CORPORATIONS

6TH ANNUAL CORPORATE GOVERNANCE CONFERENCE
SECURITIES MARKETS AFTER GLOBAL CROSSING AND ENRON*

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Hon. Edward H. Fleischman, *Linklaters and Former SEC Commissioner*
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PROFESSOR PAINTER: Good morning. I'm Richard Painter, Professor of Securities Regulation and Lawyers' Ethics at the University of Illinois College of Law. I'll be moderating this panel as an information discussion and roundtable type of panel, very similar to what we did in the previous panel.

I want to very briefly introduce our speakers. To my extreme left is Edward Fleischman, who is a senior counsel to Linklaters but formerly a Commissioner of the Securities Exchange Commission.

Sitting next to him is Uttam Dhillon, who is the Policy Director for the Republican House Policy Committee. He also has had extensive experience both in the private sector with Milbank, Tweed, Hadley & McCoy, and also with various jobs in government.

Over to my right is Edward Labaton, who is a very well-respected plaintiff's lawyer with the firm of Goodkind Labaton Rudoff & Sucharow. He will discuss many of these questions from his extensive experience representing plaintiffs in class-action and derivative suits.

I am going to lead off with the observation we've seen from the last panel that there is a perception out there of a loss of investor confidence. That's certainly what you hear a lot about in the news. Is there really a loss of investor confidence, question number one? If so, what principal factors would you see behind that loss of investor confidence.

Those are two questions I would be most interested in, but there are other issues as well, and I want to allow each of our speakers, perhaps starting with Commissioner Fleischman, to give us some of their thoughts.

MR. FLEISCHMAN: Nobody's called me a commissioner for 10 years, and I don't feel like one. I'll take advantage of the fact that you've asked two questions to give 10-second answers to each. Maybe that'll start the discussion going.

I hear everybody say there's a lack of investor confidence. So far nobody has shown me anything that demonstrates it. I haven't seen a huge flow of redemptions of stock funds or a huge flow of sales of stocks. I mentioned to Eddie Labaton a moment ago, "I don't understand what the market's doing at 9,500," but that doesn't mean I don't have confidence. I didn't understand what it was doing at 6,500. It's not my game; I'm a lawyer.

I'd like to put what we're going to do into some kind of perspective, at least the way I see the issues that we'll be talking about for an hour. We're not talking about, in the words of the Preamble of the Constitution, the establishment of justice, the insurance of domestic tranquility, the provision for the common defense, or the promotion of the general welfare.

We're not talking about depriving anybody of life, liberty, or property without due process of law, and, with an exception I'll make in a moment, we're not talking about laws abridging the freedom of speech. What we are talking about is a series of statutory declarations making it unlawful to offer or sell a security without complete and accurate disclosure. That is, we're not discussing fundamental constitutional provisions, but rather a statutorily provided right for participants in the nation's securities markets to have a seat at an honest table.

I don't abjure or diminish in any way the key role of capital markets in the economy that makes this republic great. I do want to convey some understanding, however, of relative importance and to point out that, in fact, regulation of the capital markets in the manner chosen by Congress and the President 70 years ago derogates from, to some extent, and is an exception into the rights to free speech that are fundamental.

We have been listening for the last hour to the panel talking about corporate governance, and the growth of various requirements put on the corporations that are the issuers of securities in this country. I think it was appropriate that somebody who has served both as general counsel and as a director said toward the end of the discussion, that at least four-fifths of the people who serve in governance positions in fact try to do their best along the way.

I also think it appropriate for Eddie Labaton, with whom I will disagree on most issues, to say that liability, that not only greed, but fear, is a necessary motivation to implement the Congressional determination. A very important part of our problem, however, has been that both the private litigation process and the aforementioned institution that Mr. Blackburn talked about and disclaimed speaking for about three-quarters of an hour ago have spent the last 35 years trying so to blur the threshold of what does create liability for disclosure, nondisclosure, and maldisclosure that directors and other participants in the securities markets today really don't know that it makes a difference whether they go out and lie or just fail in an after-the-fact determination to have performed their job. One way or the other disclosure will be found to have been wrong.

PROFESSOR PAINTER: Okay, thank you. And let's turn to Mr. Dhillon.

MR. DHILLON: Well, the question is, "is there a loss of investor confidence?" I don't have any empirical evidence that would compel me to believe that, but I have seen evidence in the sense of the market's performance that would make me think that might be true.

To me, it's a funny question. I don't think we should be particularly surprised that investors, if they have lost confidence, have done so. One looks back at the history of Enron and we realize that analysts, even after all the problems had become public and known, were still recommending Enron as a buy. After a lot of the bad news about Enron had come out, the credit rating agencies — even when Enron was trading at three dollars a share — still had Enron maintained at an investment grade status.

If you look back at 1994, the credit rating agencies also missed the largest municipal bankruptcy ever — Orange County, California. If you add all of that up with the bad news that comes out on a daily basis — and if you watched any of CNN-FN or CNBC yesterday, you can hear this at the top of the hour — it's just not surprising to me that people are less than enthusiastic about pouring their money back into the stock market.

Congress has addressed this issue in April. On April 24, I believe, Congress did pass a bill, H.R. 3768, the Corporate and Auditing Accountability, Responsibility, and Transparency Act. I should say the House of Representatives passed that bill. It was a bipartisan vote, 334 to 90. CAARTA, which is what we call it, actually goes to the heart of a lot of the problems that are affecting investor confidence. So Congress is addressing this issue.

There is, although I said not any empirical evidence that investors have lost confidence, a lot of circumstantial evidence. I was a former assistant U.S. attorney in a past life, and I would feel somewhat confident making the argument to a jury that there's an awful lot of circumstantial evidence here of a loss of investor confidence.

Congress is doing what it can do; the President is certainly doing what he can do. The SEC no doubt is doing an awful lot. I would say that corporate America probably needs to step up to the plate, too, and realize that they've got to clean out their own house. They have to — it's really on them to convince investors to come back to the markets.

PROFESSOR PAINTER: Thank you. Mr. Labaton?

MR. LABATON: Thanks, much. As you properly introduced me, I am generally a plaintiff's lawyer, but in other lives I've acted differently. In fact, I did a fair amount of corporate work representing the same client that Ed Fleischman represents. He's such an old friend of mine, and you can tell he's an old friend, because only my old friends call me Eddie.

I can't answer whether there's been a lack of investor confidence. There are reasons to believe why investors might lose confidence, and that's what I'd like to address.

I think there have been serious erosions in the protection of investors, not primarily, although I would say partially by the Private Securities Litigation Reform Act – the PSLRA, which I think has some serious problems in terms of the huge safe harbor — Al Sommer called it the safe ocean — for forward looking statements, which I think contributed to some of the bad things that happened in the technology industry between 1995 and 2000 when it started to collapse.

But I think there was one good thing in that statute — the lead plaintiff rule, which brought institutional investors into the litigation arena, recognizing that they had the greatest loss, and in effect, taking out the race to the courthouse element, which I think was bad for the system. It was bad for us as plaintiffs' lawyers. It was bad generally.

But the biggest fault of the PSLRA is what it did not do. It didn't correct what the Supreme Court invited it to correct in the *Central Bank* case. It didn't have any provision for aider and abettor liability, civil liability for aiders and abettors, and in effect, by not doing anything, perpetuated the wrong that was done by the Supreme Court, giving a free pass in effect to the persons who are most responsible for protecting the market, what Jack Coffee, in a recent article in a *New York Times* op-ed piece, called the gatekeepers: the accountants, the lawyers, and the investment bankers.

There is virtually no civil liability unless they actually sign off on a statement. That's true in the Second Circuit; it might not be true in the Ninth Circuit; we don't know what it is in the Fifth Circuit. But we will find out; we'll find out in the Enron case ultimately whether there is civil liability — probably on motions to dismiss. There have been motions to dismiss by all of the "gatekeeper" defendants, the banks, the law firms, et cetera. Arthur Andersen signed off on statements in which they had, I think, three restatements in a period of five years. There's going to be no motion to dismiss as to them, if they're around by the time the litigation gets resolved.

Without that gatekeeper accountability, there is a huge protection missing from the market, and I suspect that that lack of gatekeeper accountability was a partial cause for some of the things that happened, for example, among the analysts. Jack Coffee in his article noted that during the 1990s analysts lost their skepticism. In 1990 they issued six buy recommendations to every sell. By 2000, the ratio was nearly 100 to one.

We know what happened starting in 2000. There's no accountability there. Unless there may be something in terms of what the Attorney General is doing in New York, but that really doesn't protect investors that much. It's too late; it's too after-the-fact. It doesn't take out the huge profits that the companies made with pretty reckless analysts' reports.

In terms of the other gatekeepers, there's certainly virtually no accountability in the Second Circuit for lawyer misconduct in connection with the issuance of securities. So until and unless we start getting to that area of protection, we're going to have, if not a loss of investor confidence, a damn good reason for investors to lose confidence.

PROFESSOR PAINTER: I would suggest that the Private Securities Litigation Reform Act of '95 did have a provision allowing the SEC to go after aiders and abettors, which brings us to the fundamental philosophical issue of "who is best positioned to enforce the securities laws?" The Securities and Exchange Commission? The private plaintiffs bar? Or both?

Throughout the 1990s we had an enhancement of SEC enforcement powers against insider traders and a variety of statutes, including the Aider and Abettor Provision of the '95 Act and a cutting back of the powers of the private plaintiff's bar, although it's shown by the statistics there's still plenty of private securities litigation. Which is the most effective enforcer of those two of the securities laws?

MR. LABATON: I would say that they're both essential. Certainly the SEC is essential. But so is private enforcement; it's what the Commission has said time after time after time. SEC Commissioners, when asked to speak on this, have emphasized the importance of the private bar as an essential supplement.

There's a piece in the program materials, something I did in Stetson Law Review, with a quote from Richard Breeden when he was the NSEC commissioner and what he said about the importance of the private bar. There's the SEC brief in the *Borak* case. There are SEC briefs elsewhere, *amicus* briefs in a number of cases, Commission statements in a number of cases.

There is a staff report of the Congressional committee that was chaired — the PSLRA was really first proposed in a very slightly different form in a Democratic Congress. It was then called the Dodd-Domenici Bill. The staff report on that, which supported virtually everything that is in the PSLRA, emphasized the importance of the private bar in this.

Certainly the private bar by itself is not enough. No one is suggesting that the SEC has no major role. But you have the SEC being understaffed to take on all these cases, sometimes being interested only in the highest profile cases, susceptible, perhaps like many other regulatory agencies are, of being captured by the people whom it purports to regulate. That's happened in times past with other federal agencies. Some of us were concerned about that being the case shortly after Harvey Pitt was confirmed, when he spoke about a softer and gentler SEC.

I think Enron changed that attitude, but there is certainly a risk. There was certainly a risk that when the Pitt administration took over that it might be, at least to some degree, captured by the accounting industry. Those are concerns that you need safeguards against. You need the supplemental role. You need the history of the fact that it has worked. At least one can assume it's worked.

I will confess that we have more litigation in the United States than anywhere else in the world. We have more access to courts. We have a better class-action remedy. At the same time, in words I heard by Paul O'Neill at the meeting of the Council of Institutional Investors, it's the deepest, most honest, most transparent capital market.

I don't think those things are unconnected. I don't think it's the principal cause; I don't think it's the principal reason, but I think it's an element. One doesn't build confidence or transparency on one little building block. It's a whole bunch of things. One of them is the access to courts and the availability of the litigation remedy for misconduct.

MR. FLEISCHMAN: Professor Painter, yesterday morning, about 10 blocks north from here, Professor Grundfest from Stanford Law School made a very interesting presentation on the PSLRA.
Two of the matters that I think Ed Labaton would be interested in, in the arena since the passage of the PSLRA, is that of the dozen, and there is an exact dozen, of settlements at 100 million dollars or greater since the PSLRA, the gatekeepers, the auditors specifically, have contributed something in excess of 500 million dollars to the settlements in money, not in securities, not in paper, in money.

There has to be something left, it seems to me, despite the aiding and abetting decision by the Supreme Court, to make the auditors believe they have to contribute an amount in that size in a dozen cases.

The other thing that I think that you want to know that Joe said —

MR. LABATON: I'm always interested in what Joe said.

MR. FLEISCHMAN: — is that the profit maximization motive of the plaintiffs' bar has been one of the key elements in the implementation of the securities laws in the United States. It has to be seen for what it is. It is very important and beneficent in what it accomplishes. It does not stem from pro bono motives.

MR. LABATON: I don't think anybody ever suggested it did, but I think that statistic might be misleading in that incentive itself, which Ernst put up, I think the number was 350 million dollars —

MR. FLEISCHMAN: You're close, you're close.

MR. LABATON: — Yes, so that there's 150 million from other accounting firms. I might say that although the accountants have, in some cases where they haven't signed off on financial statements, been taken off the hook in effect by *Central Bank*, it's really the other gatekeepers who have not been held accountable at all. Accountants do sign statements, and they are liable generally for securities laws violations where the statements are restated or otherwise fraudulent.

PROFESSOR PAINTER: Question from the audience.

AUDIENCE PARTICIPANT: This is really not the thing to investors that plaintiffs make it out to be for the simple reason that they want to see the safe harbor law; the plaintiffs' bar proved well able to plead its way around it by pleading more cases as accounting firm cases. There is no provision in the safe harbor laws with any notion of accounting fraud. So I'm not really that persuaded by that point.

More importantly, it seems the investors and the markets are well aware of the existence of safe harbor laws and fraudulent statements, since poor looking statements are usually identified, and it seems to me that reliance on poor looking statements at this point might arguably be unreasonable.

The second point is that the Lee-Plant provision is a good thing. Milberg Weiss' market share now is over 15 percent. What you have is plaintiff firms racing off to the courthouse to follow these lawsuits. Then, they get involved in something that looks akin to a proxy contest to collect up as many investors as they can, to say our guys lost a million and your guys lost 500,000, so our guys should be the lead plaintiff.

The fact of the matter is, institutional investors, by and large, are still a very rare animal in the contest for lead plaintiffs. You just don't see them. They have other things to do than to bring securities fraud actions.

The last issue is this notion about gatekeepers, and the fact that lawyers have now been found liable is beginning to change. As far as what accountants have paid out, to date accountants have probably paid out something closer to a billion. Ernst & Young paid 335 million and Arthur Andersen just paid the last installment of the 217 million in the First Baptist case, and the list goes on and on and on. Accountants are being held liable.

As far as the other gatekeepers, if you want to call analysts gatekeepers, I don't think it's fair to say they're not being held liable. CS First Boston paid a 100-million dollar fine. Merrill Lynch paid a 100-million dollar fine. The New York Attorney General made clear he's going to go after others. I'm not certain that some of the points that were made are quite as accurate.

PROFESSOR PAINTER: What are you going to do about Milberg Weiss's market share?

MR. LABATON: I certainly would like to get a bigger portion of that myself.

PROFESSOR PAINTER: Well other than correcting that problem —

MR. LABATON: The one thing I'd like to correct at least is the sense of what the law has developed in terms of and aggregating the largest investors. Yes, that was done early on after the PSLRA was adopted on the assumption that you get a group of persons, a disparate group, and have them as a group of lead plaintiffs. The courts have been pretty clear now that they won't allow that.

AUDIENCE PARTICIPANT: Some courts have.

MR. LABATON: Most courts have not; most decisions that have been litigated in that have not. I know we don't do it. We do try to go out to the institutional investors and meet with them. We've represented institutional investors in a number of high profile cases. I think that is the better way to go.

In terms of the projections and the safe harbor, what that did was encourage a lot of pretty reckless projections. It was kind of a terrible cycle that developed. You'd have the projection, and then you'd have the analysis and the Wall Street expectations based upon those projections. Then you'd have the fraud committed to protect the projections.

Then you had the totally absurd provision in the statute that says that you're protected if you knowingly make a false projection provided that you have meaningful disclosure. Now what is meaningful disclosure if you know the projection is false? "It's a lie; it's not true; we don't believe it." I don't know what it is, but the statute says that if you have meaningful disclosure, you can have a safe harbor for knowingly false statements.

I won't debate numbers with you on accounting fraud and recoveries. I know that there have been relatively few.

I also know that, since the PSLRA, the number of restatements has tripled and seems to be going up. I don't know the full reason for that. I know that that has happened. It's gone up from an average of 49 a year to most recently better than 150 a year, and going up and up and up. That's not good.

AUDIENCE PARTICIPANT: Per the comments about investment bankers being considered gatekeepers, they're really not. They're only really required to maintain certain standards with regard to the trading activities. So the broker dealers are more directly regulated and more accountable for market purposes, SEC, NASB, et cetera, but those are also self-regulating. In other words, there's a lot of self-regulation here that we shouldn't really also forget. Back to the assumption about the investment bankers.

Perhaps there has to be some sort of oversight; perhaps a point where, within the IPO process, there's an independent auditor that's brought in by the exchanges to audit whether or not what's disclosed in a prospectus is transparent and accountable, to see whether it's credible. There isn't any of that, because really the underwriters are taking a risk themselves with their capital. They're really pretty profit driven.

Going back to what's going to mitigate all the self interest that's involved, not only with the owners who want to cash out, but those who were business school buddies with the investment bankers, you have another whole other daisy chain here that people haven't accounted for.

Your concerns about the gatekeepers — we have to truly identify them. Perhaps the public itself, because they're left with few opportunities now for their wealth to grow. The 1986 Tax Act changed that you could own two and three and four houses and write off the interest on your mortgages. The markets have become pretty much the only game in town. People treat them like the track.

You have careless investors, reckless investors who don't really respect the companies that they're investing in, so they don't do the due diligence. It's the difference between an owner and an agent/manager, and most people think it's negative.

PROFESSOR PAINTER: Let me ask, Uttam, what is going on up on the Hill on the various proposals to amend parts of the Private Securities Litigation Reform Act? Have those stalled? Where are we on those bills?

MR. DHILLON: I believe there have been seven or eight bills proposed. Excluding CAARTA I think it's seven bills proposed. Of those, five would amend the PSLRA in significant ways.

One bill that we're waiting for right now is one that Senator Sarbanes is apparently in the process of putting together. He intended to introduce it last month as I understand it, but delayed that because of objections by the Republicans on the committee. The expectation is any day now the bill will be introduced if it hasn't already, and there'll be a mark up next week.

We don't know what that bill will say. My expectation is it will be a combination of things. It'll be changes in PSLRA, also increased transparency, but I don't know what it will actually say. I don't know how far it will get. The expectation with the composition of the Senate right now is that CAARTA may not even be considered in the Senate given its present composition.

MR. LABATON: What's the likelihood of its being reconciled with any House bill?

MR. DHILLON: Without having seen the Sarbanes bill, it's hard to say, but my best guess would be that if the Sarbanes bill passed the Senate, they would be very, very different bills and that reconciliation by the end of this Congress would be probably a difficult thing to achieve.

PROFESSOR PAINTER: One of the most talked about provisions was the one appealing the stay on discovery with respect to accountant defendants. Under the '95 Act there is a stay on discovery pending the resolution of a motion of dismiss, and a proposed provision would make an exception now for accountant defendants. The way I look at that is then you might as well open up everything, because the accounting work papers have just about everything there. The accountants might be more frequently named as defendants in suits in order to get to discovery. What's your take on that? Is that provision part of most of these bills?

MR. DHILLON: Yes, Congressman John LaFalce's bill I believe is the one that makes that provision for auditors only. I believe there are other bills; one by Congressman Ed Markey actually just wipes out the entire provision. But that's correct. I think it's just a foot in the door. Once you eliminate it with respect to one area, it's probably going to disappear all together.

PROFESSOR PAINTER: And how important is that discovery?

MR. LABATON: It's very important in terms of speeding the case up. It's particularly important in light of the very short statute of limitations that is, not in the statute, but by law under the *Lamp* decision of the Supreme Court. The statute of limitations now is one year from the date you discovered or should have discovered the fraud. Most courts have applied the should-have test rather than actually-discovered test, or a maximum of three years. The absolute outside limit is three years.

Notwithstanding what people have said, it is very, very difficult to plead a case against an accountant without substantial discovery. The accountants don't have the ordinary motive to defraud that insiders have. You have very, very high pleading requirements in every circuit. Some people would like them to have higher in some circuits than they are, but they're still very high. We will not bring an accounting case in the absence of very, very strong evidence.

Generally that evidence comes out of discovery. If you have the stay, what's happened in the process is you have sixty days after the first action filed before the lead plaintiff motion is made, then that issue is litigated. It could be anywhere. In the Waste Management case, I think it took six months to decide that. We ultimately prevailed in that.

Then there's a motion to dismiss, which there was in the Waste Management case, and the judge can take another six months to decide that. In the meantime, the case is entirely stalled. You can't do anything.

PROFESSOR PAINTER: And someone's turned on the shredder.

MR. LABATON: Well, either turned on the shredder or the memories have gone, or the memories have faded, or people have disappeared. Fortunately in Waste Management the company itself had new management. They really were anxious to get the case resolved. So they gave us discovery even though they could have had the stay. They gave us at least document discovery, and we were able to resolve the case within months after the motion to dismiss was decided.

I might dispel the suggestion that has not yet been made, but I heard it the other day in another program by an accounting representative, typically you get 25 or 30 percent. The fee off the Waste Managment case was 7.9 percent.

PROFESSOR PAINTER: Question?

MR. COCHRAN: I'm Andy Cochran of the U.S. House Financial Services Committee. I don't think there's anything in the PSLRA which is probably good because nothing would pass in the House on PSLRA. It's not going to happen.

MR. DHILLON: Not in that. There may be another proposal that Senator Sarbanes is working on.

MR. COCHRAN: A separate proposal.

MR. DHILLON: Yes, because that bill does not. Yes, you are right.

MR. COCHRAN: The response of CAARTA. I'm going to talk about it on the accounting side this afternoon on a panel. I think with the help of Mr. Cox, there was an amendment to CAARTA proposed to privatize action which is not really exclusive. Elsewhere CAARTA would beat back decisively at the committee level. I would be very surprised to see anything come out of PSLRA at all this year. I can talk a little bit about the accounting side.

PROFESSOR PAINTER: Yes.

MR. FLEISCHMAN: Professor Painter, as you well know the Congress isn't the only place that there are steps being taken in response to Enron. Just yesterday the SEC proposed two new rules. One, which is also included in the New York Stock Exchange proposals that we heard about earlier this morning, is to have CEOs and CFOs essentially certify that they don't know about anything the matter with those financial statements that they are filing with the SEC. And the other to speed up the reporting on Form 8-K of events that presumably would have had to be reported anyway at the next filing, whenever the next filing was.

Commissioner Glassman made a speech a couple of weeks ago in which she detailed all the things that the SEC has been doing. It's a fairly slim list peculiarly. Some of the things kind of work against one another.

You will remember, Professor Painter, that they have proposed to accelerate the filing of periodic reports, and at the same time they've proposed substantial new disclosure that would be difficult to accomplish in the present filing period, and even harder in the abbreviated filing period.

The Chairman of the SEC has spoken about lawyers. If we can turn the discussion to that for a moment. He has said that corporate lawyers represent the company and its shareholders even though management may hire and fire them. They must be satisfied that objectives management asks them to pursue truly are intended to and do further the interests of the company.

I've been practicing for more than four decades, and I would find it very difficult to determine what truly furthers the interests of any company. I can give the company advice on what may violate the law, but as to the interests of the shareholders, I don't really think that many lawyers are in a position to live up to Harvey's high expectations.

Which brings me to your proposal. You have proposed, if I read it correctly, that the SEC expressly impose on lawyers a requirement to tell clients' directors when they are violating the law, and, through 102(e), to make the omission of that a part of the corpus on which the SEC may deprive a lawyer like me of his license to practice before the SEC.

Your proposal, while fascinatingly analogous to Section 10A of the '34 Act imposed on accountants, makes me make a determination of black or white in what is very often middle gray to dark gray. At my stage of life I have no objection to go into my board of directors above management and saying you're in a gray area. Management's probably told you this already, but I'll tell you you're in a gray area.

That's not what you're asking me to do. You're asking me to tell them when they violated the law. I find that quite an easy thing in one sense, and a very difficult thing in all the practical senses.

PROFESSOR PAINTER: In circumstances where you know that they are violating the law, what we are saying here, and we had over 40 law professors sign this, is that the lawyer for the corporate client is required to tell the client, in fact the governing body of the client, the board of directors, that they, the lawyers, believe the client is in violation of the law.

Yes, there are going to be gray areas where the lawyer is not that sure; the lawyer is worried about it. Then some judgment calls have to be made. That's what the practice of law is about, making these judgment calls. If you do believe your client is violating the law, our fundamental premise here is that the client's governing body ought to know, and that if you're getting resistance from senior management, you don't just stop there. You do have to go up the chain of command.

PROFESSOR PAINTER: The ABA has consistently resisted this. We made proposals to amend model rule 1.13 of the Rules of Professional Responsibility. They refused to incorporate into model rule 1.13 a mandatory report to the board of directors. They just said that's one of the options.

Even worse, the ABA took the position that a lawyer should be prohibited from disclosing outside the client organization. Only eight states out of 50 states have bought into the ABA's position on this. The majority of states like New York permit you to disclose to the SEC if there's going to be a fraud. Some states require it, New Jersey and Florida.

The ABA has taken the most extreme view of client confidentiality, not shared by very many states at all, and the question is, is this creating an environment in which lawyers are seen not only as inadequate gatekeepers but as aiders and abettors of fraud? Or that they can be?

MR. FLEISCHMAN: They certainly can be so perceived if one is of the mind to do so. The problem in this area of securities law is that yesterday's problem, which I've discovered today, has created a liability for omission, which is tomorrow's problem. In other words, I cannot, as I may when my client comes to me with a gun, make the distinction between when she tells me she shot him yesterday, and when she tells me she's going to shoot him tomorrow.

It's an indivisible rainbow. Once my corporate client comes and says, or I find out through diligence, that there was an omission of something that I really think was a material fact yesterday, what I want to do is preclude it from being repeated tomorrow. I can't do so with out saying to the SEC the law was violated yesterday.

PROFESSOR PAINTER: I'm speaking about that letter of prospectus, future violations.

MR. FLEISCHMAN: I'm trying to suggest to you it's very difficult in the securities practice to make that distinction the way Stan Sporkin used to stand up and say, clear as a bell. It's not clear as a bell. About 99 and 44/100th percent of the time it involves a violation yesterday that I just found out about that I don't want to have repeated tomorrow, because I don't want to involve the board of directors or myself under Section 21C of the statute without your new proposal as a contributor to tomorrow's fraud.

PROFESSOR PAINTER: Of course, accountants and many other collateral participants would argue the same thing. These are difficult judgment calls, and we're going to be held liable. Well, are you willing to go after the lawyers?

MR. LABATON: I want to go after the lawyers where they participate in the fraud, where they know of a disclosure where, for example, they're responsible for preparing documents and they don't do any diligence at all, and they're the persons responsible for the diligence. As a result, a prospectus or other offering statement which omits material facts is offered.

There was a recent decision which the court withdrew after it was granted *en banc* and settled in the third circuit. What's the name of the case? (*Klein v. Boyd*) It is the case in which the issue was whether there was primary liability for a law firm. On the basis of the facts stated, Larry Fox tells me that those really weren't the facts, but you assume that they're the facts.

PROFESSOR PAINTER: Drinker Biddle was the defendant, yes?

MR. LABATON: Yes. The facts there were that it was an offering where the principals had been found guilty of securities fraud in several jurisdictions and were barred from offering securities in those jurisdictions. One had been involved in a cocaine conviction of some kind. The lawyer knew it. The lawyer prepared the private placement memorandum and omitted those facts. Sure enough, the investment was a total failure.

I think that the investor perceives that the lawyer is responsible for preparing the offering documents. If that lawyer either doesn't do some level of diligence or ignores facts that should be known to him or her, then there ought to be culpability on the part of the lawyer.

PROFESSOR PAINTER: Primary violator? You've got to prove they're primary violators.

MR. LABATON: The Ninth Circuit and the Second Circuit are split on those issues. The Ninth Circuit, in a number of cases, including one that I litigated, the ZZZZ Best case, held that, as long as there's substantial participation in preparing of the documents, there is a primary violator. The ZZZZ Best case dealt with the accountants, and it was an interim statement, so they hadn't signed off on it, but it was plainly fraudulent.

The Second Circuit has had a bright line test. If you didn't sign the documents that the investors saw, you're not liable as a primary violator. And the Third Circuit was going to decide that in that case, Klein against Boyd.

Klein against Boyd is the name. They decided that the law firm, at least in the facts pleaded, although it did not sign the document, had substantial participation in its preparation, and if the facts as alleged were proven, the firm would be a primary violator under the '34 Act.

There have been very few cases at the Circuit Court level, since these things ordinarily come up as a motion to dismiss. If the case hasn't been dismissed, it won't go up to the Circuit. So the Ninth Circuit has had only a number of district court cases. There's no interlocutory appeal jurisdiction ordinarily, so you don't get it unless there's been a dismissal. That had happened in the *Klein* case. The Third Circuit decided they were primary violator as pleaded. The Court took the case *en banc*, and then the case was settled it.

PROFESSOR PAINTER: I've seen more and more litigation just in the past few years against lawyers. Getting back to this letter, my approach is I'd rather have the SEC trying to do something about standards in the profession rather than the plaintiffs' bar coming after us. That's my own bias.

Let me go with one more question here.

AUDIENCE PARTICIPANT: The problem with substantial participation is that it is such a vague standard. In fact, way back in I think it was a Section 12 '33 Act case, *Pinter v. Daws*, the Supreme Court rejected it. One of the reasons they rejected it is that those words aren't in the statute. I'm pleased to tell you that the SEC has abandoned the substantial participation test in its Section 5 cases and has submitted amicus briefs in the kinds of cases that Mr. Labaton is talking about, these accounting cases, that also reject substantial participation and argue for something that one could probably call a co-authorship test.

Substantial participation is something which is likely ultimately to be rejected by the Supreme Court anyway. It seems to me the lawyers need to formulate a better test than that.

PROFESSOR PAINTER: Yes.

MR. LABATON: Well, the whole body of 10b-5 law is essentially common law. It is a body of law which is developed out of the one sentence rule adopted by the Securities and Exchange Commission in about 30 seconds. The whole body of law, which is the entire basis for open market fraud in the securities area, is judicially developed. It has worked reasonably effectively. It's a necessary aspect of the American corporate law. There's no reason why courts could not develop a standard that would hold those people who actually participate substantially in a fraudulent document liable for that, particularly when the investing public, whether or not it knows that that person was responsible, knew that a lawyer had prepared the document. I know the facts in the ZZZZ Best case, which was as brazen a fraud as one can imagine. To not have held the accountants and the lawyers accountable for what they did and didn't do in that case would have been a travesty.

They ultimately settled. They were very lucky they weren't subject to sanctions by the SEC for what they did do and what they didn't do. But to simply say that the test is difficult and in the absence of Congressional action to specifically provide for aiding and abetting liability is to leave a huge, huge gap in the law protecting investors.

PROFESSOR PAINTER: This is all true except for 1934, when it seems quite clear Congress did not intend a private action under Section 10(b). The courts brought that in later. So we have all this case law based on an implied right of action that

Congress really did not intend in 1934. Is that indeed part of the problem that this has all been case law? We of course now have the '95 Act and a lot of playing around with different parts of the system, but no going back to fundamentals of: should there be a private right of action under Section 10(b) or should this be something under state law? What are the parameters of that, defining that in Congress instead of having the Supreme Court decide aiders and abettors are not liable but primary violators? We don't even know what the standard is yet for certain.

MR. LABATON: We're pretty sure.

PROFESSOR PAINTER: Pretty sure, but wouldn't it be better for Congress to have done something more? Perhaps in 1934 it should have, but it didn't. It wanted to leave securities frauds to state law and use Sections 11 and 12(a)(2).

MR. LABATON: I think in American law, as opposed to the civil law societies, we have done much, much better where we've had organic development in the law. I much prefer 10(b)(5) and the organic development of 10(b)(5) to what would be the equivalent of the Internal Revenue Code. That's all statute; that's all regulation. Do you want to live with that in the securities area? I wouldn't.

The courts have very effectively been able to deal in an organic way, organically developing a body of law necessary to meet the needs of markets that have exploded since the law was first developed. It started to develop in 1948. The reg was written I guess around 1941.

PROFESSOR PAINTER: '41, yes.

MR. LABATON: The first case that held that there was a private right of action was in 1946, *Kirkpatrick*. The Supreme Court did not approve it until what, 10 years ago?

PROFESSOR PAINTER: 1970?

MR. LABATON: No, later than that. Later than that.

PROFESSOR PAINTER: The 10(b) private right of action?

MR. LABATON: The 10(b) private right of action came 10 years later. In that whole period you had a whole body of law which lawyers understood, which clients understood, by which you were able to explain to your clients what your responsibilities were under the law, by which people were able to enforce rights under the law. Sure, there were gaps. I much prefer that solution to codification, with the laws being frozen without the ability to develop, without being able to have some experience in different circuits with different approaches so that you can understand what the implications are.

The system really works.

PROFESSOR PAINTER: I'm going to be a cynic. I'm going to say that codification is clear, makes clear rules, and case law makes unclear rules. I've certainly seen *Central Bank*, the *Gustavson* case under 12(a)(2), a bunch of very unclear decisions. Of course, unclear rules are very clear for lawyers.

MR. FLEISCHMAN: Professor Painter, there is nobody more insightful or more humorous in his insight than Joe Grundfest. Yesterday when he talked about exactly that point he passed around copies of his new Stanford article on ambiguity in statutory draftsmanship. He talked about the strong inference test in the PSLRA. He broke out approximately 100 cases. He showed that the judges in about 25 of the 100 said, no matter what the interpretation is, this case doesn't make it. Another 25 they said, no matter what the interpretation is, this case exceeds the highest possible strong inference interpretation.

Then in the 50 cases that remained, they broke into three groups, essentially: the Ninth Circuit and the Silicon Valley, something that is essentially motive and opportunity, and something that's in between. He pointed out beautifully that if you simply put the 100 judges in a room — because there are 100 district court decisions before there's an appellate interpretation in the various circuits — with a law clerk, give each judge a quarter, it essentially comes out as though you've flipped coins.

PROFESSOR PAINTER: Yes, half were Second Circuit, I think, and half were split between the other two. It's an excellent article in the Stanford Law Review that just came out, with Joe Grundfest and Adam Pritchard going through this well.

Okay, we have a lot of ambiguity. Is it good? I think we've heard very powerful arguments for perhaps why it's good.

MR. FLEISCHMAN: It comes with a real cost. It comes with what somebody once called a tax on the markets. There's a huge litigation cost that goes into the system. When it goes way off the tracks, and I would tend to agree with Ed Labaton on this one, when 10b-5 has gone way off the tracks, the Supreme Court ultimately has granted cert and has made the decisions.

This can't be something that you simply say I would have bought or sold had I known. The rest were eliminated. The standard on materiality in *T.S.C. v. Northway*, something that is more than a gossamer mite, the gossamers got eliminated.

When it really went off the tracks, the Supreme Court did find a way to take *cert* and to eliminate that. As Ed Labaton said, I think it was now Chief Justice Rehnquist who called 10b-5 an oak tree from an acorn.

PROFESSOR PAINTER: The judicial oak that has grown from a legislative acorn.

MR. LABATON: There's another aspect, too, that's unsaid. One of the things that we have is an incredibly good bench in the federal system. There are a couple of judges that all of us would prefer not to appear before for one reason or another. But on the whole, it's a bench of great integrity — very hard working. As often as not, in many of these cases, they apply that ancient judicial standard, the smell test.

Is it really bad? They're going to find whether it's bad no matter how high the standard. They're going to find some kind of exposure.

PROFESSOR PAINTER: There's different gradations of smell.

MR. LABATON: But still, the point of it is, in securities law in areas of disclosure and fraud there needs to be some degree of flexibility in terms of exposure and in terms of interpretation. It is, I think, too complex an issue, too changing in the area for us to freeze it into a code.

PROFESSOR PAINTER: Yes?

AUDIENCE PARTICIPANT: One of the issues that just was raised is materiality. That's really the heart of what you need to tell your clients, you're going to have to disclose this. I think part of the problem is that it's now increasingly unclear what is and what is not material. This is a two-edged sword. I think it's so, because under SAD99, the SEC made very clear that it should be away from quantitative rules of thumb. One percent is not material; two percent is not material. Well now, what is material? It's anybody's guess.

The other side of that is, in the *City of Philadelphia v. Corning Companies*, the 10th Circuit came out with what looks like a new standard almost as to who had to know. Basically, they have to have known that this was a material fact.

PROFESSOR PAINTER: I co-authored a report with Scott Adkins and Megan Farrell of the Jones Day firm, the Pittsburgh office.

We provide a lot of statistical data, part of it from Joe Grundfest's site at Stanford, but also from the insurance carriers and from a variety of other sources on the amount of litigation which we see has been quite healthy and robust since the '95 Act, although I think the argument can be made that the amount of fraud has increased, and that issue is still open, but that the number of suits is substantially up. Indeed, last year, 2001, it doubled.

Yes?

MR. LABATON: That's misleading, because I think the —

PROFESSOR PAINTER: The IPOs, yes.

MR. LABATON: — the IPOs. That's one category. You take that out and —

PROFESSOR PAINTER: We do stress that. Last year a lot of that was from IPOs. We go through that and the size of the judgments, which have been quite substantial. We roughly saw about a 30 percent increase in controlling for the market capitalization of the issuer, at least from some of the studies.

This is the statistical data. There's going to be statistical data showing other things. I'd very much like to see what other data there is out there. I think that this report should give some interesting insight into what's going on.

We're critical of some of the proposals currently on the Hill with respect to the Private Securities Litigation Reform Act. We felt that enhancing SEC enforcement was the better route to go, not to eliminate the private securities litigation system. But if we're going to make the steps to increase enforcement, we ought to try it with the SEC first.

This ties a little bit into the pressure I myself independently have been putting on the SEC with respect to lawyers.

Comments on anything we've said so far before we continue?

AUDIENCE PARTICIPANT: What are going to be forces at work that are going to attempt to thwart what it was that you were describing, keeping in mind that the SEC's still under the executive branch? Although we have some aspect of campaign finance changes, the practice had been to make large campaign contributions and then pretty much get what you want if you're really shrewd, unfortunately in the executive branch.

So where are we going to have again revisiting independence, disinterested third party, the sum ability to keep self interest out of this? Who do you see as the ones who are going to tend to thwart the reforms that we're discussing?

PROFESSOR PAINTER: That's an excellent question. Let's hear from the Hill.

MR. DHILLON: I'm sorry, the question is thwart the reforms?

AUDIENCE PARTICIPANT: — thwart the reforms that you're discussing today in terms of materiality, codification of what's considered material in an attempt to eliminate the murkiness within these guidelines.

MR. FLEISCHMAN: I think that there's a real incentive on the Hill to fix the problem. The refrain is "we must prevent another Enron." I think that there is actual incentive at the SEC and in the Administration and on Capitol Hill to do that.

You had asked the question earlier, who should keep everybody honest, the SEC or private rights of action? I'm actually a believer in private rights of action. I think they're very efficient. I think that private attorneys can probably spot something and raise that issue very, very quickly, possibly more efficiently than the government.

I think that missing from that was a third element, and that's criminal enforcement. I think one of the things we need to really focus on and think hard about — and I'm not talking about criminalizing corporate behavior, it's a different issue — is whether criminal behavior has occurred within the corporate world. We need to seriously prosecute that. That may take a reorganization of the SEC. It may require the SEC to alter its priorities. It may require the SEC to cross-designate enforcement attorneys or the Department of Justice to cross-designate SEC attorneys as special assistant U.S. attorneys.

I think that, if you get right back to the theme here, which is investor confidence, and if investors saw more crooks — and that's what we're talking about here — going to jail, they would feel more confident in the markets.

AUDIENCE PARTICIPANT: I just wanted to add right off your point that if you think about it, well the Wall Street firms pay the fines; they just pay the fine. They pay without admitting or denying guilt. None of these organizations really admits guilt. Perhaps that's why the prosecutors against Arthur Andersen, given how they obstructed justice forced them to admit guilt. The Wall Street firms get to slough off this whole issue. The investors don't really have a standard by which to judge what has been egregious conduct right now.

MR. DHILLON: I really believe that if lawyers, accountants, and CEOs knew that a U.S. attorney's office was going to come after them if they committed a crime, if this was a serious threat, if they weren't just going to be dealing with civil remedies, that would go a long way in convincing people and creating transparency, voluntary transparency, and creating more confidence in our markets.

PROFESSOR PAINTER: I've talked to several U.S. attorneys around the country about this. A lot of them don't even have staff who have substantial experience in the securities laws. That's not true obviously in the Southern District of New York, but you go to some of the regional offices in major cities and they don't have the funding for that slot. The commitment from the Department of Justice is not there to provide that kind of funding outside of the major financial centers where, of course, these cases are brought with some frequency.

MR. LABATON: A lot of these cases really would make a jury's eyes glaze over. The ones that we think of as headline cases wouldn't clearly. Most of the cases would make a jury's eyes glaze over. There's very little incentive for a U.S. attorney around the country to bring that case, to devote his resources to it, and try to first educate a jury before he persuades it about what's going on.

The chap who was in yesterday's paper or today's paper who essentially got indicted — it's a newspaper report, so it appears to be a clear jump ahead of the release of public news. That one's easy for a U.S. attorney or for a jury. When you get into these so called financial cookbook cases, you can demonstrate the damages fairly quickly if you're the prosecutor. But to construct the theory of liability and educate the jury is a very different kind of question, it seems to me.

PROFESSOR PAINTER: The Arthur Andersen case in point.

MR. LABATON: I agree generally there has not been enough criminal enforcement. I think that where the criminal law changes in the last year, particularly the sentencing guidelines and the resultant power of the prosecutors to force plea bargains as a result of that, you get a fair number of guilty pleas to some offense. Arthur Andersen obviously couldn't, but many could.

There's a certain irony in the decision to prosecute Arthur Andersen, because I think that may have really resulted in ultimately failing to adopt basic reforms in the accounting industry itself. I think you'd kill the Volcker plan, which was very good. It took the heat off all the other accounting firms. It focused on one relatively narrow aspect of what was going on in Enron and the accountants. It's made it much easier for the accounting industry to lobby against some basic reforms.

I read a piece in the paper the other day. They spent four million dollars so far in trying to prevent certain legislation from going forward that would have essential reform in it. Unfortunately, while in principle it's a good idea to prosecute criminal wrongdoing, in the case of Andersen I think it may have backfired in terms of what's going to happen as a result and what will not happen as a result.

PROFESSOR PAINTER: Sir?

AUDIENCE PARTICIPANT: Several years ago there was a proposal to regulate energy trading. Congress, as I understand, was heavily lobbied by the interests, including Enron, to leave the energy trading unregulated. It mentioned political contributions and so forth. They did so, and of course, the unregulated energy trading was the primary cause of the Enron situation. Now we find other companies involved.

So Congress didn't act because of its, you might say, political contributions and so forth. So Congress is not free of guilt.

PROFESSOR PAINTER: Doesn't this raise an interesting question about the federalization of corporate law. One of Bill Carey's complaints in his Yale Law Journal article several decades ago was that Delaware was in the back pocket of the corporations and their lawyers. We see a lot less going into the Delaware legislation by way of campaign contributions and so forth, than we certainly see in the Federal system.

Does it not make sense to at least have some of our law governing these issues be under the law of states where there's some jurisdictional competition, rather than giving the Federal government a monopoly that would make these problems even worse? Of course, the plaintiffs' bar makes campaign contributions, but there are contributions from both sides. Congress ought to be making all the rules in this area.

AUDIENCE PARTICIPANT: Four or five years ago I went with a client of mine who had been basically a victim of a securities crime to senior Federal law enforcement officials here in Manhattan for a meeting about the situation. He was told at that time that, since he had only been a victim to the extent of about 20 million dollars, that we were small fry. The Feds wouldn't even look at it and said that we should go instead to the state office and get the state involved.

There's a de facto division between the Feds and the states based upon the volume of the crime.

PROFESSOR PAINTER: And the states seem to be looking for an opportunity — if there's a vacuum to be filled and a reputation to be made, front page of the *New York Times* and so forth, it will be billed by state attorneys general. That may be a good or a bad thing, but that is certainly the way it works.

AUDIENCE PARTICIPANT: It's de facto that that seemed to be the way things were operating here a few years ago.

PROFESSOR PAINTER: Scott?

AUDIENCE PARTICIPANT: Before we infuse collective guilt to the Congress, I think we should focus on what the problems in an Enron really were. One, there was a corporate governance problem. Two, there was a disclosure problem. Three, there was an accounting problem: ground tripping, market to market accounting. Those were the problems. It wasn't really necessarily energy trading per se, but it was the accounting practices and revenue recognition practices which are a violation of existing law, at least allegedly. I don't think that regulating energy trading would at all be responsive to the problems that caused Enron.

MR. FLEISCHMAN: The point that it was all a violation of existing law is the fundamental point to be made, I think, when you consider the market after Enron, after Global Crossing. Without ascribing motivation, intent to defraud, or anything to any particular individual, without saying where the failures were, certainly it's clear to us all in retrospect that these people maldisclosed. They not only misdisclosed, they not only omitted, they had every possible combination of maldisclosure in what they put out to the public.

PROFESSOR PAINTER: They lied.

MR. FLEISCHMAN: They lied. It doesn't take a Congressional reform of present law to deal with that. It doesn't take a top to bottom reform of the SEC and its regulations to deal with that. One has seen, I think, throughout the history of markets and of non-market human activity, that if somebody sets out to lie, it's going to take a while before he or she trips and everybody else realizes that he or she is a liar.

What's on the books would have been enough had there been some clue. In fact, following up on what the gentleman just said, the clue was not the disclosure so much as it was that market participants in that energy trading market refused to deal any longer with Enron and it choked. Had it not choked in its operations, it might have been able to go on with the game.

PROFESSOR PAINTER: So the market worked?

MR. FLEISCHMAN: In that sense, a lot of what we are seeing post-Enron is the market working.

PROFESSOR PAINTER: Now what's with all these hearings up on the Hill? How many Enron hearings have we had up on the Hill?

PANELIST: The accounting standards were also enormous. The relationship of Andersen as both the consultant and an auditor, as I understand it, permitted the partner in charge to overrule the national office on key accounting issues. That would have been unheard of 10 years ago. Absolutely unheard of. Those kinds of things are things that I think have to be corrected at an accounting level.

I know later on there's another part of the program on that, but I think that is perhaps the most critical aspect of Enron.

PROFESSOR PAINTER: Yes, sir?

AUDIENCE PARTICIPANT: I share an alumni membership to the same club as Ed Fleischman, although at best at different levels. I'd like to hear Ed's view of what the conditions responsive thus far give to Enron, and whether he shares my skepticism that they're not doing anything meaningful. Concerning the idea of requiring the CFO and CEO to certify financial statements, does anyone think that Mr. Pascal and Ken Lay would not have signed those? I view this as regulating for the sake of regulating. The Commission is out there trying to look like the official regulator, but in effect it isn't very effective. I don't know if Ed shared that view or not?

MR. FLEISCHMAN: Going back to the very first point that Professor Painter made about the public's loss of confidence, just from reading the newspapers, the SEC must demonstrate that it is a vigorous regulator right now. The way it does that so far, according to Commissioner Glassman, is by putting out all these proposals, only one of which holds water, but none of which really addresses what was going on. Because what was going on, it seems to me, is going to be an enforcement problem.

Bob Blackburn and his staff at the SEC's New York office are going to have more say on preventing future Enrons than are a whole bunch of new rules.

PROFESSOR PAINTER: I'm going to throw out one other rule that I have not seen yet from the SEC. Jesse Freed, professor at Berkeley, suggested another 16(a). You ought to be required to file your report prior to making the trades, like two days or so before the insiders have made their trades so the market can find out.

MR. FLEISCHMAN: But most of those people do have to file on Form 144. Although they don't have to report the trade, they have to report the intention to trade if they are directors or CEO officers before they trade, and then report afterwards what the trade has been and what the price was.

So there is information out there. A lot of people file Form 144 filings.

PROFESSOR PAINTER: But everybody isn't filing those. It depends on whether it's applicable.

MR. FLEISCHMAN: It is required for anybody who is control of the company.

PROFESSOR PAINTER: Yes.

MR. FLEISCHMAN: Certainly the senior officers, perhaps not the independent directors, but many directors are counseled to file, to treat themselves as controlling persons anyway for the purpose of filing a Form 144.

PROFESSOR PAINTER: Anybody who hasn't asked a question?

AUDIENCE PARTICIPANT: I'm interested in your reaction to the question of whether the audit committee's independence and willingness is important.

If the audit committee met with the auditors alone without internal financial management and really asked some hard questions, would that have changed any of the Enron situation? Is that the kind of thing that might make a difference?

MR. FLEISCHMAN: I chair an audit committee of a public company. We're not New York Stock Exchange listed. I don't think I would pass the New York Stock Exchange proposed new test of financial management experience, so I may be relieved of this responsibility soon. I won't miss it. It seems to me that the answer to your question is, yes and no. I can easily construct a set of circumstances in which the right questions would have gotten such answers as to put the audit committee on notice that there was more to ask. That would be the lesser piece of the pie, it seems to me, because I would have to have both the insight to know the exact right questions and the luck to ask the questions that were particularly germane to what Duncan knew about.

That doesn't happen very often. It happened to me once, nearly 40 years ago. I was a tad of a lawyer, and somebody offered me a board position in a new company from the garment district. The partners of my then firm were fool enough to let me accept. But I got lucky. I asked to talk to the auditors myself before the statements were published. I was promised, and I asked again, and I was promised. I asked a third time, and I was told perhaps I'd better not. Then I said then you don't want me as a director.

I was very lucky. Not that I had any idea what I would ask, but it turned out later the old Touche Ross firm had let them count units for dozens, and the company went down. Would I have ever found that? What question could I have asked that would have elucidated the fact that somebody didn't audit right, that somebody let them count units for dozens?

AUDIENCE PARTICIPANT: Thank you. The comments about how Enron committed fraud and what I'm asking are different questions, because I actually think that the Enron issue goes right to the White House. So the potential for something really being done to prevent or to address the fraud that Enron management committed, and I actually am —

PROFESSOR PAINTER: Where's the connection?

AUDIENCE PARTICIPANT: Well, with regard to Enron or improvements to be made in the market because of Enron, actually — I wouldn't say that they colluded with their banks, but the typical process would be bankruptcy. I think they declared bankruptcy to shed shareholder lawsuits. Because the senior management had emerged themselves with the stock, had it remained a public company, they would have been on the line for shareholder litigation. When you declare bankruptcy, you share the shield of the company in a relationship either by debtor in possession or by creditor figures.

Having said that, there was a level of collusion, no doubt, between the accounting firm and the banks and the other parties on the steps by which they would eventually create a liquidity crisis and declare bankruptcy. With this being the scenario, and I'm fairly certain this is really what happened, I'm interested to hear the thoughts on how this process is going to be remedied. Now all the shareholders that were left holding the bag of Enron stock were the last to know the truth. Everybody else, obviously the investment banks, trust funds, and everything else, Deutsche Bank, and I think a number of these other companies, perhaps they sold these shares. See what I'm saying?

PROFESSOR PAINTER: Well, it's a mess. One of the problems is you seem to have a lot of guilt by association. You see the President before he became President drinking a beer with Kenneth Lay, and suddenly the White House is wrapped in it. Of course, Arthur Andersen has so much money all over the Hill on both sides. Maybe there is too much money in politics, but I think we have to clarify what exactly was the problem with Enron. You have the energy trading side and that issue, and then the securities fraud side.

I'm not so sure you can link Enron's political campaign contributions to any governmental action on the securities side in terms of the fraud. Now Arthur Andersen, you could debate that one. So it's a terrible mess with lots of different strands coming out of it. The problem is, and we've had endless hearings up on the Hill, more of the energy seems to be going into the blame game than into how it affects what went wrong and if any fixing is required. I think that needs to be stressed, perhaps we don't need so much fixing.

MR. FLEISCHMAN: A partial answer to the lady's question is that the insurers for the banks and the banks are engaged in litigation in which each side is pelting the other. The issue of whether the banks did collude, I think was the word she used, is in litigation. We will get at least some kind of answer to that issue without regard to securities litigation.

AUDIENCE PARTICIPANT: If I can get away from the legal part of it for a minute and just talk for a minute about how modern technology has changed our fathers' security market. For example, one of the most popular trading vehicles now are the QQQs, which are exempt from the optic rule when making insured sales.

Coming up, which you're very familiar with I'm sure, are the so-called single stock futures, which have been fostered by the Chicago Futures and Options Exchanges, which will bring in certain elements of futures markets into trading stocks.

PROFESSOR PAINTER: I heard Judge Easterbrook give a lengthy lecture on that at the University of Chicago, of course suggesting that that not be regulated, which would open up some very interesting opportunities we might say.

One more question.

AUDIENCE PARTICIPANT: To go back to the focus of what the paper says this about, is there a crisis in investor confidence? I think one of the reasons that there's a lot of storm and fury about appearing to do things and very little action about really changing it is that there really isn't a crisis of investor confidence.

There is a crisis of some public confidence. However, one of the interesting footnotes of Enron is the degree to which a lot of market participants do not actually actively control their investments. How many of them had vast amounts of money tied up in Enron stock and for inertia or lack of information reasons didn't do anything about it?

Most of the people out there today participate obliquely or opaquely in the market. They've got money tied up in pension funds which are being managed by the real investors, the pension funds. Or they've got money in mutual funds who couldn't leave the market if they wanted to, because the fund prospectus says we're going to be invested in X, Y, Z type assets.

So because of that fundamental lack of mobility in the market, a lot of so-called investors, the beneficial interest holders, really aren't in the position to act if there were a crisis of their confidence. The market players have put all this in perspective and said, okay, we've got some accounting irregularities and some violation under current law in the regulations. Would you see the hiccups of the real investors?

Every time that there's another one of these little accounting bubbles, bang, they're out of that market. But are they wrongly out of the market? Are they broadly suffering in lack of investor confidence? No. That's why there isn't any real impetus to fundamentally change the system.

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