment banks and, in some cases, attorneys.

Over the course of my career, I have had significant interaction with the auditing profession. While I believe that the vast majority of auditors seek to comply with their legal, ethical and professional obligations, I have had a unique opportunity to see how various influences and incentives can adversely affect an auditor's work, as well as the demanding burden of proving accounting fraud in such circumstances. Importantly, I am often in the position of investigating alleged accounting fraud and analyzing specific facts and circumstances in comparison to then-existing GAAP and auditing standards.

It is with this perspective that I address the Advisory Committee's Developed Proposal 3.4, regarding standards of professional judgment as set forth in its February 14, 2008 Progress

Report. I will also briefly comment on Developed Proposals 3.1, 3.2 and 3.3 regarding restatements. The views set forth herein are my own views and I do not purport to speak on behalf of members of my firm or my firm's clients.

II. <u>COMMENTS ON DEVELOPED PROPOSALS IN CHAPTER 3</u>

A. <u>Generally</u>

I strongly agree with the notion that "the financial reporting system should give pre-eminence to the needs of investors, while not ignoring the interests of other relevant parties." (Progress Report at 2.) Who would quarrel with that? The key purpose of public financial reporting, after all, is to give investors and others who rely on the financial statements an accurate portrayal of a company's financial condition.

Unfortunately, the proposals in Chapter 3 of the Progress Report will not serve that purpose. They appear to be designed more to protect issuers and auditors from regulatory oversight and civil liability than to promote the interests of investors. As a result, I believe that the interests of investors will suffer from these proposals by making it even more difficult to regulate and pursue fraudulent accounting practices, thereby encouraging even more "aggressive" accounting of the kind that produced such terrible consequences in the first half of this decade. Moreover, although one of the main themes of the Progress Report is the need to reduce complexity and increase uniformity of accounting results, Chapter 3's proposals will, in my view, lead to greater complexity and confusion, less transparency, and less uniformity in individual companies' financial disclosures. Below, I explain in more detail why we have come to these conclusions.

B. <u>Developed Proposal 3.4</u>

Developed Proposal 3.4 calls for a "judgment framework" for accounting and auditing. This framework "would include choice and application of accounting principles, as well as the estimates and evaluation of evidence related to the application of an accounting principle therein." The framework would consist of a checklist of nine factors to be considered in exercising the accountant's and auditors "professional judgment" that is "based on a crucial and reasoned evaluation made in good faith." Further, the Advisory Committee proposes to replace "rules-based" standards and to substitute "principles-based" standards, premised on the notion that such a move would further the interests of investors:

> Investors will benefit from more emphasis on "principles-based" standards, since "rules-based" standards … may provide a method, such as through exceptions and bright-line tests, to avoid the accounting objectives underlying the standards. If properly implemented, "principles-based" standards should improve the information provided to investors while reducing the investor's concern about "financial engineering" by companies using the "rules" to avoid accounting for the substance of a transaction.

(Progress Report at 62.)

On the contrary, I am convinced that a move away from specific accounting rules and toward a regime governed only by general "principles" would be harmful to investors. It would make enforcement of meritorious cases of accounting fraud even more difficult for the simple reason that it is easier to prove that a company broke a rule than to prove that a company's "judgment" was unreasonable.

More often that not, the problem for investors is not that companies use specific rules to avoid accounting for the substance of a transaction. The problem is that companies often break the rules or stretch their interpretation beyond recognition. In the massive accounting scandals of the last decade, which cost investors hundreds of billions of dollars and led to the passage of

Sarbanes-Oxley and the creation of the PCAOB, the perpetrators simply broke the rules, and auditors knowingly or recklessly let them do so.

In the *WorldCom* case, for example, the perpetrators capitalized line costs when the rules clearly forbid doing so.[1] Similarly, the *Enron* case involved breaking the rules governing off-balance-sheet entities – for example, by the use of purportedly independent outside investors who were not, in fact, independent.[2] Arthur Andersen, the auditor in both cases, recklessly failed to insist on the more detailed disclosures regarding WorldCom's capitalization of line costs[3] and the off-balance sheet risks associated with Enron's thousands of SPEs (special purpose entities),[4] relying instead on the professed "judgment" of the corrupt management of both companies. Without specific rules governing those companies' accounting "judgments," those perpetrators could have had an "out" by arguing that what they did was reasonable under their particular circumstances – especially if they and their auditors had carefully ticked off the "Critical and Good Faith Thought Process" checklist proposed on page 69 of the Progress Report. The proposed "judgment framework" would have made it more difficult to convict the perpetrators and to achieve a civil litigation recovery for defrauded investors.

Our concern is that financial statements will be *less* accurate and reliable if specific rules are discarded and if there is less opportunity to challenge, through litigation or regulatory enforcement, accounting judgments of issuers and auditors. This will be the inevitable result of the proposed move from rules to principles. On this point, we note that the Advisory Committee cites no empirical evidence (for example, comparing the practice with IASB standards with the

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[1] *See In re WorldCom, Inc. Sec. Litig.*, 294 F. Supp. 2d 392, 401 (S.D.N.Y. 2003).
[2] *See In re Enron Corp. Sec., Derivative & Erisa Lit.*, 235 F. Supp. 2d 549, 614-15 (S.D. Tex. 2002).
[3] *See In re WorldCom, Inc. Sec. Litig.*, No. 02 Civ. 3288(DLC), 2003 WL 21488087, at **4 (S.D.N.Y. June 25, 2003) (denying Andersen's motion to dismiss); *In re WorldCom, Inc. Sec. Litig.*, 352 F. Supp. 2d 472, 497 (S.D.N.Y. 2005) (denying Andersen's motion for summary judgment).
[4] *See In re Enron*, 235 F. Supp. 2d at 681.

situation under FASB) to support the notion that the proposed judgment framework would result in less manipulation.

The Advisory Committee overlooks the enormous incentives to companies to report favorable quarterly and annual results. It will be even easier to succumb to those incentives if there are no specific rules one has to break or interpret creatively in order to achieve such results. As stated so forcefully by the letter from the Consumer Federation of America of January 16, 2008 to Chairman Cox, "the combined threat of tough enforcement actions and civil litigation have provided an essential check on managers who have a strong incentive to keep bad news off the books and auditors who have been all too willing to let them." The only antidote to the pressure to misstate results is pressure *not* to misstate results in the form of strong and predictable enforcement.

In addition, the proposed judgment format will make it more difficult for responsible auditors to challenge management, again because it is easier to point out the misuse of a rule than the exercise, however unreasonable, of "judgment." This is true not only as to outside accountants, but perhaps even more so with management accountants, who, as noted by the Institute of Management Accountants, bear the responsibility for "building quality in" the financial reporting process before the external auditors' roles begin.[5]

Developed Proposal 3.4 essentially will immunize issuers and auditors from meritorious regulatory oversight and civil liability. This intent is explicitly stated at page 66, which refers to a "safe harbor for the exercise of judgment in accordance with a specified framework" that "would seem to provide greater support to auditors and preparers than a statement of policy."[6]

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[5] Institute of Management Accountants Position Statement on Professional Judgment, February 4, 2008, submitted to the Committee's website.

[6] The Advisory Committee is correct, however, to doubt that the SEC would have the legal power to adopt such a safe harbor. I address the safe harbor issue further in Part III of this submission.

Further, the Advisory Committee states: "While both auditors and issuers appear supportive of a move to less prescriptive guidance, they have expressed concern regarding the perception that current practice by auditors and regulators in evaluating judgments does not provide an environment in which such judgments may be generally respected." (Progress Report at 62.) In other words, issuers and auditors do not want to be pursued by regulators or sued civilly when their judgments are suspect.

There is no evidence – and common sense suggests otherwise – that investors' interests would be served by an auditor's safe harbor. Investors care about accurate financial statements. If financial statements are accurate, then auditors' judgments will indeed be respected.[7]

A de-emphasis of specific rules also will lead to less uniformity of accounting results among various issuers. Different accountants can reasonably reach different answers when applying the same principle, as the Advisory Committee recognizes. This is of course true even now. It will be even more so with a move toward more principles-based accounting. This result will not be good for investors. The financial statements of similar companies will be less comparable because two companies may apply the same principle differently, even though both may be reasonable. Consequently, if the interests of investors are to be "paramount," financial statements will have to be *more* complex than they are now. Issuers will have to devote far more space to explaining their own accounting policies, not just generally, but with respect to every line item that depends on the accountant's judgment derived from general principles. Otherwise, analysts and investors will not be able to compare the results of companies in the same industry.

[7] As pointed out by the AFL-CIO's comment letter of February 10, 2008, the executive director of the Center for Audit Quality, at the February 4, 2008 hearing of the Treasury Department's Advisory Committee on the Auditing Profession, the proponents of such a rule could not provide a single example where auditors were inappropriately second-guessed in the major corporate scandals of the last few years. *See* transcript of hearing of Advisory Committee on the Auditing Profession, Feb. 4, 2008, at 95-96.

The general concern with rule manipulation also is overstated. Present rules provide for departure from the rules if adherence would make the financial statements misleading. For example, the AICPA's Code of Conduct Rule 203 provides that members may state that the financial statements are in conformity with GAAP, even when they contain a departure from a GAAP principle, if the member "can demonstrate that due to unusual circumstances the financial statements or data would otherwise have been misleading" and if the member describes "the departure, its approximate effect, and why compliance with the principle would result in a misleading statement."

Further, even if a bright-line rule is susceptible to manipulation, that problem can be solved by rewriting the rule rather than discarding rules-based standards. The Advisory Committee itself provides examples elsewhere in the Progress Report of rewriting rules to prevent bright-line manipulation.[8] Indeed, the Progress Report's recommendations in Chapters 1 and 2 as to specific GAAP rules seem at odds with its preference, in Chapter 3, for principles-based accounting.

We believe that there are truly effective ways to reduce incentives to misstate financial results. Some obvious methods would be minimizing management compensation, including bonuses and options, based on short-term financial results, requiring managers to return compensation based on results that turn out to be false or materially misstated, and eliminating auditors' financial dependence on the individual companies they audit. Further, auditors'

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[8] The Progress Report at pages 17 and 23-24 refers to the rule regarding lease accounting. The specific rule is FAS 13, which provides that the lessor shall account for a lease as a capital lease (and thus as the acquisition of an asset) if the present value of the minimum lease payments equals or exceeds 90% of the fair value of the leased property; otherwise it is treated as an operating expense. As a result, leases are commonly leased at 89.9% of the fair value of the leased property. To avoid this kind of "bright-line" manipulation, the rule could simply be rewritten, perhaps in the manner suggested at page 24 of the Progress Report. On the other hand, a principles-based solution would not solve the problem of failing to properly account for leases. The predecessor rules to FAS 13, which were closer to principles than bright-line rules, left it up to the reporting company to determine whether the lease had the aspects of a capital asset or not. As a result, leases were virtually never capitalized, because it was not in the reporting company's interest to do so.

potential exposure to civil liability for financial misstatements would be reduced by recognizing civil liability for secondary actors who knowingly participate in those misstatements.[9] (We recognize, of course, that such measures are not within the scope of the Advisory Committee's work.)

Finally, it should be noted that the accounting profession currently has principles and specific rules, and accountants and auditors have to exercise their professional judgment every day. Thus, it is unclear what the proposed "judgment framework" would change when there is a material error in a financial statement. As noted by the comment letter of February 10, 2008 from the AFL-CIO, if the numbers are within the scope of a principle, then the current regime protects the issue and the auditor. If the numbers are outside a principle, or violate a rule, it does not matter what level of professional judgment was involved. The "judgment framework" may provide more explicit guidelines than are currently provided for determining whether an issuer or auditor has exercised good faith in ambiguous situations. But other than providing a safe harbor immunizing issuers and auditors from civil liability, it is unclear how the proposed framework would otherwise materially change issuers' and auditors' duties.

In summary, Developed Proposal 3.4 is bad for investors because it would make pursuit of fraudulent accounting by regulators and civil litigants even more difficult (thereby making accountants less accountable); make it more difficult for competent, honest auditors to challenge management's "judgment" (thereby encouraging fraudulent accounting); and reduce the transparency, comparability and uniformity of financial statements while increasing their

[9] As noted by John P. Coffey, a co-managing partner of this firm, at a February 4, 2008 hearing of the Treasury Department's Advisory Committee on the Auditing Profession, auditors' exposure to civil liability actually has increased as a result of the recent decision of the Supreme Court in *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S.Ct. 761 (2008), which makes it easier for secondary actors to lie to auditors because they are far less likely to be held accountable for such lies. *See* transcript of hearing of Advisory Committee on the Auditing Profession, Feb. 4, 2008, at 108-09.

complexity (thereby further harming investors' interests). Ultimately, this will result in more scandals of the kind that plagued the markets in the first half of this decade. The only beneficiaries, in the short run, will be dishonest managers and compliant auditors.

C. Developed Proposals 3.1, 3.2 and 3.3

Developed Proposals 3.1, 3.2 and 3.3 consist of eleven distinct proposed items concerning restatements of past financial statements. Some of these items merely confirm general principles already well recognized, such as the statement that materiality "should be judged based on how an error affects the total mix of information available to a reasonable investor."[10] As discussed below, one of them would, in our view, benefit investors. However, many of the proposals, as well as the proposals' overall approach, suffer from flaws similar to those discussed above with respect to Developed Proposal 3.4.

The basic problem, according to the Advisory Committee, is that there are just too many restatements. Creating barriers to enforcement and civil litigation will not reduce restatements. To the contrary, more reliable accounting will reduce both restatements and litigation. The recent increase in restatements indicates to me that managers and auditors indeed have become more careful as a result of the Sarbanes-Oxley reforms. This is obviously good for investors.

In general, the goal of reducing restatements serves no discernible investor interest. The Advisory Committee's proposals in this area, again, appear designed not to benefit investors but to make it easier for companies to avoid restating financial results and thereby avoid regulatory "second-guessing" and investor litigation. Moreover, it is likely that under the current regime, restatements will decrease over the next few years as companies' increased carefulness, encouraged by Sarbanes-Oxley and the PCAOB, reduces the need to restate.

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[10] The Supreme Court adopted this definition of materiality thirty-two years ago, in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

More importantly, the proposals are generally bad for investors. For example, expecting management to identify with the "needs of current investors" is unrealistic because the interests of management are generally not aligned with the interests of investors. (If they were, we would have far less need of accounting rules in the first place.) Thus, as discussed in more detail below, asking management to base its determination on the "needs of current investors" is really a way for allowing management to get away with not restating past financials when, under the current regime, they would be required to do so. Importantly, reducing restatements by reducing the accuracy and reliability of financial statements will only cause more harm to investors in the long run, increased regulatory oversight, and more rather than less civil litigation.

If the goal is to reduce securities litigation (a recurrent subtext of Chapter 3), reducing the number of restatements will not bring that goal any closer. More accurate and reliable financial statements will. For example, loss reserves are often adjusted without restatement. Nevertheless, when reserve adjustments are sudden and large, they raise legitimate questions about prior financial statements and internal controls, reduce investor confidence, and often lead to litigation. That no restatement is issued, in such cases, does not eliminate the litigation.[11]

Several of the proposed items clearly will give managers and auditors more room to arbitrarily decide the time and manner of disclosures. An example is the proposal that there may be no need to file restated financials "if the next annual or interim period report is being filed in the near future and that report will contain all of the relevant information." (Developed Proposal 3.2, Progress Report at 57.) As the letter from the Consumer Federation of America of January

[11] *See Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 83 (1st Cir. 2002) (holding that the failure of a company to restate its financials does not eliminate the inference of an accounting error because "[t]o hold otherwise would shift to accountants the responsibility that belongs to the courts. It would also allow officers and directors of corporations to exercise an unwarranted degree of control over whether they are sued, because they must agree to a restatement of the financial statements"). There were no restatements in the Raytheon Company litigation mentioned above.

16, 2008 to Chairman Cox put it, "it doesn't take a genius to figure out that companies will try to get as many restatements as possible handled this way."

Another example is the following proposal:

> The determination of how to correct a material error should be based on the needs of current investors. For example, a material error that has no relevance to a current investor's assessment of the annual financial statements would not require restatement of the annual financial statements in which the error occurred, but would need to be disclosed in an appropriate document, and, to the extent that the error remains uncorrected in the current period, corrected in the current period.

(Developed Proposal 3.2, Progress Report at 57.) This proposal gives incredible leeway to management and auditors, with no discernible benefit to investors. In the first place, as noted above, management is ill-placed to determine the "needs of current investors" – particularly, if it involves self-reporting the nature of prior accounting irregularities. Management's interest lies in not restating. There is no doubt, therefore, that management is likely to find that the "needs of current investors" do not require restatement of past financials whenever there is the remotest rationale for so finding. Further, the only reason to report prior errors in "an appropriate document" or in the current period is to avoid the stigma of the word "restatement." It would harm investors by increasing confusion and making it more difficult to review and analyze prior financial statements. The proposal is also incoherent. If an error is material, how can it possibly have no relevance to a current investor's assessment of the annual financial statements? If it is not material, why report it at all, in any financial statement? This inconsistency increases the danger that such a rule will be misused.

One more example of a harmful proposal, from an investor's point of view, is the proposal that restatements of interim financials do not necessarily require restatements of the annual financials including the interim period in which the error occurred; rather, the 10-K being filed at the time of the disclosure of the error would explain the discrepancy. This will cause confusion and incoherence with, again, no corresponding benefit to investors. What will happen, once the interim period is restated, is that the interim periods will now not be consistent with the overall annual results. The investor will then have to go to the *current* annual financials to figure out how to reconcile the *past* interims with the *past* annual results. This makes the investor's job harder, not easier. Again, the only point of this proposal appears to be to avoid the stigma to management of restating past annual financials which were materially misstated when issued.

While there are other similarly flawed items in Developed Proposals 3.1, 3.2 and 3.3, these examples should suffice to show why we believe the Advisory Committee's approach to this question does not promote the interest of investors at all.

To summarize, the Advisory Committee's approach to restatements is a solution that will lead to greater problems. It will harm investors by giving management more incentive and more means to manipulate restatements, increasing the complexity of the investor's task of interpreting and analyzing corrected errors, and increasing the likelihood that material errors will not be reported. These outcomes will increase rather than reduce regulatory enforcement and civil litigation. A better approach, from the investor's point of view, would emphasize that management should err on the side of correcting errors in the period in which they occurred, with the comfort that immaterial corrections cause no harm to investors or the company itself.

There is one exception, however. We agree with the Advisory Committee that companies' initial restatement disclosures, as well as their disclosures in the "dark period" between the initial first announcement and the actual restatement should be improved. (Progress Report at 59-60). The Advisory Committee's suggestions on this topic are well taken and will clearly benefit investors by requiring fuller and more complete disclosure about the nature of the error, its impact, and management's response to the control issues and other business repercussions of the error.

D. Conclusion of Comments on Chapter 3

Respectfully, the underlying flaws I see in the Advisory Committee's approach are based on the assumption that the main obstacle to transparent and accurate financial reporting is that issuers and auditors acting in good faith are inhibited from the full and free exercise of their honest judgment by the fear of regulatory second-guessing and litigation. Not only does this assumption ignore the experience of the last ten years, but it is unworkable as a basis for any enforcement regime. The goal of enforcement is to promote good faith reporting by punishing bad faith reporting. Clear rules are required to effectively prosecute bad faith reporting. The vaguer the standards, the harder they are to enforce. Unfortunately, Chapter 3 of the Progress Report is heading in that direction.

III. COMMENTS REGARDING CURRENT LEGAL PROTECTIONS FOR AUDITORS

As noted above, the Advisory Committee mentioned the possibility of a safe harbor for auditors who exercise judgment in accordance with a specified framework. Progress Report at 66. I submit that such a safe harbor would be harmful to investors because it would greatly diminish the threat of enforcement or litigation and would further deter responsible auditors from challenging management and enforcing strictly existing accounting standards. To put this issue in the proper context, I believe it appropriate to briefly explain current civil litigation protections for auditors.

The Private Securities Litigation Reform Act of 1995 ("PLSRA") contains a number of provisions that curtail litigation risks for defendants, including auditors, in private securities actions. Among other things, the PSLRA establishes the most stringent pleading standard in any field of civil litigation in the United States. Moreover, unless and until a federal court determines that a private plaintiff's complaint has met those very high standards, an automatic stay of discovery is in place. In other words, a private plaintiff cannot seek any information from defendants or third parties to support a securities claim until *after* a federal judge has ruled that the plaintiff has already made a strong and particularized showing that a defendant made a misleading statement or omission and, further, that the defendant did so with the requisite fraudulent state of mind, or scienter. The PSLRA also requires that a plaintiff prove at trial that a defendant's violation actually caused the loss of which the plaintiff complains. One of the most significant developments brought about by the PSLRA was establishing a regime of proportionate fault in securities fraud cases that sharply limits the potential liability of defendants unless it can be proven that they knowingly, as opposed to recklessly, committed fraud in violation of the federal securities laws.

A further modification to the federal securities laws, the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), significantly limits the ability of injured investors to bring claims in state court.

Over the past dozen years, courts have applied the PSLRA to further constrain private plaintiffs' ability to recover their losses through securities actions. Significantly, the United States Supreme Court has issued three opinions within the past several years that impose additional obstacles for investor plaintiffs. In *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336 (2005), the Court mandated a standard for pleading economic loss that was tougher than that adopted by many lower courts, and thereby substantially reduced defendants' potential exposure to liability. In *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, 127 S. Ct. 2499 (2007), the Court tightened the requirements for pleading a "strong inference" that a defendant acted with a wrongful state of mind, holding that the allegations in a complaint must paint a "cogent and compelling" portrait of scienter if a claim is to survive. The latest example of this trend is the recent opinion in *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S.Ct. 761 (2008), which limits the ability of investors to hold third-parties accountable for engaging in deceptive acts that they know will be used by a company to falsify its financial results. Each of these decisions further inhibits investors' abilities to pursue private actions to recover for losses suffered as a result of financial fraud. The flip side of these limits, of course, is the reduction of a prospective defendant's potential exposure to possible liability for wrongful conduct. These hurdles are even more substantial when the defendant is an auditor.

The provisions of the PSLRA and SLUSA were intended to curb private securities litigation and weed out weak or frivolous cases, and the record shows that these laws have accomplished that goal. In fact, a review of various public records, including the federal judiciary's PACER website, suggest that relatively few private securities class action cases filed in 2006 and 2007 named auditors as defendants. While not a comprehensive study, our review found eleven securities class actions initiated in 2006, and nine cases in 2007, in which Big Four auditors were named as defendants.

The rate of dismissals of these actions has nearly doubled since passage of the PSLRA in 1995. Between 1991 and 1995, just over 19% of private securities fraud cases were dismissed. This figure increased substantially between 2000 and 2004, when 38.2% of these cases were dismissed. And that does not account for the cases that are never filed by virtue of the PSLRA's deterrent value.[12]

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[12] *See* "Recent Trends in Shareholder Class Action Litigation: Filings Plummet, Settlements Soar," NERA Economic Consulting, Jan. 2007 at 4 (available at www.nera.com). Professor James D. Cox, a securities and corporate law professor at Duke University School of Law, studied 600 class action lawsuits during the decade following passage of the PSLRA and concluded that the statute made pursuing such claims more difficult and that

The last time the audit profession got comfortable with the idea that its litigation exposure was circumscribed after the passage of the PSLRA, the results can be summed up with more than a few examples: *WorldCom*, *Enron*, *HealthSouth*, *Tyco*, *Cendant*, *Adelphia*, *Parmalat*, and others. These massive accounting frauds – which led market watchers to ask plaintively, "where are the auditors?" – caused enormous harm to our financial markets and the country as a whole. While it is not be possible to say with certainty that the PSLRA's barriers were the sole cause of these accounting catastrophes, it would be wrong to dismiss the correlation as a mere coincidence. Indeed, based on what I have seen in my cases, there is compelling evidence that removing or seriously weakening the threat of litigation contributed significantly to the poor audits that were done in the late 1990s and the abdication of the auditor's traditional role as an independent watchdog. Significantly, after Congress passed Sarbanes-Oxley and several of the Big Four firms paid nine-figure settlements to resolve some of the cases cited above, auditors realized again that they could be held liable for their conduct, and the number of accounting frauds has dropped markedly. This recent history offers a lesson too painful to be learned a second time.

"abusive or malicious" filings were difficult to locate. *See* Stephen Labaton, "Businesses seek new protection on legal front," The New York Times, Oct. 29, 2006 (available at 2006 WLNR 18761145) at Note 75. One significant observer of trends in private securities actions opined that the reduction in filings might be traced to "improvements in corporate governance following high publicity filings and settlements such as Enron and WorldCom, along with the passage of the Sarbanes Oxley Act of 2002." *See* "Securities Class Action Case Filings – 2005: A Year in Review," Cornerstone Research, 2006, at 2 (available online at: http://securities.stanford.edu/clearinghouse_research/2005_YIR/2006010301.pdf.).