Statement of Rex Staples, General Counsel
North American Securities Administrators Association
Before the U.S. Treasury Advisory Committee on the Auditing Profession

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Chairmen Levitt, Nicolaisen, and members of the Committee, thank you for the opportunity to testify.

By way of background, the North American Securities Administrators Association, Inc. ("NASAA"), is the nonprofit association of state, provincial, and territorial securities regulators in the United States, Canada, and Mexico. It has 67 members, including the securities regulators in all 50 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. Formed in 1919, it is the oldest international organization devoted to protecting investors from fraud and abuse in the offer and sale of securities.

The U.S. members of NASAA are responsible for administering state securities laws and regulations. Their activities include regulatory functions such as licensing broker-dealers, registering local securities offerings, and conducting compliance examinations. Especially important is their enforcement role: protecting the nation's investors by bringing literally thousands of enforcement actions every year against the firms and individuals who have committed fraud and abuse in the sale of securities. In those cases, state securities regulators often seek restitution to help make injured investors whole, although both state and federal regulators recognize that the best hope of recovery for the vast majority of defrauded investors is through the courts in private actions for damages. NASAA supports the work of its members through training programs, enforcement assistance, and legislative analysis. Another important role of the association is representing the membership's position as amicus curiae in significant cases brought by private plaintiffs as well as government regulators involving the interpretation of the securities laws and the rights of investors.

As advocates for the rights of investors to seek redress, NASAA and its members have a direct interest in the recommendations of this Committee. The recommendations as to litigation may have a profound impact upon the ability of investors to seek redress in cases of auditor misconduct. If the Committee were to recommend exclusive federal jurisdiction or the establishment of more burdensome standards at the pleading stage, many victims of auditor misconduct, negligence, or recklessness with meritorious claims would lose the opportunity to recover their damages.

The Committee's recommendations may also affect the role of private actions as a deterrent against securities fraud. Private actions by defrauded investors are an enormously important complement to regulatory enforcement actions as a means of policing the securities marketplace. State and federal securities regulators work tirelessly to detect, enjoin, and punish financial fraud. However, private actions not only provide the principal means of redress for victims of securities fraud, they also play a vitally important role in protecting the integrity of the marketplace through deterrence. Congress and the courts alike have recognized this fact. The Senate Report accompanying the Private Securities Litigation Reform Act of 1995 described the importance of private rights of action as follows:

> The SEC enforcement program and the availability of private rights of action together provide a means for defrauded investors to recover damages and a powerful deterrent against violations of the securities laws. As noted by SEC Chairman Levitt, "private rights of action are not only fundamental to the success of our securities markets, they are an essential complement to the SEC's own enforcement program." (citation omitted)

See S. REP. NO. 104-98, at 8 (1995) ("Senate Report"), *re-printed in* 1995 U.S.C.C.A.N. 679, 687; *see also Basic Inc. v. Levinson*, 485 U.S. 224, 230-31 (1988) (observing that the private cause of action for violations of Section 10(b) and Rule 10b-5 constitutes an "essential tool for enforcement of the 1934 Act's requirements"). To the extent that the Committee's recommendations may erect unwarranted barriers to recovery in private actions, an important deterrent that benefits the marketplace as a whole could be undermined.

<u>General Overview</u>

NASAA believes that it is proper that the Committee give careful consideration to the important issues before it. While there are many important issues the Committee must consider, NASAA will limit its comments to the potential proposal that Congress consider providing the Federal courts with exclusive jurisdiction over certain claims presently brought in state courts and the establishment of a uniform standard of care against which such claims would be adjudicated.

We understand that a formal recommendation by the Committee to Congress that certain lawsuits against auditors be argued in federal rather than state court would provide substantial relief for the accounting industry from damages. However, we question whether such relief is warranted and whether investors are served by such a recommendation.

We believe that any recommendation made by the Committee must be fully informed. To that end, we note with grave disappointment the refusal of the auditing firms to provide the Committee with the essential data that would allow the Committee to make a fully informed recommendation regarding litigation.

In the deliberations of the Treasury Committee on the Auditing Profession, the major auditing firms continue to push hard for a recommendation supporting litigation reform for them. Auditors are intent on limiting their liability for securities fraud and are heavily lobbying Congress, the White House, and business organizations to make this happen.

Blair A. Nicholas and David A. Thorpe of Bernstein Litowitz Berger & Grossmann LLP have eloquently made the point that while auditing firms continue to call for limitation of their liability and federal pleading standards ratchet ever higher, state law claims still provide an avenue with which to hold audit firms accountable. Within the past year, there have been no less than three reports calling for additional limitations on investors' rights to recover damages through civil litigation against auditor defendants.[1] Recommendations for limiting auditor liability have included capping damages, creating safe harbors from liability for certain audit work and forcing the arbitration of claims.[2]

The reason auditing firms seek to limit their liability is obvious. Auditors have stood in the eye of the storm in connection with the largest corporate meltdowns in recent history due to massive financial fraud and failed to perform as gatekeepers for investors. Indeed, auditor defendants were named in the top four largest securities class action settlements to date.[3] In 2006 alone, 68% of federal securities actions alleged violations of Generally Accepted Accounting Principles ("GAAP").[4]

In response to the calls by auditing firms for limited liability, NASAA strongly believes that investors should rightly be allowed to shift their efforts to individual actions alleging state law violations in order to pursue legitimate claims and remedies from auditor defendants rather than accept unreasonable and artificial limits on auditor liability under the federal securities laws.

Time should be allowed to develop optimal recommendations

The Treasury Committee on the Auditing Profession has an opportunity to make recommendations that will have a positive effect on the auditing profession, integrity of information available in the U.S. capital markets, and on the confidence investors have in such information and markets. As others have pointed out, the Committee follows in the footsteps of other committees and panels that have made recommendations for the profession in the past including the Cohen, Treadway and O'Malley committees.

In each of these instances, the committees took significant amounts of time to research, analyze, get public input and discuss the issues they studied. For example, the Cohen Commission met monthly beginning in November 1974, and issued their final report in 1978 after a total of 66 meeting days, a series of research reports, and more than 60 meetings of professional and business organizations. The Treadway Commission, a

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[1] Interim Report of the Committee on Capital Markets Regulation, 14 (November 30, 2006) recommending cap on damages or a safe harbor from liability for certain audit practices); Sustaining New York's and the US' Global Financial Services Leadership, 20 (January 2007) (recommending arbitration of claims and "a cap on auditor's damages"); U.S. Chamber of Commerce, Commission on the Regulation of U.S. Capital Markets in the 21st Century, Report and Recommendations, 171 (March 2007) (recommending a cap on damages for auditors citing "[c]atastrophic litigation claims in a market in which commercial insurance simply is not available to the firms in adequate amounts to cover such claims.").

[2] *Id.*

[3] The four largest securities class action settlements to date include Enron Corp. (partial settlement of $7.14 billion), WorldCom, Inc. ($6.15 billion), Cendant Corp. ($3.56 billion) and AOL Time Warner, Inc. ($2.65 billion).

[4] Cornerstone Research, Securities Class Action Case Filings 2006: A Year in Review, 3 (2006)

private sector initiative formed in 1985, commissioned 10 external research studies, had its staff complete more than 20 research projects and briefing papers, consulted with over 80 external experts, first voted on recommendations in October 1986, published an exposure draft in April of 1987, twice appeared before congress during its deliberations, and issued a final report in October 1987. The O'Malley Panel, formed in October 1998, conducted a survey, held public hearings both before and after the issuance of its exposure draft, conducted in depth reviews of the quality of a significant number of audits, and conducted research into circumstances leading to SEC Auditing Enforcement Releases, before issuing its final report in August 2001. We hope the Committee will take its time and avoid the inevitable pressures to rush to put out a report within a predetermined time frame.

Relevant data must be provided to the Committee to allow it to develop sound recommendations

To assist the Committee with its research and deliberations, and to ensure a quality report based on adequate research and facts, a substantial amount of data was requested to enable the committee to make informed decisions with respect to the issues before it.

Unfortunately, we understand that the firms have refused to provide certain data with respect to a number of areas, including litigation. In particular, Committee members requested in October 2007, the following information regarding litigation:

1. The number of federal securities actions filed against the ten largest audit firms in the U.S in each year since the passage of the Private Securities Litigation Reform Act broken down between those filed in federal courts and those filed in state courts.

2. The number of federal securities actions filed against the ten largest audit firms in the U.S in each year since the passage of the Private Securities Litigation Reform Act broken down between those filed in federal courts and those filed in state courts, which were dismissed by the courts.

3. The number of:

   a. Settlements, court verdicts and jury awards in each of the last ten years against each of the ten largest audit firms related to an audit of a public company.

   b. The average mean and median amounts of the settlements, verdicts or awards in (a) above.

   c. The average, mean and median amount claimed by the plaintiffs in each of these cases.

4. The number of settlements, court verdicts or jury awards in each of the last ten years, for each of the ten largest audit firms broken down by awards related to (a) audits of public companies, (b) audits of private companies, (c) income tax services and (d) other.

5. A detailed breakdown and analysis of the 25 largest settlements and/or jury awards in the last decade, that provides:

   a. Name of the case.
   b. Description of the case.
   c. Name of plaintiff.
   d. The amount of the claim.
   e. Whether a restatement was involved and if so, the magnitude of the restatement.
   f. Amount of the settlement including a breakdown of settlements settled in private rights of actions and settlements arising from the action of a law enforcement agency such as the SEC.
   g. Amount of initial court verdicts or jury awards as well as amount of subsequent adjustments by the courts or parties to the initial awards.
   h. Whether or not the SEC or Justice Department brought an action against the audit firm or a member of the audit firm, and if so, what the outcome of the action was.
   i. Whether the action was covered by insurance or not, and if so, to what extent the coverage was provided by an external insurance company versus internal sources or captive insurance.

6. A legal analysis of the impact that PSLRA and the Supreme Court decisions in the matters of Central Bank and Dura Pharmaceuticals or other significant cases have had with respect to the ability of plaintiffs to bring federal securities litigation against independent auditors.

It is our understanding that, to date, the firms have refused to provide this data to the Committee. In order to fully serve the public interest, we believe the Committee must have the full cooperation from those who have and control the data. We believe the Committee should take all necessary steps to ensure it receives this data in order make a fully informed recommendation.

Changing Pleading Standards

In the deliberations of the Treasury Committee on the Auditing Profession, the major auditing firms continue to push hard for a recommendation supporting litigation reform that benefits them. In particular, they ask for a recommendation that Congress provide federal courts with exclusive jurisdiction over certain claims that may presently be brought in state courts against auditors. Should Congress take up this recommendation, the firms ask that Congress develop a uniform standard of care.

As early as 1985, auditing firms have been calling for litigation reform through exclusive federal jurisdiction and changes to the pleading standards. The audit firms want the pleading standard to be fraud, not recklessness. On the other hand, investors have argued for a standard that includes negligence, as in SEC Rule 102(e). The firms frame this as a desire for a clear and uniform standard when, in fact, it is a desire for a higher pleading standard - one that does not include recklessness or negligence.

Recently, the Supreme Court introduced a new standard for pleading scienter in the *Tellabs* decision.[5] In *Tellabs*, the Supreme Court clarified the test that courts must apply to determine whether a complaint pleads a "strong inference" of scienter as required by § 21D(b)(2) of the PSLRA.[6] The Supreme Court held that "[a] complaint will survive [a motion to dismiss]... if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged."[7] Accordingly, on a motion to dismiss, it is a defendant's burden to establish that the inference of non-culpable conduct is stronger than the inference of scienter raised by a plaintiff.

Speaking for the *Tellabs* Court, Justice Ginsburg notes that on the recklessness issue, "[w]e have previously reserved the question whether reckless behavior is sufficient for civil liability under §10(b) and Rule 10b-5. See Ernst & Ernst v. Hochfelder, 425 U. S. 185, 194, n. 12 (1976). ***Every Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required.*** See Ottmann, 353 F. 3d, at 343 (collecting cases). The question whether and when recklessness satisfies the scienter requirement is not presented in this case." (emphasis added)[8]

The *Tellabs* case on the pleading standard was decided less than a year ago. This raises a question as to why, in light of this decision, there is need for any further Congressional action prior to close examination as to how this decision, as well as others such as the Dura case cited, impact litigation.

Given the shifting landscape and rigorous standards for pleading scienter and scheme liability under § 10(b) of the Exchange Act, in certain cases, investors may find litigating claims in state court provides for a more fair result. The progeny of cases requiring a heightened pleading standard for auditor defendants are irrelevant with respect to state law claims that require a plaintiff to plead and prove their claims against an auditor defendant under less rigorous liability standards.[9]

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[5] Tellabs, Inc. et al. v. Makor Issues & Rights, LTD., et al., 551 U.S. ___ (2007).
[6] *Id.* at 1-2.
[7] *Id.* at 12-13.
[8] *Id.* at 7.
[9] *See, e.g., Kouri v. Superior Court*, 148 Cal. App. 4th 460, 468 (2007) (reversing trial court's dismissal of misrepresentation claim holding that "blatant deviations from GAAP support an inference of an accountant's recklessness when those deviations are tantamount to 'red flags.'").

<u>State law claims and remedies serve the public interest without undue burden on firms</u>

NASAA believes that investors clearly benefit from the availability of state law causes of action with broad standards of liability. These generally prohibit larger categories of conduct than federal securities claims under either § 10(b) of the Exchange Act or § 11 under the Securities Act of 1933 ("Securities Act"). While auditor liability in connection with federal securities claims is generally limited to the issuance of false financial statements within a relevant period, several important state law claims provide for liability well beyond this limitation.[10] Many state law claims, such as misrepresentation and common law fraud, prohibit entire categories of fraudulent conduct outside the mere preparation and dissemination of company financials. These claims are generally unavailable to plaintiffs in the federal context.

In contrast to federal securities claims, many state statutes and precedents set out their own schemes of liability and damages, quite distinct from the rule for federal § 10(b) claims as set forth in *Dura Pharmaceuticals v Broudo*.[11] For example, violations of many state Securities Acts do not require proof of causation.

The ability to allege state law causes of action is important in order to effectuate the public policy of accountability for wrongdoing. To the extent that state law provides investors with greater latitude, it serves a laudable goal. We trust that the Commission will make no recommendation to the contrary without careful study and analysis of all relevant data.

Conclusion

Audit firms are lobbying to restrict their liability under the federal securities laws and federal courts have raised the bar for pleading and proving securities fraud against auditors. In turn, investors have responded by increasingly pursuing litigation against auditors in state courts. While auditing firms often escape securities fraud liability under federal law, litigation in state court can ensure that audit firms are held accountable.

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[10] In the federal context, there has been some success in alleging liability for auditors beyond audited financial statements. *See, e.g., Wright v. Ernst & Young LLP*, 152 F. 3d 169, 177 (2d Cir. 1998) (auditors "do have a duty to take reasonable steps to correct misstatements they have discovered in previous financial statements on which they know the public is relying") (citations omitted); *see also SEC v. Manor Nursing Centers Inc.*, 458 F.2d 1082, 1095 (2d Cir. 1972) ("[p]ost-effective developments which materially alter the picture presented in the registration statement must be brought to the attention of public investors"); *In re Ikon Office Solutions, Inc. Sec. Litig.*, 66 F. Supp. 2d 622, 636 (E.D. Pa. 1999) (auditor required to perform subsequent events review through effective date of registration statement).
[11] 544 U.S. 336 (2005).