US Securities and Exchange Commission moves to further limit liability for corporate fraud

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14 February 2007

The US Securities and Exchange Commission (SEC) has taken further steps to limit the liability of corporations and accounting firms that engage in fraud and corruption.

According to an article published in the *New York Times* Tuesday, the SEC has filed a brief in a Supreme Court case urging the court to adopt a legal standard that would make it more difficult for shareholders to win lawsuits charging corporations and executives with fraud. The agency is also considering placing caps on the liability of accounting firms for facilitating fraud.

The SEC is the federal agency responsible for administering securities laws and overseeing corporate regulation.

In the Supreme Court case, *Tellabs Inc. v. Makor Issues & Rights Ltd*, the SEC has filed a brief urging the court to adopt a narrow interpretation of the Private Securities Litigation Reform Act of 1995—the law that is the basis for investor lawsuits against corporations for fraud. The law requires that "in any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall . . . state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."

At issue is what is meant by "strong inference" This is significant because it determines how difficult it is for an investor to charge that an executive or corporation willfully defrauded shareholders. If it is difficult to demonstrate a "strong inference" then it will be difficult for private individuals or investors to win a fraud case.

The *Times* notes, "[T]he United States Court of Appeals for the Seventh Circuit, in Chicago, interpreted the law to mean that the investors had to show whether the accusations, if true, would permit 'a reasonable person' to infer that the company and the executives 'acted with the required intent'"

In its brief in the appeal to this decision before the Supreme Court, the government is taking the position that the law should be interpreted more narrowly than the Circuit court ruled. The SEC says that the law should require investors to show "a high likelihood" that the defendant had a particular state of mind and acted with a particular intent.

According to the *Times*, "Jill E. Fish, a securities and corporate law professor at Fordham University, said the SEC brief sought to set an exceedingly high standard for getting a case to a jury and that it was unusual although not unprecedented for the commission to side against investors in a fraud lawsuit at the Supreme Court."

The SEC, which is tasked with regulating corporations, generally intervenes on the side of investors. The *Times* quotes Fish as noting, "This does not read like an SEC brief since it does not articulate anything about the commission's experience in the area. It reads, instead, like a litigant's brief."

On the same day that the SEC filed its brief, the commission's chief accountant, Conrad Hewitt, said that the SEC was developing ways to limit liabilities for accounting firms. "Mr. Hewitt said that he had witnessed numerous meritless lawsuits against auditing firms when he was the managing partner of Ernst & Young," the *Times* reported, "and that the potential claims against some firms were now so large that they could lead to bankruptcy and force further

consolidation in an industry that was already heavily concentrated," according to audience members at a conference of security lawyers addressed by Hewett.

Since the November elections, the Bush administration has taken several steps to roll back regulations on corporations and accounting firms. In December of last year, the Public Company Accounting Oversight Board (PCAOB) announced proposals for new standards for auditors that would reduce the burden on audited companies, particularly as relates to Section 404 of the Sarbanes-Oxley Act. Earlier that same month, the SEC announced proposed changes that would have a similar effect, though the SEC regulates the audited corporations themselves, while the PCAOB oversees accounting firms.

The Sarbanes-Oxley Act, passed in 2002 in response to the accounting scandals at Enron and WorldCom, contains a few minor regulations on business reporting and accounting. Section 404 has been at the center of corporate discontent with the act because it requires corporate management to assess internal corporate financial controls and also requires an outside audit of these controls.

The proposed revisions by the PCAOB and the SEC require a 70-day period for public commentary before going into effect, a period that will end in late February and early March.

On January 31, President Bush gave his explicit approval to these steps when he told an audience of business executives that one section of the Sarbanes-Oxley Act, Section 404, "may be discouraging companies from listing on our stock exchanges." Bush said, "We don't need to change the law [Sarbanes-Oxley]; we need to change the way the law is implemented." The political establishment has decided that it would be too damaging politically to amend Sarbanes-Oxley directly, and this is why the revisions are taking the form of regulatory changes from the SEC and the PCAOB, rather than changes to the law passed through Congress.

Also in December of last year, the Justice Department issued new guidelines that place greater constraints on local prosecutors in going after corporations and executives for corruption.

Both the Democrats and the Republicans have swung behind the attempts to water down corporate regulation. The new governor of New York State, Democrat Eliot Spitzer, who while serving as the state's attorney general made a name for himself by prosecuting Wall Street financial firms and other corporations, announced his support for a study that calls for loosening Sarbanes-Oxley regulations. The study released last month was signed jointly by Senator Charles Schumer, a Democrat from New York, and New York City's Republican Mayor Michael Bloomberg.

One of the principal concerns of Wall Street, as outlined by the study, is that New York financial markets are losing business to foreign exchanges because of the supposedly excessive regulations imposed in the United States.