2007 ALI-ABA SECURITIES LITIGATION PROGRAM

BOSTON, MA

LANGHAM HOTEL

JUNE 7-8, 2007

THE INTERPLAY OF THE U.S. FINANCIAL MARKETS, SECURITIES FRAUD CLASS ACTIONS AND AUDITOR LIABILITY

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INTRODUCTION

The debate over the proper scope and function of securities regulation has been heating up in recent months, with critics suggesting that the U.S. financial markets are losing ground due to excessive regulation and overly harsh enforcement. In particular, the Committee on Capital Markets Regulation ("CCMR") and the McKinsey & Co. Report commissioned by New York Mayor Michael Bloomberg and Senator Charles Schumer have criticized the current U.S. legal and regulatory environment as detrimental to U.S. competitiveness.[2] Both the CCMR and the McKinsey Reports attribute this seeming decline in U.S. financial markets to, in part, concerns over audit firm liability for securities violations.

The CCMR, Mayor Bloomberg, Sen. Schumer and the audit firms themselves also assert that audit liability is a crucial issue because, with only four large audit firms

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[2] *See* Committee on Capital Markets Regulation, *Interim Report*, ix, Nov. 30, 2006, http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (asserting that "the evidence presented here suggests that the United States is losing its leading competitive position as compared to stock markets and financial centers abroad"); McKinsey & Co., report commissioned by New York Mayor Michael Bloomberg and Sen. Charles Schumer, *Sustaining New York's and the US' Global Financial Services Leadership*, 7, 14-17, Jan. 22, 2007, http://www.nyc.gov/html/om/pdf/ny_report_final.pdf ("The most pressing issues affecting New York's leadership as a global financial hub [and other U.S. financial centers] [are] regulation, enforcement and litigation.").

remaining (the "Big Four" firms of Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers), a catastrophic award resulting from securities litigation could force one of these firms to close, thus concentrating the auditing industry to a dangerous degree. The CCMR and McKinsey Reports also add that the current unavailability of third-party insurance for large audit firms (who currently self-insure) contributes to the threat to the viability of the "Big Four" firms.[3]

Accordingly, both the CCMR and McKinsey Reports recommend imposing a cap on auditor liability, with the cap set so as to prevent catastrophic loss.[4] To ensure a balanced view of both the state of the U.S. financial marketplace and the prudence of caps on auditor liability, this article examines the CCMR and McKinsey Reports' assertions about the impact of supposed over-regulation and over-enforcement on the U.S. financial markets and whether a cap on auditor liability is the answer.

I. <u>A Balanced Picture Of The State Of The U.S. Financial Markets</u>

The CCMR and McKinsey Reports fail to present a full, balanced picture of the current state of the U.S. financial markets. Instead, they present the views of issuers and the financial services industry, and ignore the views of investors, consumer advocates and regulators.

The CCMR was partly funded by Maurice Greenberg, the ex-CEO of American International Group who was forced to resign that position when he was named a defendant in numerous securities and breach of fiduciary duty law suits and became the subject of various government investigations. The CCMR members include the heads of

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3 Committee on Capital Markets Regulation, *Interim Report*, *supra* note 2, at 86-89; McKinsey, *supra* note 2, at 20, 102.

4 Committee on Capital Markets Regulation, *Interim Report*, *supra* note 2, at 89; McKinsey, *supra* note 2, at 20-21.

two of the "Big Four" accounting firms, PricewaterhouseCoopers and Deloitte, top executives from issuers and investment banks and a panel of legal advisors from top defense firms.[5] The McKinsey Report specifies that the McKinsey research team interviewed over fifty "financial services industry CEOs and business leaders" and surveyed more than thirty financial services CEOs as well as an additional 275 global financial services senior executives.[6] As for investors and consumer advocates, however, the McKinsey Report offers only a vague statement that the research team also interviewed "numerous representatives of leading investor, labor, and consumer groups".[7] It is not surprising that the CCMR members and the 355 financial services and business leaders interviewed for the McKinsey Report were in favor of loosening U.S. securities regulations. Consequently, neither the CCMR nor the McKinsey Report offers a comprehensive view of the state of the U.S. markets or of the best practices for maintaining these markets going forward.

In fact, prominent commentators have expressed alarm at the CCMR's proposals: the Council of Institutional Investors, a not-for-profit association of 130 public, labor, and corporate pension funds, issued a November 2006 press release stating that it "disagrees strongly with the [CCMR's] assertion that overzealous regulation is stifling U.S. competitiveness."[8] The Council added that it "believe[s] that many of the panel's recommendations, if adopted, would undermine the effectiveness of market watchdogs

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[5] Website of the Committee on Capital Markets Regulation, http://www.capmktsreg.org/committeemembers.html and http://www.capmktsreg.org/legaladvisors.html (last visited Apr. 5, 2007).

[6] McKinsey Report, *supra* note 2, at 8.

[7] *Id.*

[8] Council of Institutional Investors, *Statement of the Council of Institutional Investors in Response to the Report of the Committee on Capital Markets Regulation*, Nov. 30, 2006, http://www.cii.org/press/cii_releases/11-30-06%20Paulson%20Commission-2.pdf.

and weaken critical investor protections."[9] Duke Law School Professor James Cox commented that "[t]his is an escalation of the culture war against regulation", and that it "would be a dark day for investors if the proposals were adopted".[10]

The CCMR also pointed to the increased regulation and oversight of auditors by the Public Company Accounting Oversight Board (PCAOB), which was created by the Sarbanes-Oxley Act of 2000, and asked whether the existence of the PCAOB renders exposure to civil liability for audit firms unnecessary.[11] Given the current enforcement environment, however, exposure to civil liability certainly is necessary. The SEC recently filed an amicus brief in *Tellabs, Inc. et al. v. Makor Issue & Rights Ltd. et al.*, Supreme Court Docket No. 06-484 (on Writ of Certiorari to the U.S. Court of Appeals for the 7th Circuit) (certiorari granted 01/05/2007), in which it asserted that the "strong inference" standard of scienter pleading under the Private Securities Litigation Reform Act of 1995 was too low and that the standard should instead be reset to a "high likelihood" that the defendant intended to violate the law.[12] The *New York Times* characterized the SEC's amicus filing as a step "to protect corporations, executives and accounting firms from investor lawsuits that accuse them of fraud."[13]

The SEC's position that would make it more difficult for public and private institutional investors and other shareholders to recover losses in securities class actions

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[9] *Id.*

[10] Stephen Labaton, *Businesses Seek Protection on Legal Front*, N.Y. TIMES, Oct. 29, 2006, http://www.nytimes.com/2006/10/29/business/29corporate.html?ex=1319778000&en=ebbdb1f837a2893b&ei=5088&partner=rssnyt&emc=rss.

[11] Committee on Capital Markets Regulation, *Interim Report*, *supra* note 2, at 86.

[12] *Brief for the United States as Amicus Curiae Supporting Petitioners*, *Tellabs, Inc. et al. v. Makor Issue & Rights Ltd. et al*., Supreme Court Docket No. 06-484 (Feb. 2007).

[13] Stephen Labaton, *SEC Seeks to Curtail Investor Suits*, N.Y. TIMES, Feb. 12, 2007, http://www.nytimes.com/2007/02/13/washington/13sec.html?ex=1329022800&en=90ca36690ce8f3b3&ei=5088&partner=rssnyt&emc=rss.

prompted Ohio Attorney General Marc Dann to file an amicus brief arguing that "making it much more difficult to have securities cases heard in court 'would severely damage one of the most powerful mechanisms for controlling fraud in the marketplace: legitimate securities lawsuits by large institutional investors such as the States' pension funds.'"[14] The Attorneys General from Alaska, California, Delaware, Idaho, Illinois, Iowa, Maryland, Minnesota, Nebraska, Nevada, New Hampshire, North Dakota, Oklahoma, Oregon, Puerto Rico, Samoa, South Dakota, Tennessee, Utah, Vermont, and West Virginia shared Mr. Dann's concern and also signed on to the amicus brief.[15]

A. The U.S. Financial Markets Continue to Capture a Healthy Share of Global IPOs

As evidence of the U.S. market's decline due to overregulation and overenforcement and the need for regulatory adjustments such as caps on auditor liability in order to halt this decline, both the CCMR and the McKinsey Reports assert that the U.S. has lost market share in global IPO listings over the last several years. According to the CCMR, U.S. share of global IPOs has dropped from 48 percent in the late 1990s to 6 percent in 2005, rising to an estimated 8 percent in 2006.[16] Similarly, according to the McKinsey Report, the volume of foreign IPOs listing in the U.S. in 2006 was a third of what it was in 2001.[17]

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[14] Marc Dann, Attorney General, State of Ohio, Press Release, *Ohio Attorney General Marc Dann leads nationwide bipartisan effort to protect public pension funds, private investors*, Mar. 9, 2007, http://www.ag.state.oh.us/press/07/03/pr070309.asp; *Brief for Ohio and 23 Other States, Territories and Commonwealths as Amici Curiae in Support of Respondents*, *Tellabs, Inc. et al. v. Makor Issue & Rights Ltd. et al*., Supreme Court Docket No. 06-484 (Mar. 9, 2007).

[15] *Id.*

[16] Committee on Capital Markets Regulation, *Interim Report*, *supra* note 2, at 2.

[17] McKinsey, *supra* note 2, at 43.

These numbers alone, however, do not present a complete picture: the CCMR and McKinsey Reports ignore data showing that the U.S. continues to capture a healthy share of global IPOs. In the first eleven months of 2006, for example, there were 172 U.S. IPOs raising over $40 billion in capital, with the absolute amount of capital raised by foreign IPOs in the U.S. reaching its highest level since 2000.[18] New issues of IPOs of greater than $100 million were up by over 20%, as compared to only 11% for the London Stock Exchange (LSE).[19] Moreover, during the last quarter of 2006, there were 94 registered IPOs on U.S. exchanges, which was the highest quarterly level since 2000.[20] Similarly, U.S. IPO volume increased by 22% from 2005 to 2006, and by almost 170% from 2003.[21] In fact, a report by Ernst & Young on global IPO trends in 2005 trumpeted the U.S. market as "the largest national source of IPO activity in the world."[22]

i. IPOs Made on the LSE's AIM are often Unable to Meet U.S. Listing Requirements and are Unable to Attract Sufficient U.S. Investor and Underwriter Interest

Both the CCMR and the McKinsey Reports pay special attention to the higher number of global IPOs being listed on the LSE as a sign that the U.S. is losing ground in the global IPO market: the CCMR Report notes that London's percentage of global IPOs

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[18] Jay W. Eisenhofer and Gregg S. Levin, *Investor Litigation in the U.S. – The System is Working*, Vol.22 No.5 SEC. REFORM ACT LITIG. REPORTER 618, 620 (Feb. 2007); U.S. Securities and Exchange Commission, *Speech by SEC Commissioner: Remarks Before the Consumer Federation of America Financial Services Conference*, Commissioner Roel C. Campos, Dec. 1, 2006, http://www.sec.gov/news/speech/2006/spch120106rcc.htm.

[19] David Henry, *London's Freewheeling Exchange – It's winning the listing war against New York, but investors can get burned,* BUSINESSWEEK, Nov. 27, 2006, http://www.businessweek.com/magazine/content/06_48/b4011060.htm.

[20] Eisenhofer, et. al., *supra* note 18, at 620; Henry, *supra* note 18.

[21] Jack Willoughby, *IPOs Catch Fire*, BARRON'S, Jan. 29, 2007.

[22] Ernst & Young, Strategic Growth Markets, *Accelerating Growth: Global IPO Trends 2006*, 19, http://www.ey.com/global/download.nsf/International/IPO_-_Global_IPO_Survey_2006/$file/E&Y-SGM-GlobalIPOSurvey2006.pdf (last visited Apr. 5, 2007).

has increased from 5 to 25 percent over the past three years, while the McKinsey Report states that "very small cap" companies in the U.S. "increasingly favor[]" the LSE's [Alternative Investment Market] over the NASDAQ.[23]

These statistics, however, are deceiving in that they include new offerings placed on the LSE's "Alternative Investment Market" ("AIM").[24] The companies listing on AIM tend to be lower-quality ventures that simply would have been unable to list in the U.S., either because they are too small to attract U.S. underwriters and investors, or because they would not have been able to meet U.S. listing requirements.[25] As noted in a recent *BusinessWeek* article, "just because London's listings are soaring doesn't mean it's doing a better job of raising capital. All major stock markets have weak companies, but the new issues in London these days seem especially so."[26] Investors have taken note: in 2006, the share prices of NASDAQ issues of at least $100 million were higher than those

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[23] Committee on Capital Markets Regulation, *Interim Report*, *supra* note 2, at 32; McKinsey, *supra* note 2, at 12.

[24] *See* McKinsey, *supra* note 2, 12, 50-52.

[25] *See* Greg Ip, et. al., *Trade Winds: In Call to Deregulate Business, a Global Twist*, WALL STREET JOURNAL, Jan. 25, 2007, at A1 (quoting Noreen Culhane, executive vice-president of listings at the NYSE, who stated that "[m]any of the companies listed on AIM today wouldn't come anywhere close to meeting an NYSE listing standard.").

[26] Henry, *supra* note 19 (also quoting James Chanos of the hedge fund Kynikos Associates, who recently called the new LSE issues the "worst dreck I've ever seen"). Commissioner Campos expressed a similar sentiment during a 2006 speech, humorously remarking that "most of the companies not listing in the U.S. these days tend to be or look like companies from 'Borat' (referring to the recent movie)." As examples of these "Borat"-type companies, Commissioner Campos listed several companies that recently had conducted London IPOs, including Kazakhmys, whose Chairman and CEO controls nearly half the company and one of whose independent directors works for the bank advising the company; and Sistema, a Russian telecommunications company which listed as risk factors in its offering document that the company's president and board member will "beneficially own" 65.45 percent of the company's outstanding shares" and that the interests of the president could "conflict with the interests of our shareholders … and he may make decisions that materially adversely affect your investment". Campos, *supra* note 18 (citation omitted).

of the LSE's AIM. This data, Henry asserted, was a sign that "the bloom is off LSE IPOs".[27]

ii. A Variety of Factors, and not Securities Regulations, are Responsible for Changes in the U.S. Share of Global IPOs and in its Financial Markets Overall

In addition, a variety of other factors that are unrelated to the regulatory environment help explain the decrease in IPOs on U.S. exchanges, including that: 1) a percentage of IPOs listing on foreign exchanges are secondary listings where the company has already listed in the U.S.; and 2) the markets took a downward turn following the implosion of the tech market.[28]

Similarly, the view that excessive regulation is responsible for a decline in U.S. markets "downplays a different explanation for why U.S. exchanges are under pressure -- the changing nature of global finance."[29] "Stock markets around the world have become better and deeper, encouraging companies to seek IPOs in their home market. Trading across borders has become simpler, cutting the prestige and usefulness of a big-country listing everywhere."[30] In fact, a look at foreign company listings demonstrates that "the world has changed for all big-country stock exchanges" and not just for the U.S. Although listings of foreign companies fell 4% on the NYSE from 2002 to 2006, and 34% on the NASDAQ during that same period, foreign listings on the LSE's blue-chip Main Market declined 23% since 2000, on the Deutsche Börse by a whopping 58% and on the Toyko exchange by 39%.[31]

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[27] Henry, *supra* note 19.

[28] Campos, *supra* note 18; Ip, et. al., *supra* note 24.

[29] Ip, et. al., *supra* note 25.

[30] *Id.*

[31] Ip, et. al., *supra* note 25.

II. The Current Regulatory System Confers Important Benefits On The U.S. Financial Markets

Against a background of change in the global marketplace, the current U.S. regulatory system has in fact produced significant benefits for the U.S. financial marketplace. Post-Enron U.S. regulatory changes, for instance, have proven effective at preventing fraud: a recent report by research firm Glass, Lewis & Co. found that restatements at companies complying with Section 404 of Sarbanes-Oxley declined 14% in 2006, while restatements at companies that have not yet been required to comply with Sarbanes-Oxley rose by 40%.[32]

Issuers also enjoy a listing premium and lower cost of capital in the U.S.[33] A 2006 study found "strong evidence that cross-listings on U.S. exchanges [were] associated with a significant decrease in firms' cost of capital."[34] As NYSE Executive Vice-President Noreen Culhane commented, "a U.S. listing is worth it, despite the incremental cost of compliance with Sarbanes-Oxley … [g]lobal investors feel a new-found confidence when companies are willing to accept U.S. laws and regulations, and they value those companies more."[35] Commissioner Campos also commented that "the U.S. regulatory system is, in fact, a 'competitive advantage' for our markets … because of the structural protections available to shareholders of U.S. companies, investors have a greater degree of confidence in U.S. companies."[36]

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[32] Glass, Lewis & Co., *The Errors of Their Ways*, 1, Feb. 27, 2006.

[33] *See* Eisenhofer, et. al., *supra* note 18, at 622.

[34] Luzi Hail & Christian Leuz, *Cost of Capital Effects and Changes in Growth Expectations around U.S. Cross Listings*, 36 (European Corporate Governance Institute, Working Paper No. 46, Oct. 2006), *available at* http://www.law.yale.edu/documents/pdf/CBL/HL_ECGI_Fin461.pdf.

[35] NYSE Group, THE EXCHANGE, Vol. 12, No. 10, *Foreign Firms Cross-Listed in the U.S. Valued Higher*, Oct. 2005, *available at* http://www.nyse.com/about/publication/1131450075226.html.

[36] Campos, *supra* note 18.

A. Overseas Markets are Following the U.S.' Lead and Tightening their Own Regulations

Evidence that U.S. securities regulations have benefited American financial markets overall has not gone unnoticed in overseas markets, which are "stiffening their own rules, bringing them closer to the U.S. model."[37] To the extent that overseas markets do have looser regulations, there is evidence that such regulations have been accompanied by increased fraud. In a fraud report released February 1, 2007, global accounting firm BDO Stoy Hayward ("BDO") noted that 2006 "has been a record year for fraud in the UK, with reported business fraud up almost 40%" from 2005.[38]

Increasingly, companies cannot dodge tight regulation by avoiding the U.S.[39] In fact, the Director of International Affairs of the SEC, Ethiopis Tafara, recently stated that the more controversial provisions of SOX concerning internal controls have basic equivalents in all of the major capital markets.[40] According to Tafara, the global adoption of the major provisions of Sarbanes-Oxley "suggests that these major provisions, in and of themselves, have not competitively disadvantaged US markets, simply by virtue of the fact that they have been widely adopted elsewhere."[41]

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[37] Ip, et. al., *supra* note 25.

[38] BDO Stoy Hayward, Press Release, *Fraud costs rise 40 per cent to record levels in 2006, but businesses only report 15 percent to the police*, February 1, 2007, http://www.bdo.co.uk/BDOSH/Website/bdouk/websiteContent.nsf/vAll/5A1850529550213B802572600038707A?OpenDocument.

[39] *Id.*

[40] Ethiopis Tafara, *Statement by SEC Staff – A Race to the Top: International Regulatory Reform Post Sarbanes-Oxley*, INT'L FIN. LAW REV., Sept. 2006, http://www.sec.gov/news/speech/2006/spch091106et.htm (noting that Japan and France have enacted legislation "closely resembling the internal controls requirements of SOX" and China and Canada both appear to be following suit).

[41] *Id.*

Regulatory officials and industry insiders have observed this trend: Andrew Bernstein, a partner in Cleary Gottlieb's Paris office, commented that "[p]retty soon the vast majority of Sarbanes-Oxley will be applicable either at the European level or at the national levels … [t]he regulatory costs are in the process of converging."[42] Hong Kong's former chief securities regulator, Andrew Sheng, told a Senate panel in 2004 that Hong Kong "has moved 'closer to the U.S. SEC regulatory model'".[43]

Similarly, a spokesman for the Netherlands' ABN AMRO Bank NV, which trades on the NYSE, stated that, although the U.S. regulatory burden has increased, an increase in this burden has occurred in most of the countries where the bank operates.[44] The EU, Canada, Mexico, Australia, Hong Kong, Brazil, the U.K. and Germany, for example, have all tightened standards for audit committees.[45] In fact, some countries have adopted even more stringent measures than SOX. For example, Germany prohibits anyone from serving on its auditor oversight body if he or she has been a member of the accounting profession within the past five years, while SOX merely limits membership in its oversight body, the PCAOB, to former practitioners with no time period limitation between practice and membership in the PCAOB.[46] In sum, it appears that many of the

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[42] Ip, et. al, *supra* note 25.

[43] *Id.*

[44] *Id.*

[45] Tafara, *supra* note 39.

[46] *Id.* Other examples of countries adopting some of the key provisions of SOX abound: for example, Germany, China and Japan have introduced prohibitions on specific non-audit services similar to the prohibitions found in SOX. The UK, although not prohibiting specific non-audit services, mandates the disclosure of each type of non-audit service as well as a breakdown of its costs. *Id.* Moreover, since the enactment of SOX, "the EU, UK, France, Hong Kong, China, Japan, Australia, Canada and Mexico have all passed reforms requiring mandatory audit partner rotation." *Id.* (further noting that large capital markets such as the EU, UK, France, Hong Kong, Japan, Australia and Canada are all introducing similar SOX restrictions aimed at reducing conflicts of interest between auditors who leave to work for a company at which he or she previously provided audit services).

capital markets outside of the United States have adopted the major provisions of SOX, diluting the argument expounded by some that the costs of complying with U.S. regulations are the cause of foreign companies choosing to list on non-U.S. markets.

III. <u>Audit Firms Are The First Line Of Defense For Fraud Prevention; Decision Makers Should Therefore Be Extremely Cautious About Capping Auditors' Liability</u>

Given that U.S. securities regulations play an important role in maintaining the health and stability of the U.S. financial markets, decision makers should not make any policy changes without carefully considering auditors' crucial position in the overall regulatory scheme: "accountants acting as public auditors have a different role. They are the first line of defense in protecting the public interest."[47]

Such care is especially important given that there is evidence that auditors conduct more careful audits when litigation risk is higher.[48] One study, for example, found that auditors hired for IPO audit engagements, which, because IPOs must be

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Tafara further noted that: "[s]ince passage of SOX, the number of large capital markets that require a public company to have an audit committee has increased. The EU, Canada, Mexico, Australia, Hong Kong and Brazil now mandate that public companies have an audit committee or an equivalent body as part of their corporate structure" and the UK and Germany have imposed an audit committee requirement on a "comply-or-explain" basis. *Id.* In addition, since 2002, the UK, Hong Kong, and Canada, among others, have introduced reforms that require the independence of all audit committee members. *Id.*

Major capital markets have also enacted provisions similar to SOX's requirement that compels management to state its responsibility for establishing and maintaining the company's system of internal controls. For example, Canada will require a similar statement of responsibility from the company's CEO and CFO, and "Germany, Japan, and China now have laws that require that a company have an adequate internal controls system," some countries actually prescribing the internal control systems that a company must have in place. *Id.* Lastly, several countries have adopted related requirements to Section 404 of SOX which requires the company's auditor to attest to, and report on, management's assessment of the company's internal controls. *Id.* (noting that China, France and Japan all require the auditor to report on management's assessment of the company's internal controls system.).

[47] Ethan S. Burger, 28 HAMLINE L. REV. L. 1, 27 (Winter 2005).

[48] In a 2006 U.S. Federal Interagency Advisory on liability-limiting provisions in letters of agreement between issuers and their external auditors, agencies including the Department of the Treasury and the Federal Reserve opined that limitations on external auditors' liability "may weaken the external auditors' objectivity, impartiality and performance". *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters*, 71 FR 6847-01 (Feb. 9, 2006). Although the agencies were commenting on limitation of audit liability by issuers rather than by regulatory agencies, *id.,* the situation is sufficiently parallel that the agencies' comments are relevant here.

registered under the 1933 rather than the 1934 Act, impose a higher litigation risk on auditors, were more "conservative" in their audits. [49]

Decision makers should therefore be sure to maintain appropriate incentives for audit firms to do high-quality work. As former head of the Hong Kong Securities and Futures Commission Andrew Sheng has commented, to achieve a "balance" between regulatory costs and benefits, high disclosure standards enforced by courts and market competition and civil or criminal sanctions should work alongside an approach that pushes "market participants to adopt as much self-regulation as possible".[50] In light of auditors' important role in ensuring regulatory compliance, one way to achieve this "balance" is to use regulations and the threat of criminal or civil sanctions and civil liability to motivate audit firms to perform thorough and accurate audits.

IV. Threats To The Viability Of The "Big Four" Have Been Greatly Overstated

In addition to the evidence that audit firms perform their crucial auditing function more carefully and thoroughly where there is liability exposure, there is little if any evidence that audit firms' viability is truly threatened by such exposure.

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[49] Ramgopal Venkataraman, et. al., *Litigation Risk, Audit Fees and Audit Quality: Initial Public Offerings as a Natural Experiment*, 2, February 17, 2005, presented at the Spring 2005 Empirical Accounting Conference at Carlson School of Management, University of Minnesota, http://www.csom.umn.edu/assets/37726.pdf. An auditor has a number of additional responsibilities, and therefore additional liability exposure, under the 1933 Act. The auditor's responsibility does not end as of the date of the financial statements, but instead extends until the effective date of the auditor's report. The auditor also is required to read the entire registration statement to ensure that it does not conflict with the financial statements and that all material facts have been disclosed. Finally, the auditor normally provides a "comfort letter" to the underwriter regarding financial information that is not covered by the auditor's report and on events that occurred after the audit report date. Under the 1933 Act, the burden of proof additionally shifts from the plaintiff to the auditor, while neither privity with the plaintiff nor reliance on the financial statements is necessary to bring suit. Also, ordinary negligence is a basis of liability for third parties. *Id.* at 7.

[50] Andrew Sheng, Chairman, Hong Kong Securities and Futures Commission, *Securities Regulation versus Prudential Regulation*, presented at the Joint Programme on What Banking Supervisors should Know about the Securities Industry and Securities Regulation, May 3, 2005, http://www.iosco.org/library/speeches/pdf/securities_regulation_vs_prudential_regulation_may05_as.pdf.

A. Securities Fraud Claims Against Auditors are Rare, and Declined From 2005 to 2006

A study by the insurance company Aon found that as of September 2005 there were 20 claims outstanding against U.S. auditors in which damages sought or estimated losses were over $1 billion.[51] This statistic, however, loses some of its punch when viewed in concert with the facts that 1) only 3% of securities fraud actions filed in 2005 named an audit firm as a defendant; and 2) actions naming auditors declined to 2% in 2006.[52]

B. The *Central Bank* Decision Already Has Limited Audit Firms' Liability

The low percentage of securities fraud actions naming audit firms as defendants is unsurprising given that litigation against auditors was severely curtailed with the Supreme Court's 1994 decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), eliminating "aiding and abetting liability" under Section 10(b) of the Securities Exchange Act of 1934 (the Court also added in dictum that no aiding and abetting liability exists under any of the liability provisions of either the Securities Act of 1933 or the Exchange Act).[53] Investors therefore must prove that auditors actually took part in fraudulent conduct in order to prevail in court.[54] Given the limited scope of auditors' liability, it is questionable whether a cap is necessary. Moreover, given that a cap would tend to protect only those auditors that actually

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[51] David Reilly, *Booming Audit Firms Seek Shield from Suits*, WALL ST. J., Nov. 1, 2006.

[52] Cornerstone Research, *Securities Class Action Case Filings – 2006: A Year In Review*, Jan. 2007, 20, http://securities.stanford.edu/clearinghouse_research/2006_YIR/20070102-01.pdf.

[53] *Central Bank*, 511 U.S. at 191.

[54] Carrie Johnson, *Accounting for the Future: Down to four big firms and fearing the effects of even one major suit, the audit industry presses for legal relief*, WASHINGTON POST, Mar. 9, 2007, at D1.

participated in a fraudulent scheme as "primary violators", a cap is not good public policy.

C. No Major Audit Firm Has Ever Failed Due To Securities Litigation

The McKinsey Report claims that the "threat of securities-related litigation" forced the accounting firm Arthur Andersen to close its doors.[55] This, however, is revisionist history: Arthur Andersen was not forced into liquidation because of civil penalties or judgments, but rather because of its (subsequently overturned) criminal conviction.[56] Moreover, the McKinsey Report "cites no other examples of [major] companies liquidated because of securities litigation. The reason is that they do not exist."[57]

The threshold of a "catastrophic" penalty or award may well be so high as to make a cap somewhat meaningless. As the *Wall Street Journal* commented, "[t]he firms also have shown they can weather pretty big hits. Over the past two years, KPMG has agreed to pay out nearly $700 million in fines and settlements related to criminal and civil actions. In 2000, Ernst & Young LLP settled for $335 million a shareholder suit related to its work for Cendant Corp."[58]

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[55] McKinsey, *supra* note 2, at 75.

[56] Eric L. Talley, *Cataclysmic Liability Risk Among Big Four Auditors*, 106 COL. L. REV. 1641, 1648 (Nov. 2006) ("as was the case for Arthur Andersen, firms can fail because a criminal conviction causes them to lose their ability to practice – a regulatory death penalty for accounting firms."); Venkataraman, et. al., *supra* note 48, at 1; (referring to "the U.S. Justice Department's indictment (and consequent demise) of Arthur Andersen")).

[57] Eisenhofer et al, *supra* note 18, at 629.

[58] Reilly, *Booming Audit Firms*, *supra* note 50.

D. The Biggest Threat to the Viability of Audit Firms Comes From Sources Other Than Civil Liability

As USC Law Professor Eric L. Talley has commented, civil liability resulting from securities litigation hardly represents the only threat to the viability of audit firms.[59] An audit firm could fail because it loses its ability to practice due to a criminal conviction, or because the conviction or other scandal harms a firm's reputation and incites both clients and employees to abandon the firm.[60] Firms also could fail due to criminal and civil penalties, fines and damage awards from many different types of litigation other than federal securities class action litigation.[61] Within this broader context, the threat posed by federal securities class action suits is "but one scenario".[62]

In fact, thus far criminal prosecution has proven to be the only threat to the viability of the Big Four that has actually been realized.[63] In addition to the example of Arthur Andersen, KPMG "suffered a near-death experience" last year because of its sale of improper tax shelters; KMPG was saved from the threat of going out of business only after federal prosecutors decided not to indict the firm.[64]

E. Would A Cap On Liability Protect Audit Firms From Failure?

Given that auditor liability does not stem only from securities litigation, but from an "aggregation of numerous overlapping, but distinct, sources of law traversing

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[59] Talley, *supra* note 55, at 1648.

[60] *Id.*

[61] Talley, *supra* note 55, at 1648.

[62] *Id.*

[63] *See* Johnson, *supra* note 53.

[64] *Id.*

numerous jurisdictional divides, including state/federal, civil/criminal, and private/administrative", a cap on auditor's civil liability would protect against only one out of many possible scenarios that could cause a Big Four firm to fail.[65]

Consequently, imposing a cap on auditor liability simply will not protect audit firms from catastrophic liability. A cap may protect against one-time large damage awards, but will not protect against criminal prosecution, administrative civil penalties, or multiple damage awards or settlements obtained through multiple suits.

Nor would it be desirable to protect audit firms from all possible sources of liability. Audit firms already appear to have a degree of protection from criminal prosecution: federal prosecutors' decision not to indict KPMG indicates that the Big Four are seen by the federal government as too important to fail.[66] Given prosecutors' apparent reluctance to bring criminal charges against the big audit firms, the threat of liability may constitute the only method of inducing auditors to do high-quality work.[67] Similarly, audit firms should not be protected from the possibility of multiple settlements (such as 10 settlements for $40 million each) aggregating to a catastrophic amount as "a firm forced to settle those many actions at those levels probably does not deserve to survive."[68]

i. A Cap on Auditor Liability May Not Even Make Audit Firms Insurable

It is also debatable whether a cap on liability would make audit firms insurable. Prof. Talley conducted an empirical study of the distribution of liability exposure faced

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65 Talley, *supra* note 55, at 1673.

66 *See* Reilly, *Booming Audit Firms*, *supra* note 50.

67 Johnson, *supra* note 53.

68 *See* John C. Coffee, Jr., *Nobody Asked Me, But …*, Jan. 18, 2007 N.Y.L.J. 5, (col. 1).

by major audit firms based on federal securities class actions filed from 1994-2005.[69] He concluded that, over the long term, filings against auditors tend to be distributed such that the risk should be insurable.[70] It therefore appears that the lack of an insurance market for the Big Four auditors is not due solely to catastrophic liability risk exposure.[71] Instead, in addition to such risk exposure, "it is plausible that scale economies and agency costs also help explain the absence of an insurance market for dominant auditing firms."[72] Consequently, imposition of a cap on auditor liability may well fail to resolve auditor uninsurability, one of the major problems such a cap was designed to address.

F. Audit Firms Can Raise Their Fees To Reflect Their Liability Risk

Audit firms also are not helpless in the face of increased liability risk: they are able to increase their income stream and provide themselves with an additional cushion against the danger of large penalties or damages awards by raising their fees to reflect their liability risk.[73] There is evidence that audit firms already do this: one study found that audit firms received higher fees for IPO engagements, which impose a higher litigation risk on auditors.[74] The study's authors concluded that auditors "receive higher fees … when auditing IPOS" and this is "consistent with the effect that an increase in litigation exposure should have on their incentives."[75] The study's authors also

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69 Talley, *supra* note 55, at 1680-1690.

70 *Id.* at 1690.

71 *See id.*

72 *Id.*

73 *See* Talley, *supra* note 55, at 1643-1644.

74 *See* Venkataraman, et. al., *supra* note 48, at 2.

75 *Id.*

extrapolated from their results to conclude more generally that "audit fees reflect litigation risk differences across liability regimes."[76]

It is also worth noting that, because the large audit firms are private partnerships, they normally do not disclose their financial condition or results.[77] Consequently, "outsiders don't know how much capital the firms have, their level of profitability or even how much insurance they carry", making it difficult to asses the level of risk faced by the audit firms.[78]

G. Auditor Liability in Overseas Markets

In spite of the many factors indicating that a cap on auditor liability is both inadvisable and unnecessary, European countries nevertheless appear to be moving toward imposing such a cap. In January 2007, Charlie McCreevy, European Commissioner for the Internal Market and Services, issued four different proposals for limiting auditors' liability in Europe.[79] The four proposals,[80] based on an independent study conducted by London Economics in October 2006,[81] include the following: (1) establishing a fixed monetary cap at the European Union level; (2) establishing a cap based on the market value of the audited company; (3) establishing a cap based on a

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[76] *Id.* at 24.

[77] Reilly, *Booming Audit Firms*, *supra* note 50.

[78] *Id.* *See also* Johnson, *supra* note 53 (quoting Bevis Longstreth, a former SEC commissioner who served during the Reagan administration, as stating that "[i]t's just unacceptable to cap liability and not even look at profit … [n]o one knows what profits are because there is no transparency.").

[79] *See* European Commission, Directorate General for Internal Markets and Services, *Commission Staff Working Paper: Consultation on Auditors' Liability and Its Impact on the European Capital Markets*, 12-13, Jan. 2007, http://ec.europa.eu/internal_market/auditing/docs/liability/consultation-paper_en.pdf.

[80] McCreevy sought commentary on these proposals up until Mar. 15, 2007.

[81] London Economics in association with Professor Ralf Ewert, Goethe Univ., Frankfurt am Main, Germany, *Study on the Impact of Auditors' Liability Regimes: Final Report to [European Commission Internal Services and Market Directorate General]*, Sept. 2006, *available at* http://ec.europa.eu/internal_market/auditing/liability/auditors-final-report_en.pdf.

multiple of the audit fees charged by the auditor to its client; or (4) introducing proportionate liability, which would hold the auditor liable only for the portion of loss that could be specifically attributed to them.[82] It is expected that the European Union might issue "a nonbinding recommendation that member states adopt one or more of the[se] suggestions" by the end of the year.[83]

The current status quo concerning auditor liability varies considerably among the different European countries. For example, Spain is one of the only members of the European Union that has introduced the concept of proportionate liability, with the vast majority of European Union members still applying joint and several.[84] The United Kingdom, also an exception to the norm, recently adopted a provision that allows limited liability agreements between a company and its auditor so long as the agreement is disclosed and approved by the shareholders of the company.[85] Currently, the only countries within the European Union that have placed some type of cap on auditors' liability are Austria, Belgium, Germany, Greece, and Slovenia.[86] "In these countries, the auditor is jointly and severally liable with the company only up to the cap provided."[87]

H. Suggestions For Managing Auditor Liability

Should any of the above-mentioned proposals be adopted in Europe, increased pressure will likely be placed on Congress to limit auditors' liability in the United

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[82] *Id.* at 12-13.

[83] David Reilly, *EU Offers Plans for Accounting Firms' Audit-Liability Caps*, WALL ST, J., Jan. 19, 2007, at C8.

[84] London Economics, *supra* note 80, at 153.

[85] Companies Act 2006, Ch. 46, Part 16, Office of Public Sector Information (U.K.), *available at* http://www.opsi.gov.uk/ACTS/acts2006/ukpga_20060046_en.pdf (last visited Apr. 5, 2007).

[86] *See* European Commission, *supra* note 78, at 4.

[87] *Id.* As the majority of countries that belong to the European Union currently have little or no limit on auditors' liability, adoption of any of the four proposals issued by the European Commission could have considerable ramifications on lawsuits brought against auditors in Europe.

States.[88] Decision makers should consider all alternatives, however, and, if liability caps are implemented, they should be carefully structured to protect auditors only from catastrophic liability, and not from all liability.[89]

For example, as suggested by the European Commissioner for Internal Market and Services, proportionate liability, which would hold the auditor liable only for the portion of loss that could be specifically attributed to them, could be substituted for joint and several liability.[90]

Also, if a cap is imposed, it should be implemented along with a trade-off of some kind. Columbia Prof. C. Coffee, Jr. recently proposed such a trade-off, suggesting that aiding and abetting liability for auditors be restored in exchange for a cap set at a level that would protect against one-time catastrophic awards.[91] Commenting on the "trade off" of granting investors a cause of action against auditors for aiding and abetting, Prof. Coffee specified that such a cause of action should be the same as that now available to the SEC under § 20(e) of the Securities Exchange Act: the plaintiff would have to show that the defendant "'knowingly provide[d] substantial assistance' to the primary violator."[92] To avoid the predictable problem of other potential defendants, such as law firms and investment banks, resisting a reversal of the *Central Bank* prohibition against

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88 In fact, the SEC's Chief Accountant, Conrad Hewitt, recently indicated at a Northwestern University legal conference that accountants should consider seeking new protections from Congress this year. Judith Burns, *SEC Accountant Wants to Limit Liability*, ASSOCIATED PRESS, Jan. 25, 2007, *available at* http://www.boston.com/news/world/europe/ articles/2007/01/25/sec_accountant_wants_to_limit_liability. During his speech, Hewitt also mentioned the impending proposals under consideration in Europe and predicted that one of the proposals, or some combination of them, would be adopted in Europe and that "it may be time for accountants to seek similar protections in the United States." *Id.*

89 *See* Coffee, *supra* note 67.

90 *See* European Commision, *supra* note 78, at 13.

91 *See* Coffee, *supra* note 67.

92 *Id.*

aiding and abetting liability, Prof. Coffee suggested a restoration of aiding and abetting liability only for defendants who are covered by a cap on their aggregate liability.[93] This would effectively restrict such liability to audit firms. He added that, although this proposed trade off would expose auditors to more litigation, "[i]f they would spurn such a compromise, it probably would suggest that their desire for the cap on their liability has been overstated."[94]

As discussed earlier, the evidence weighs against both the necessity and the wisdom of a cap on auditor liability. Nevertheless, if such a cap must be imposed, then restoration of aiding and abetting liability, along with (in line with some of the European Commissioner for Internal Market and Services' proposals) a flexible cap keyed to the size and profitability of each audit firm (and perhaps, as suggested by Prof. Coffee, measures allowing the audit firms to raise additional capital from outsider investors) could satisfy business interests while controlling the risk of future financial fraud.

CONCLUSION

When determining whether it is even necessary to implement a cap on auditor liability, and how to structure such a cap if it is implemented, decision makers should carefully consider the possibility that protecting auditors from liability and loosening regulations may actually weaken rather than strengthen U.S. financial markets.[95] Regulations, and the risk of liability, are a necessary part of the financial markets, and essential to their continued stability and growth. As former Hong Kong chief securities regulator Andrew Sheng has commented, financial regulations are "the insurance

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93 *Id.*

94 *Id.*

95 *See* Ip, et. al, *supra* note 25 ("paring regulations might not alter the [condition of U.S. markets], except to give a helping hand to Wall Street.").

premium that society must pay in order to prevent the high costs of financial crises or serious market damage that arise from excessive greed or misconduct."[96]

[96] Sheng, *supra* note 49.