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Panel Presentation: Securities Regulation and Corporate Responsibility


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PANEL II: LAWYERING AND DISCLOSURE
AFTER THE SARBANES-OXLEY ACT

MS. SIEGEL: Good morning, let's continue. I'm Professor Mary Siegel, a professor here at the Washington College of Law of American University.

The Sarbanes-Oxley Act of 2002 was crafted by Congress in the aftermath of financial collapses at many corporations including but not limited to Enron. The law establishes the framework for a new regime of accountability by public companies by imposing new responsibilities not only on CFOs and CEOs, but also on accountants. New responsibilities, however, are federal responsibilities. The Act, which went into effect last July, empowered the SEC to issue and implement rules to effectuate the Act's purposes. The SEC has very recently issued rules on key provisions of the act and other rules are still in the making.

Our first panelist, John Huber, will discuss how these important federal rules under Sarbanes-Oxley are made, a topic with which he has much practical experience. Mr. Huber was director of the SEC's Division of Corporation Finance and was the primary draftsman of the first tender offer rules and going private rules. He was also in charge of the division's rule-making program for the integrated disclosure and the shelf-registration rules. He is a partner at Latham & Watkins. Despite these impressive credentials, my opinion is that the biggest feather in his cap is that he used to be one of our very successful adjuncts.

Two of our other panelists will discuss several aspects of Sarbanes-Oxley. Some aspects of this new federal law, particularly in the area of corporate governance and in the regulation of attorneys raise a variety of questions not the least of which is that they raise fundamental questions about the ability of the federal government to regulate aspects of law that throughout our modern history have traditionally been regulated by the states. In the last decade the Supreme Court has limited the scope of Congress's power under the Commerce Clause and other constitutional provisions several times. Moreover, even if properly within the commerce power, the Supreme Court has struggled about those areas that are traditionally regulated by state law. While we must await the constitutional challenges that will inevitably occur, we can consider today the wisdom of what Congress has enacted.

First, Professor Donald Langevoort will discuss how Sarbanes-Oxley changes the balance of power in the regulation and enforcement of corporate governance. Professor Langevoort was a special counsel in the general counsel's office of the SEC. He too had the distinguished honor of being a WCL adjunct before entering academia full time, primarily at Vanderbilt

Law School and Georgetown Law School. He is the author of numerous law review articles as well as a casebook on securities regulation and a treatise on insider trading.

Thereafter, Professor Thomas Hazen will discuss the new rules for lawyers under Section 307 of Sarbanes-Oxley. After leaving private practice in New York City, Professor Hazen was a professor at the University of Nebraska, and is currently at UNC-Chapel Hill Law School. He is the author of many securities articles, a four-volume treatise on securities regulation, three different multi-volume works, and several casebooks.

Lastly, Professor Jerry Markham will discuss restructuring of financial regulatory systems. Professor Markham was an attorney in the general counsel's office at the SEC, counsel for the Chicago Board of Options Exchange, and chief counsel for the Division of Enforcement at the Commodity Futures Trading Commission. He was in private practice before joining the faculty at UNC-Chapel Hill. In addition to publishing numerous law review articles, he is the author of three separate treatises and several casebooks. We'll begin with Mr. Huber.

MR. HUBER: Thank you, Mary. When I was chief of the Office of Disclosure Policy, which is the predecessor to the Office of Rulemaking in the division of Corporation Finance at the SEC, I had ten rules of the road that I used to teach rule writers about their craft. These rules went much further than just telling a wordsmith to go read the Administrative Procedure Act, although I recommend that too.

First, I would like to talk about those rules of the road and compare them then to what is happening now.

Second, I'd like to talk about some of the fundamental changes that have occurred in rule writing under Sarbanes-Oxley which I'm going to refer to as "SOX," and third I'd like to really go and quote Commissioner Glassman's rules of the road that she's following and compare them to mine.

My first rule of the road is have the authority to do what you want to do. That's important. Under the current Sarbanes-Oxley, you hear a great deal about the Commission implementing the words and the spirit of Sarbanes-Oxley. The concern that I have here is whether the agency is exceeding jurisdiction with respect to rulemaking. Will the rule result in preemption even if it is not intended to do so of state corporation law, or will it blur the line between state corporation law and the federal securities laws.

How is the fiduciary duty of a director affected under state corporation law when explicit duties are established for the director and the director's committees under federal regulation. An example here, is the audit committee, which is the focal point of more than one section of Sarbanes-

Oxley. Section 301 of SOX refers to the audit committee in its capacity as a committee of the board of directors.

While this clause may be read to mean that Congress did not intend to preempt or interfere with state corporation law, other sections of SOX are not so clear. Rules that prescribe everything from the qualifications of the audit committee, and financial experts to what the audit committee should consider before approving non-audit services by the outside auditor to the company, raise the issue of the relationship between federal regulation and state law, regardless of whether the rulemaking takes the form of a Commission rule or a direction to a self-regulatory organization.

Second rule of the road. If you expect others to obey the rules you adopt, you have to follow the regulations that apply to you during the rule-making process. Not only is this true now, but it was true back then. If you don't do it, the rule can be invalidated and can result in people losing respect for your rule and not supporting it. It is difficult, in the short time periods with all of the regulations that are now applicable to rulemaking, for the rule writer to do this.

However, the process is very important, and it's not enhanced by statements, such as the cost-benefit analysis, in the proposed new release to implement Section 404 of SOX. That section would require companies to report on the effectiveness of internal controls and procedures and to include that report in any reports. The proposing release estimates the compliance costs for these proposals at five hours per filing and states that the Commission has, "no basis for making the estimate."

Most public companies tell me that their employees and their advisors will spend untold hours to develop and refine internal controls and procedures and that their compliance costs are going to go up dramatically.

Third rule of the road. What is the purpose you are trying to achieve and is a rule the best way to achieve it. Is there another means available to accomplish the same results? For example, can an enforcement case, an interpretive release or "no action" letter resolve an issue and achieve the Commission's purpose without having to adopt a rule that applies to all public companies and causes every public company to have compliance costs? Here the rule writer should identify exactly what the rule should accomplish to make sure that the rule is in the best interests of the investors and the best means to accomplish that public purpose. The first thing here is to do no harm.

The Commission's response should not be more than is necessary to achieve the result. Too many rules result in regulatory overload and an inability for the Commission to effectively enforce its rules.

Fourth, keep the rule as simple as possible. While complexity may sometimes be necessary, such as in the net capital rule, it should not be an

operating principle of rulemaking. My example here is the Section 16 Rules and I won't dwell on it. But the advice on any Section 16 rule that is frequently given to officers, executive officers and directors, is don't do anything until you consult a lawyer and that lawyer had better be an expert in Section 16.

Today people are discussing standards based rules for disclosure, controls and procedures to provide more flexibility since one size does not fit all for companies. There's also much talk about principle-based accounting rules, which is a major point of discussion between the Commission and the International Organization of Securities Commissions.

IASCO, Both the SEC and IASCO are trying to achieve convergence between U.S. and European GAAP. As Bob Herz, who is your luncheon speaker, has recently stated GAAP will be principle based with some rules underneath. Ironically, at the same time that the accounting rules are becoming more principle-based and therefore require more not less judgment from accountants, the Commission is tending towards more detailed and prescriptive rules in which companies are specifically instructed to disclose what the Commission wants with less flexibility and less opportunity to apply judgment.

My example there is all of the MD&A proposals from December of 2001 on including the proposals for critical accounting estimates in May of 2002.

Five. Balance the need for investor protection with the cost of compliance. SOX was enacted to restore investor confidence. However, cost of compliance is also important. An example of the need to have balance is the metaphor of the safe car. Assume you could build the perfect car, one that would be one hundred percent safe, and could guarantee the buyer that he or she would survive any accident. But to be safe, the car would cost a million dollars. Who would buy it? The moral of the perfect car is that the cost of rulemaking is important and if it's too high, companies will leave the reporting systems if they can, and fewer companies will become subject to the reporting system in the future.

So companies will go private and private companies will not go public. Moreover, foreign private issuers may choose not to become subject to the reporting requirements of the Exchange Act, which would defeat the concept of investor protection in the United States. If accommodations are made for foreign private issuers, you've got competitive questions. There's also a statute that the Commission has got to make a judgment on the rule's effect of competition.

If foreign private issuers are exempt from a regulation, what competitive cost does that put on domestic companies, particularly small and mid-sized companies which are still required to comply.

Six. Follow the ripples of your rulemaking. Even if your rule fulfills the purposes you intend, it can also have unintended consequences. If so, what are they, and can you build a rule that prevents their occurrence.

Seventh. Be ready to adjust. Recognizing that there may be unintended consequences that cannot be anticipated before adoption of the rule. Be ready to look at it and review it after it's been adopted. For example, the shelf rule, which was the most dramatic part of integrated disclosure was proposed three times, had hearings held once, was adopted as a temporary rule before final adoption, and then even after it was adopted in 1983, it was amended in the late 1990s.

Eighth. Coordinate with other rulemaking bodies to avoid duplication as well as conflicts. During my tenure at the Commission, the best example of this was Regulation D. The Commission coordinated with state commissioners to avoid conflict between federal and state regulation of private offerings. Today, the challenges are even greater.

To cite two examples, the coordination of federal and state corporation law and second, the whole idea of the Financial Accounting Standards Board coordinating with the SEC and the new Public Company Accounting Oversight Board. Coordination in these areas will affect everything that we are doing in the future.

Just to add a little bit of zest, that Oversight Board may be setting GAAS, Generally Accepted Auditing Standards, traditionally done by the American Institute of Certified Public Accountants, so there's even more of an audience to contend with.

Ninth. Think long and short term. A rule may address a current need but could become a burden rather than protect investors in the long term. And here, all of this rulemaking that everybody was talking about as necessary may become a burden in the future and the regulatory program in the year 2010.

Tenth. Think big picture. Here the watch-word for the rule writer is to understand not only where the rule fits into SEC regulation, but how it affects the economy and society in general. If you think that that is something that is just a minor point, we're going to be talking about Section 307 of SOX which will show you exactly how big a point that can be.

With those ten rules of the road, I would submit to you that there are big-ticket differences between the past and right now. First, it's a much more political atmosphere.

Second, what I call the CNBC effect. Everything the Commission is doing is hitting the front pages as opposed to the business pages and as a former rule writer, I never liked to hit the newspaper at all.

Third, people are more invested today. You've got more than fifty-percent of the population having an interest in the stock market. Quite

honestly, that drives a great deal of interest in what the Commission is doing.

Fourth, the Commission is under time deadlines. I'd like to close with a small part of what I'm talking about in terms of the current area. We're talking about a very dedicated, hardworking staff at the SEC. They are good and smart. They are under tremendous pressure and new challenges. They're led by a Commission that has a Commissioner on it that I'd like to cite with real favor from my side because as a fellow rule writer, her rules of the road are something really to look at. Commissioner Glassman recently said, "[I]n evaluating our proposals, the comments we have received and the Staff's recommendations focus on the following factors.

First, what are the objectives of the rule? Second, will the rule meet our objectives? Does it go far enough or does it go too far? Third, does it meet the spirit as well as the letter of the law. Fourth, does it make sense? Are there likely to be unintended consequences. Are the benefits commensurate with the costs? Fifth, does it raise unrealistic expectations?"

Commissioner Glassman concluded her remarks with, after all the pain that investors have suffered, the last thing we want to do is to make things worse. That's why the comments are so important in highlighting pitfalls and helping us perfect our proposals. And with a philosophy like that I'm actually very encouraged by what the Commission is doing with respect to its rulemaking program under SOX.

MS. SIEGEL: Thank you very much. Professor Langevoort.

Mr. Langevoort: What I want to do is talk about the big picture, as John suggested, and consider the likely spillover effects of Sarbanes-Oxley. I want to do this in a discretely administrative law-oriented way, taking two themes that were very visible and driving forces behind the legislation. The first, as Mary suggested in her opening remarks, is a question about federalism. It has been common for the last twenty years, at least, to trot out—as John just did—a distinction between federal and state spheres of competency. The SEC is on the disclosure side, while the substance of corporate law (e.g., the mechanics of how decisions are made) is left to the states. I don't think you can read either the text or the "music" of Sarbanes-Oxley and think that this is much of a viable distinction anymore. If Congress really believed in the importance of that distinction as a matter of policy, Sarbanes-Oxley would be a very, very different statute.

If the congressional choice to rethink that attitude toward federalism is right—and I think it is—then over the next few years we're going to see ripples in a number of interesting directions. Let's take rulemaking. If you look back at either judicial interpretations of Rule 10b-5 or questions such

as whether the SEC can get into the world of corporate governance by pressuring the self-regulatory organizations to use their power in that arena, you often find a reiteration of the principle I just described. A very famous case called *Business Roundtable v. SEC* talks about the history of the '34 Act and then genuflects in front of that notion of a clear separation between state and federal authority. The question today is if you posed the same issue—does the SEC need Congress' permission to pressure the SRO's or develop proxy rules that get into the substance of corporate governance—should the answer come out differently? I think so. Similarly, there are questions under Rule 10b-5 about whether "simple" mismanagement or breaches of fiduciary duty are actionable if not disclosed. Many courts have resisted that, saying that mismanagement is for the states, not the SEC. My guess is that we will see this notion erode in a way that changes some of the underlying themes of securities regulation.

The other ripple that I want to talk about has to do with the disclosure environment itself. We are moving, we are told, toward something called "real time disclosure." At least the way I teach it to my students, this is the idea that there is a duty to disclose on a continuous basis all material information that comes into a company's possession. That, however, has thus far not been the law in two respects. First, the law is clear that disclosure currently is a snapshot—periodic—except with respect to a rare and small group of circumstances. Second, the law has never insisted on "all" material information. It has recognized implicitly or explicitly that there are kinds of confidential information or unripe information that shouldn't be forced into the disclosure regime because disclosure would hurt investors more than help them.

Even before Sarbanes-Oxley, we were moving toward more real time disclosure. Sarbanes-Oxley gives a big push in this direction—Section 409, which directs the Commission to talk in terms of "rapid and current disclosure" of material changes in a company's financial condition, as well as other portions of the Act. My sense here—and I agree completely with John—is that there is going to be a temptation for the SEC to take one issue at a time in a way that leads us to collapse the historic emphasis on periodic disclosure and make things much more rapid. The 8-K release that adds more possibilities for what has to be released promptly is one example. The SEC's certification requirements asking executives to speak not only to obeying line item requirements but also add everything else necessary to "present fairly" the condition and operations of the issuer is another. My question is are we going to a world where we are accelerating the timing of disclosure and then enlarging the scope of what has to be disclosed such that we really are imposing a continuous duty to disclose all material information? My sense—and my punch line here—is that there probably is a

virtue to thinking in those terms. But, as John said, it has to be done carefully, prudently, in a way that considers second-order and spillover effects, rather than just addressing the immediate issues. If you look at Australia, New Zealand and a number of other countries, they have sat down and tried to tackle, by rule or statute, the question of how far a corporation has to go in a real time world toward full disclosure. It's not easy to write that rule. You need very clear thinking to get it right. If Sarbanes-Oxley is pushing the Commission to engage in more rulemaking in this direction, I hope that the Commission will be attentive to questions of confidentiality, ripeness, and cost—without which you can't write a good rule.

MS. SIEGEL: Mr. Hazen?

MR. HAZEN: I'm going to start off with a quote that is very timely, especially in the wake of the Super Bowl. "Just as a fine natural football player needs coaching in the fundamentals and schooling in the wiles of the support, so too it takes a corporation lawyer with a heart for the game to organize a great stock swindle or income tax dodge and drill the financiers in all the precise details of that play. Otherwise, in their natural enthusiasm to rush in and grab everything that happens not to be nailed down and guarded with shotguns, they would soon be part offside and penalized. And some of the noted financiers who are now immortalized as all time all American larcenists never would have risen beyond the level of a petty thief or the short-change man."

This timely quote was made in 1923 in a newspaper observation by Westbrook Pegler. The reason I mention this is that concerns about the roles of the attorney and the lawyer in the corporate world are not new concerns. This is an age-old problem. The SEC, since its inception in 1934, has been regulating lawyers to some extent. It has had rules governing lawyers since 1935. Even as recently as the 1990s, a very oft-cited quote today, coming from an opinion by former Judge Stanley Sporkin and former SEC Enforcement Director Stanley Sporkin, talking about the scandals in the savings and loan industry—and this is a paraphrase.

"Where were the lawyers, where were the accountants?" Again, it's not a new concern to ask to what extent should lawyers operate as gatekeepers. Namely what is our role as lawyers in preventing these corporate frauds, especially when you're talking about disclosure issues where lawyers are filing disclosure documents or at least drafting disclosure documents along with the client. You have a very sensitive balance that needs to be struck.

Of course Sarbanes-Oxley has accelerated all of this controversy by mandating some lawyer rules that I'll talk about in a moment. But, again, this isn't news. As I said, since the mid-thirties, the SEC has looked at

lawyer conduct at least in terms of regulating the practice before the Commission.

It seems to me you have two issues here. One, a large policy basis. Should administrative agencies be in the business of regulating lawyer conduct, especially in terms of practice before that agency?

Second question. Is the wisdom of these particular SEC rules that have just been adopted clearly going to change the way that corporate securities lawyers practice? Just to keep this in perspective—and again this is not to advocate one way or the other for the correctness of this point—this is not novel. A lot of agencies for a long time had administrative rules governing what types of lawyering characteristics or what types of conduct qualifies you for practice before that administrative agency.

Some of the rule requirements are as vague as saying that the agency may prevent a lawyer from practicing before it, based on unfit character. Talk about vague guidelines in rulemaking. That certainly would be a vague guideline. So this too is not new. Those rules have been around for a long time, but we now have an increased focus on this because of Enron, because of the new Sarbanes-Oxley Act and because of the new specificity of the SEC rules that have just been adopted.

Just a little bit by way of background. Certainly most of the panelists and many in the audience are aware of this already. Of course the SEC has, in its arsenal of enforcement weapons such as the anti-fraud statutes the power to go after the lawyers, as well as anybody else, who clearly violates the securities laws.

The question is, especially with this expansion of the SEC rules, do we want a heightened standard for lawyers? Congress has certainly said that it does. Therefore we have a rule that although in the guise of what constitutes proper practice of law, is clearly geared to increase what was talked about earlier in the first panel. The new rules attempt to put more of a burden on lawyers to help bring to light violations that have occurred or are occurring.

The SEC has for a long time had a rule, now Rule 102(e), that is more specific than most agencies in regulating conduct of professionals. It is not limited to lawyers. It applies to professionals.

It applies equally to accountants, and the SEC has used the rule against accountants and accounting firms. I haven't made an empirical count, but my recollection is that the rule has been used more times against accountants than it has against lawyers. Now with these new specific rules mandated by Sarbanes-Oxley, certainly there is a push for the SEC to be looking harder at lawyers. Again, this is not new. The controversy that we have today is the controversy to what extent should the SEC be regulating

lawyer conduct. Traditionally, that's been a matter of state bar associations or state bar committees to regulate lawyer conduct.

Back in the 1970s, the SEC became quite aggressive in trying to regulate lawyer practice before the Commission. Those efforts died or went away or were beaten down by the American Bar Association. You can take any one of those descriptions of what happened. But in the late 1970s, the SEC backed off from its attempt to regulate and define what constitutes the proper practice of law before the Commission.

Fast forward to post-Enron, and about a year ago. March 7th 2002—and this is a little bit of instruction on to some extent how administrative law can be made—there was a letter sent by a group of law professors, drafted primarily by a professor at the University of Illinois, Richard Paynter, that urged the SEC to consider expanding the current Rule 102(e) to define what constitutes proper practice before the SEC in terms of legal representation.

There was also some discussion in that letter of conforming the SEC rule to the ABA Model Rules of Professional Conduct in terms of the lawyer's obligation to report within the organization wrongdoing that he believed or she believed was going on and was not being taken care of properly.

The law professors, and I was one of them who signed the letter, were not in agreement as to whether the rules should go further and in fact require what is now being called a noisy withdrawal; namely, that at some point a lawyer must resign from the position and be noisy about it without breaching client confidences—simply say that he or she was no longer confident in proceeding with the representation.

There was a very quick response from the SEC through the then-general counsel of the SEC, which said, that the SEC had considered these rules in the past back in the 1970s. Since 1981, the SEC has taken the position that it will not get involved in regulating lawyer conduct, in terms of basically saying that's something the bar associations do a lot more efficiently.

The next step in the legislative history of this was Senator John Edwards, the senator from the state in which I currently reside. He had a real concern for having some involvement in Sarbanes-Oxley, what became Sarbanes-Oxley, was concerned with what could be done—what might be added to the legislation.

Senator Edwards was aware of the law professors' letter. His office was interested in it. He contacted a number of people who had written the letter and drafted the legislation that is now Section 307 of the Sarbanes-Oxley Act. The drafters of the Act itself accepted Senator Edwards's draft as part of the legislation, and that's how it became embodied in the law.

What does this statute mandate? The statute is intentionally vague—intentionally vague in the sense that it delegates to the SEC the responsibility

and the obligation to expand its rules to define what constitutes proper conduct before the Commission.

There was some thought of actually legislatively writing the rule—having a detailed provision in the statute, rather than let the SEC deal with the tough issues and the nuances. That thought—and I'm not suggesting that was the thought of Senator Edwards, it was the thought of some of the professors who were involved in the initial letter. Luckily, at least that's my opinion, that thought dropped out of the process. And the idea became, if somebody's going to pass these rules, let it be the SEC who can consider the pros and cons, seek administrative public comment as they have, and then craft appropriate rules.

There is in the statute, though, one mandate. That mandate is that the SEC rules at a minimum must contain what is now referred to as an up-the-ladder requirement. Basically, if a lawyer has sufficient evidence of wrongdoing in connection with representation of a public company and if that wrongdoing is material or serious (again, it's not a trivial piece of wrongdoing) that lawyer does have an obligation to start climbing the corporate ladder and report that.

The up-the-ladder reporting is within the corporation. Again, not external, not any breach of any attorney-client privilege, but climbing the ladder, whether it be to a higher executive or whether it be to the audit committee or whether it be to the board of directors itself now, as the rules are being implemented. There are likely to be or there will be committees within the corporation geared solely to hear these types of reports by lawyers. But the idea being that the lawyer needs to report up-the-ladder so the corporate executives who direct this can address the problems in question.

But again, the statute did not attempt to deal with the very tough question of what is the threshold of that reporting requirement.

A couple of words about the SEC rules, and I only have two minutes, so it will be very few words. The rules also, as proposed, have this noisy withdrawal requirement that I mentioned earlier; namely, that the lawyer not only report within the corporation, but if the corporation did not take appropriate action, that at some point the lawyer might need to resign and alert the SEC to the effect of the resignation.

Those rules, not surprisingly, were highly controversial. The ABA and many other lawyers opposed them significantly. The SEC did not take those proposals off the table. They are still considering the noisy withdrawal requirement but did not put them in the rulemaking that was just adopted.

There was also some concern among the lawyers that the SEC standards for the threshold of reporting within the corporation were too vague and therefore needed some more guidance. The SEC's response—and I guess

John talked earlier about the agency following its own rules, and I'm afraid in this sense it broke at least one of its rules. It adopted a double negative.

The reason I say it violated one of its rules and in its plain English requirements, the SEC cautions for us not to engage in a double negative. But the double negative is that a lawyer must start climbing the ladder when it would be unreasonable not to conclude that a material violation has not occurred.

There has been a lot of controversy about whether this is an effective enforcement tool, whether it's too vague on the one hand. I think this probably is going to be difficult to enforce. Does that make it a bad rule? It makes it a bad rule to the extent that there may not be that much enforcement action.

On the other hand, one clear message that is coming through from 307 and the SEC rules even as vague as they may be, is a consciousness raising effort. Namely, that lawyers practicing before the SEC, and I know many securities lawyers who are already aware of this level of consciousness, doing public disclosure work, need to really be thinking about are my eyes open? Are my ears open? Is there something here that smells bad? Should I do something about it, at least in terms of talking to people within the organization?

I really don't want to go overtime. There was a handout when I walked in, an article I guess. It was just in today's or yesterday's paper about the SEC lawyer rules. I suggest you take a look at it, because it does point out that the nature of law practice is going to change, that we now have a new industry in corporate compliance work, and that's going to be the question of when lawyers need to start reporting up this corporate ladder.

MS. SIEGEL: Thank you very much. Mr. Markham?

MR. MARKHAM: Over the years I've been told that the federal securities laws were designed for certain purposes. One was to stop a market run up in the 1920s, to stop fraud and to assure for an accurate accounting of the companies for public investors.

One market bubble later, 650 restatements from major public corporations, and thousands and thousands of cases of fraud, some on a scale so massive as to defy imagination, it's very clear that the federal securities laws have failed in their purposes. We need to revisit them. We have done that in other areas.

In the banking area, we've looked at the Glass-Steagall prohibitions or restrictions on commercial banks and investment bankers combining their operations that were passed as part of the New Deal as well. Those restrictions were repealed.

In the commodity area, again, more 1930s legislation. The Commodity Futures Modernization Act of 2000 repealed the commodity exchange monopoly that they'd enjoyed for many years and deregulated the over-the-counter derivatives markets, a substantial part of our financial industry these days. And we still have no federal regulation of insurance in our country.

Why are we not reexamining the federal securities laws instead of trying to patch them to add more regulation on? It didn't work before. I think the reason is there are several myths out there. When we talk about federal securities laws, we have to drop our voice an octave, put them in quotes. They're very sacred sort of things. And those myths are, that I've heard through the years, that the federal securities laws are responsible for creating the largest financial system in the world.

That's not true. We had that largest financial system in the world before the adoption of federal securities laws. We had achieved it by World War I. During that war, we financed a large part of the expenditures of the English in that war, of the French and the Germans, before we went to fight them. And then J.P. Morgan and crew sold liberty bonds to finance the U.S. efforts in that war. We were truly in a dominant position in the financial markets of the world by the end of World War I.

Second myth, the stock market crash of 1929 caused the Great Depression. I don't think there's any living economist, with the possible exception of John Kenneth Galbraith, who takes that position today. They mostly say it was a factor. Well, the weather was a factor too, but that was not something that we can tie it to.

The next myth, number three, is that the federal securities laws allowed the markets to recover, regain confidence by investors in the markets and allowed our markets to operate again. Well, I don't know how you can say that. First of all, it was the Great Depression, and these statutes were passed there. We had no other depression that lasted that long, although one in 1893 was close.

Did the federal securities laws bring us out of that? No they didn't. We had the capital strikes after the passage and later had another capital strike in 1937 after the attacks by Franklin Roosevelt on the financiers. It did nothing that we can see to encourage recovery in the market. In fact, the markets did not regain their 1929 high until 1954. I don't see how we can say that that myth is true.

Next myth, the federal securities laws assure full disclosure. Well, we've already seen that that has not happened. We do not have full disclosure. The number of restatements coming out has been absolutely incredible, and also the myth of the market bubble. We had a bubble. The federal securities laws did not prevent that.

Why have they failed? Why did they not meet their goals? I think the answer is—I don't want to say it's simple. I don't want to say it's clear. But in my thinking, it's because we rely on the accountants. The SEC does not have enough staff to go out and examine firms, extrapolating out what the big five, plus the other accounting firms that do public company work, it would take adjusting for government efficiency. We're talking about a million additional government employees to assure full disclosure. And I guarantee you, even then they're not going to get it all.

No one is going to approve a million additional government employees for such a goal. What has the SEC done instead? They've used accountants as their policemen. They've required the certification of public statements as the means to assure that there will be accurate disclosure, and during that process, they've tried to turn the accountant into the cop on the beat, who would go out and do that investigative work for them.

And now we've got legislation requiring them to disclose violations. And with Sarbanes-Oxley, even more onerous provisions stuck on these accountants. What is an accountant? What do they do and who are they? How do we think that they can be these kind of policemen? Remember, the SEC and the U.S. Attorney's offices with all their resources, subpoena power, they didn't uncover these frauds. The market did. How are these accountants going to do this?

What is an auditor? I'd like to quote from a decision by the Supreme Court of California, *Miley v. Arthur Young & Co.* "An auditor is a watchdog, not a bloodhound." As a matter of commercial reality, an auditor performs in a client-controlled environment. The fundamental and primary responsibility for the accuracy of financial statements rest upon management.

The client engages the auditor, pays for the audit and communicates with audit personnel through the engagement, because the auditor cannot in the time available become an expert in the client's business and record-keeping systems. The client necessarily furnishes the information basis for this audit. And if we have an accounting rotation, it's going to put it even more in the hands of the managers of the company.

But even with all of that, there are other flaws. Again, accounting statements give you only a snapshot, and it's backward looking as to what the company has done. We're dependent on management entirely for projections and forecasts of what is to come.

An accountant, as I said before, is not a trained investigator. They don't know how to conduct an investigation. They don't have the power to grant immunity. They don't have the power to subpoena. What they do is a very basic verification of some of the company's activities. They kick a few

tires, not much else. That is not enough to uncover a complicated fraud where the management has control of the books and records.

The new accounting board, "peek-a-boo", is designed to bludgeon these accountants a bit more. And we've seen in recent SEC statements how we're going to attack the accounting firms if one of their auditor's doesn't measure up. We've seen the actions against Arthur Anderson. We're going to beat them into submission to make them be policemen whether they want to be or not. I don't think it's going to work, but I could be wrong.

A new regulatory model is needed, and I don't think it has to be a very complicated one. Information is a commodity. It's got value. Like any commodity, it should be purchased and sold. We do this every day. Americans own a lot of stock. But sixty-seven percent of American families, the last time I looked at the numbers, owned homes. They go out and purchase a home.

They don't get a certified financial statement from somebody when they purchase that home. What they basically get in some states, several states, is a disclosure form in which the owner may, if desired, check a box disclosing defects in the home. And if they go in and get a mortgage, they sign another group of documents. If you've ever gone through this process, you don't know what they say, but you sign them anyway, to be sure there are some disclosures in there, including the magical APR, which I've never yet been able to figure out, the Truth in Lending regulations.

We allow people to buy their homes without all this massive information. Why are we making this requirement as a part of stock purchases for investors in the marketplace? Why don't we treat this as a commodity? Now. We've had a lot of labeling laws for commodities. We have labeling laws for alcohol, warnings. We have labeling laws for cigarettes for warnings. I think there is a Wool Act, a Fur Act, a Hazardous Substance Act and the Lanham Act on country of origin and some others. But we label and disclose the contents and things. But these are very basic disclosures. It's nothing like we pretend to have under the federal securities laws.

What would happen in a commodity-based regimen where we had a commodity model for this information? Well, there's the old Supreme Court case of *Laidlaw v. Oregon*, where Justice Marshall told us how it would be. There an individual obtained the information about the signing of the Treaty of Ghent from some British sailors. He immediately realized the value of that information and went and bought tobacco, knowing the price is going to immediately rise with the knowledge that the treaty had been signed. And indeed, it did rise substantially, fifty-some percent when that knowledge became know.

Justice Marshall said there's no duty on the part of this individual to disclose that information. He gathered that information. He used the information. He had no duty to disclose. But he could not mislead the individual. And the individual asserted that he had asked if there had been any news that might affect the price of tobacco, and the purchaser had said there was none, and the case went back to trial on that issue.

That would be a commodity-based model. Now of course the controversial issue is insider information. How would that fit in the model? Would it be a free market approach where you could buy and sell and trade on it? Well, I don't know. We can still debate that. But the commodity model fits the misappropriation theory pretty nicely. You can't steal a commodity. And if you steal information, just as you could any other commodity, you could be prosecuted for that.

MS. SIEGEL: Thank you. Wonderful presentations. Do you have any questions? Yes?

VOICE: I've got one for Professor Hazen. I was just wondering, I've been speaking to some in-house counsels in some different companies for some research. What they were telling me is, they're trying to comply with Sarbanes-Oxley. They're trying to come up with disclosure packets for every transaction that's occurring in the business.

And when they're speaking to the top attorneys, the top counsel, they said, well, how much am I supposed to disclose? How much is supposed to be going in this report? And they would ultimately say, well, anything substantial or substantive, which covers just about everything.

When do you think there might be a rule clarification where we're able to say okay, this is too much, this is what's necessary, and this is what you'd better put in, otherwise you'll get in serious trouble?

MR. HAZEN: A total clarification, my short answer would be never. I think the last part of your question, though, I think is a very good one. And this gets to John's point and Don's as well. If you're going to be having rulemaking, especially in this particular area, it can be very helpful, especially when you're mandating disclosure, to at least say A, B, C, and D have to be disclosed

I think the problem that comes up and the evidence at least with 307 is now this double negative I mentioned, is when you're trying to take the big picture in a single standard, reasonably believe or does not reasonably believe, et cetera, or as you say, substantial or material, those guidelines just don't fall into a bright line test.

So there's always going to be some degree of uncertainty. The hope is to get rules that can provide as much certainty as possible in the clear areas at the margins, and maybe that will help give definition to the what is substantial, what is material, what is not unreasonable, to use the SEC's language.

MR. HUBER: In the 1970s, the Supreme Court clarified materiality to be a "would test". After that for about fifteen years until *Levinson v. Basic*, that was really the test. In 1999, the Commission came out with Staff Accounting Bulletin 99, which first was only applicable to financial statements, but after a Second Circuit decision in 2000, may be applicable to more than financial statements.

My point is, even before Sarbanes-Oxley rulemaking, the concept of materiality has in my mind been degraded. And it's degraded into more and more stuff, all right. In Sarbanes-Oxley, what you've now got, and the Commission is sitting here with proposals in one of my favorite rules, MD&A, Item 303 on Regulation S-K to the concept of reasonable likelihood.

And this is really important to me because the precision of writing a rule to elicit disclosure is the hallmark of what a good rule does. And the fact of the matter is, the concept of reasonably likely, if you look at the new release that came out two days ago on auditors, and it really has got more to do with audit committees, it talks about the concept—now get this—put your arms around this thought. What is reasonably likely to be material, okay.

What is reasonably likely to be material. First of all, what's material is the first step. The second step is what's reasonably likely to be material. Now I do this for a living. I write this stuff. Whoever is the, "counsel" that your companies are talking to, okay, doesn't know the answer. And I'm telling you that the answer is changing to be more and more information and you put together what Professor Langevoort talked about with respect to current disclosure, the two trend lines in this area are quicker disclosure.

So it's quicker, okay. And I've got to tell you a secret. Human beings can't meet that test. You're setting up a pattern of disclosure policy where it's not going to be capable of being done, and then in five years, somebody is going to have a Senate hearing someplace, where were you on the night of the 24th and you missed the disclosure? Well, I was asleep, because on the night of the 23rd, I was writing the disclosure.

And that is a system that is untenable to me as a practitioner. It's the wrong way to address the problems that we saw in 2000.

MS. SIEGEL: I want to address a quick question to Professor Langevoort. You talked about the traditional dichotomy between the federal and the state law being disclosure management and how Sarbanes-Oxley clearly changes that. What do you see as either the new line, or are you seeing a preemption?

MR. LANGEVOORT: Certainly not preemption, but concurrent jurisdiction that allows either state or federal law to top the other. If we assume—which I think is Congress's expectation—that federal law will usually be more aggressive, it will do the topping by imposing a more rigorous standard. As I've implied, I've never really believed that what the Supreme Court and others courts kept saying about the federalist line of separation ever made any sense. It was not a tenable line. Thus I'm thrilled that Sarbanes-Oxley causes us to recognize that so long as the SEC is targeting deception, it can police the full range of corporate governance. I'm happy with that, but it is going to be a big change in the law.

MS. SIEGEL: Other questions?

VOICE: A question for Mr. Markham. You mentioned you would like to go more towards a commodity-based approach toward disclosure. Could you just elaborate a little further on that? I don't quite understand how you would, I guess, get rid of the current approach and make it more towards a commodity-based approach. You said in the absence of being misled that would suffice.

MR. MARKHAM: I think the commodity-based approach, you could see the CFTC, the Commodity Futures Trading Commission, as an example. What they did is require disclosure in a one-page statement of the risks of trading commodity futures contracts. They're very stark. They would curl your hair. And that's what the consumer gets. They don't get a financial disclosure about pork bellies or soy beans. That would be the extent of it.

There would also be the fraud prohibition. We don't allow you to commit fraud in the marketplace, and we've got Rule 10b-5 and those other provisions for that to prevent fraud. Otherwise, we would not have a disclosure requirement where you have to give certified financial statements if you're going to give the public the appearance that those financial statements are guaranteed accurate. They're not. I don't know if that added any structure.

MS. SIEGEL: I want to thank this wonderful panel.