PwC Advisory
Crisis Management

2005 Securities Litigation Study*

Observations from the editor

At the end of every interview in an investigation, the late Alan Levenson, former Director of the SEC Division of Corporation Finance and head of the Fulbright & Jaworski securities practice, would always ask, “Are there any questions I should have asked but did not?” At the end of this year’s PricewaterhouseCoopers Securities Litigation Study, its editor asks the same of our readers. Our PricewaterhouseCoopers Securities Litigation and Investigations Consulting practice maintains an extensive database on private securities litigation, SEC enforcement actions, securities-related DOJ prosecutions, litigation involving foreign private issuers, and financial fraud–related accounting and auditing information. If there is some new topic or additional analysis you would like to see included in next year’s Securities Litigation Study, let us know by contacting us at www.10b5.com.

Over the past ten years, since enactment of the PSLRA, we have been tracking the frequency and nature of private securities class actions. The gravamen of the cases may differ, but the basic theories of claims and the principal allegations—both for accounting cases and disclosure cases—are relatively similar. Accounting misstatements tend to fall within a few major categories, the most prevalent being revenue recognition. The underlying accounting principles tend to center on a few areas of GAAP: software revenue recognition, the general rules of revenue recognition, sales returns and accounting for revenue recognition when “right of return” exists, accounting estimates, impairment of long-lived assets, and accounting for contingencies. What has changed over time has been the magnitude and average values of settlements.

Since enactment of the PSLRA, total settlements have amounted to more than $37 billion. There have been more than 155 cases settled for over $20 million, with more than 65 of those cases settled for over $60 million and 40 mega-settlements over $100 million. In 2005, there were 20 settlements greater than $60 million and 12 settlements above $100 million.

Since 2001, the US economy has been strong, major business failures have been relatively few, and the stock market has performed reasonably well. If the US does enter into another recessionary period—with increased bankruptcies and significant declines in the stock prices and market capitalizations of companies, it is likely that securities litigation and mega-settlements will increase. That is to say, this may be the lull before the next storm.

During 2006, we will be providing periodic updates on key securities litigation trends and events in our PricewaterhouseCoopers Securities Litigation Consulting newsletter, *Solutions*. And, we will be asking questions—and undertaking analysis—in several new areas, including: the securities litigation plaintiffs' bar and its effect on the frequency and timing of private securities class actions; the impact of settlements on the cost of D&O insurance, and trends in D&O rates; and the effect(s), if any, of Sarbanes-Oxley (especially Sections 302 and 906 certifications, and Section 404, "Management Assessment of Internal Controls") on securities litigation.

I would like to thank my co-editor, Ms. Grace Lamont, our "research guru," Ilan Kranz, and his staff, and our "Op-Ed" commentators—Mark Radke, Roger Witten, and Ms. Lamont—for their invaluable contributions to this year's PricewaterhouseCoopers Securities Litigation Study. And, I would like to say goodbye: Next year, Ms. Grace Lamont will assume the role of editor. It has been my privilege and great pleasure to edit the Study over the past ten years, and I look forward to the PricewaterhouseCoopers Securities Litigation Study continuing to be a critical piece of research in the coming years.

Daniel Dooley
Partner, PricewaterhouseCoopers

Table of Contents

Overview

Private securities class actions subside in 2005 as settlement values skyrocket.

In 2005, there were 168 new private securities litigation cases filed in the United States. This is the lowest number in nine years.

What is behind these lower numbers? One factor might be the current backlog of major cases—Enron, WorldCom, Adelphia, and so on—already being handled by the plaintiffs' bar, consuming the time and resources of securities plaintiffs' lawyers and causing them to delay new case filings. Another reason may be the hoped-for deterrent effect of Sarbanes-Oxley, as corporate executives observe the long prison sentences handed out in connection with Enron, Dynegy, WorldCom, Tyco, and other matters. More vigorous investigation, enforcement, and prosecution by the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ) may also be helping generally, while the recently completed initial year's Management Assessment of Internal Controls under Sarbanes-Oxley Section 404 may have helped management at publicly listed companies focus on improving internal accounting and reporting controls.

Simultaneous with the drop in case filings is a rise in the average cost of a private securities litigation settlement, which increased to $71.1 million in 2005, excluding the "mega-settlements" in the Enron and WorldCom matters. That number represents a 156% surge from the $27.8 million average value of settlements in 2004.

Key indicators:

As we have noted in prior years, the dramatic rise in settlement values appears to be the result of three factors:

1. The "lead plaintiff" provision of the Private Securities Litigation Reform Act of 1995 (PSLRA)
2. The enormous theoretical economic damages that result when stock-price drops of 20% or more collide with companies' multi-billion dollar market capitalizations
3. The expansion of securities litigation cases to more third parties, including auditors, investment bankers, financial institutions, fund managers, and financial advisors

The $7.1 billion in Enron settlements and the $6.1 billion in WorldCom settlements are perfect examples of the confluence and effect of all three factors.

Trends

1. Number of cases decrease.

The 2005 figure of 168 cases represents a 17% decline from the 203 cases filed in 2004, and it is slightly below the ten-year (1996-2005) average of 188 cases per year. Also on the way down is the percentage of private securities class actions alleging accounting irregularities. In 2005, “accounting cases” represented 46% of all private securities class actions filed; this is the lowest percentage since 1996 and also the first time since 1996 that accounting cases fell below 50% of all cases filed.

Recent history, however, shows that such a drop does not necessarily indicate a long-term trend. In 2001, the 176 cases filed represented a 13% decline from the previous year, but was followed by a 23% increase (to 217 cases filed) in 2002. In 2003, 176 cases were again filed (representing a 19% decline), only to be followed by a 15% increase in 2004, to 203 cases filed. The table on page 7 shows that this seesaw pattern has occurred somewhat regularly during the period from 1996 through 2005, and it is likely that 2005’s drop in filings of private securities litigation cases is only a respite.

In addition to its overall drop in filings, 2005 was the first year since 1996 (when we began classifying accounting issues) in which revenue recognition allegations in securities class actions represented fewer than 50% of all accounting cases. However, aside from the more general “internal controls” allegation, revenue recognition still remained the most frequently asserted type of allegation in accounting cases. As noted in the chart on page 10, other accounting matters in which plaintiffs filed suit included overstatement of receivables (accounts receivables and loans receivables) and understatement of allowances for doubtful accounts; overstatement of inventories and understatement of costs of sales; failure to impair long-lived assets in a timely and adequate manner; improper accounting for restructuring charges and reserves; understatement (and under-recognition) of expenses and overstatement of capitalized costs; and failure to properly accrue and/or disclose contingencies.

In 2005, 55% of all accounting cases filed asserted that companies' internal controls were materially weak and contributed to financial fraud. The overall decline in accounting cases vis-à-vis non-accounting cases may be due to improved internal accounting and financial reporting controls and increased anti-fraud auditing by companies' independent auditors; however, another factor at work is the continued growth of so-called "product-efficacy" cases, especially in regards to pharmaceutical and healthcare companies. In 2005, 10% of all cases filed were such product-efficacy cases.[1]

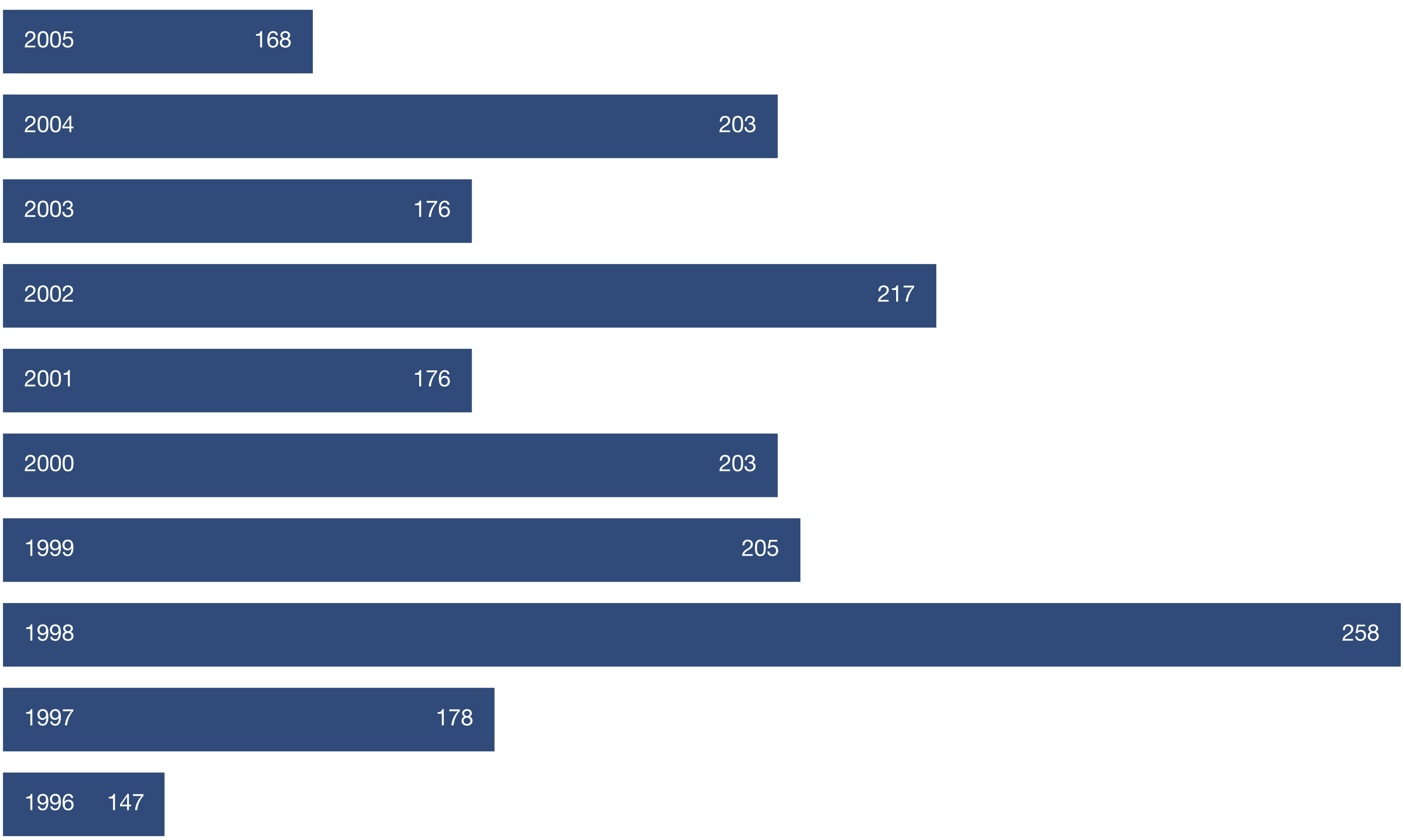
1 Typically a product-efficacy case alleges that a stock-price drop, relating to some negative news concerning a product (e.g., a drug), was due to fraud—the theory being that management intentionally withheld material facts concerning the negative information and/or intentionally made materially false and misleading disclosures concerning the efficacy or success of the product.

Securities class action lawsuits[1]

Year filed[2]	Federal cases	State-only cases	IPO Laddering cases	Analyst cases	Mutual Fund cases	Total
2005	168	—	—	—	4	172
2004	203	—	—	1	19	223
2003	176	—	—	19	16	211
2002	217	—	1	46	—	264
2001	176	—	309	—	—	485
2000	203	—	—	—	—	203
1999	205	—	—	—	—	205
1998	245	13	—	—	—	258
1997	167	11	—	—	—	178
1996	122	25	—	—	—	147

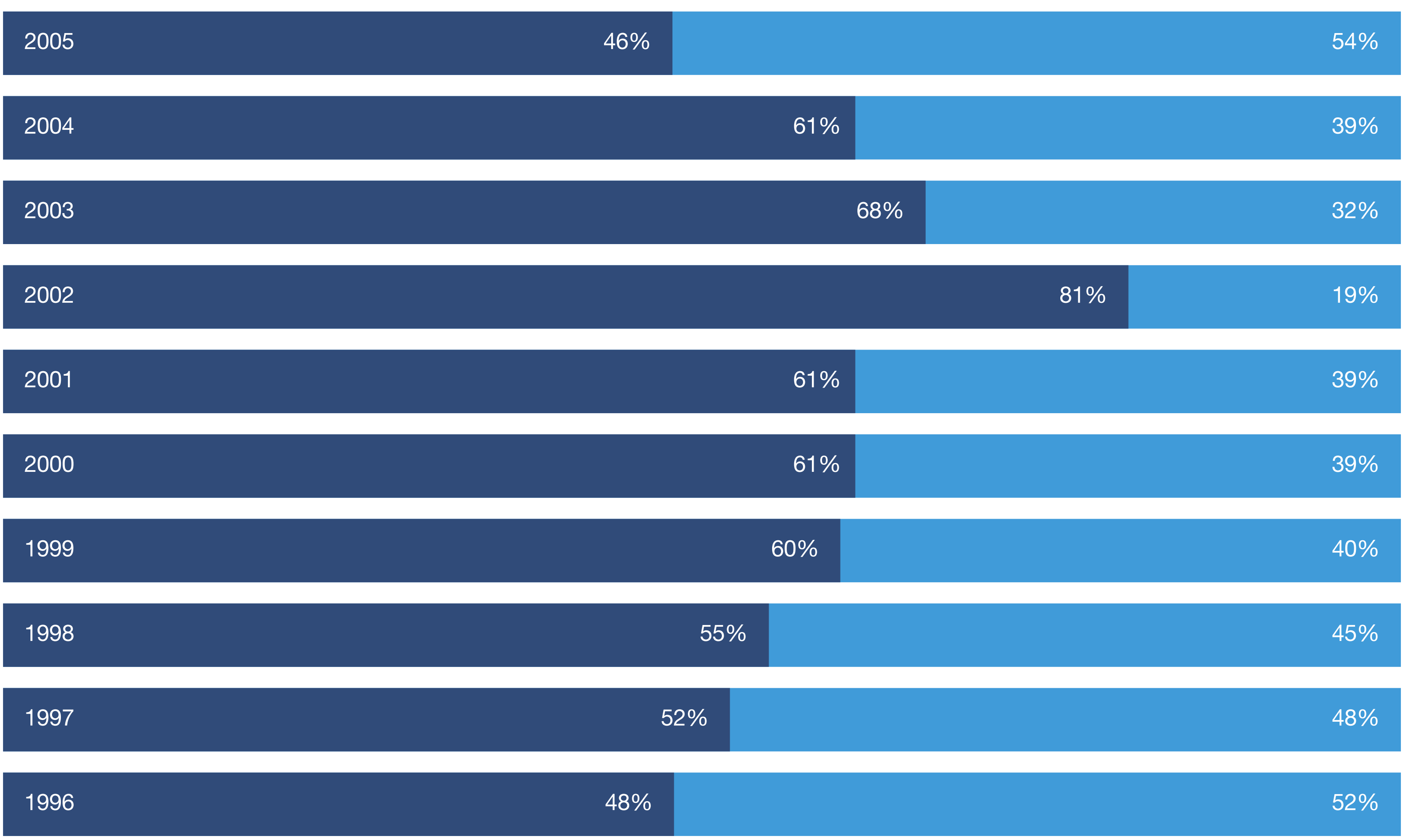
1 The year a case is filed is determined by the filing date of the initial complaint in state or federal court.
2 Filings from 1996 onward occurred after the Private Securities Litigation Reform Act of December 22, 1995; filings for 1999 through 2005 occurred after the Securities Litigation Uniform Standards Act of November 3, 1998.

Federal securities class action lawsuits filed per year, 1996-2005[1]



1 2001-2005 numbers exclude “IPO Laddering,” “Analyst,” and “Mutual Fund” cases.

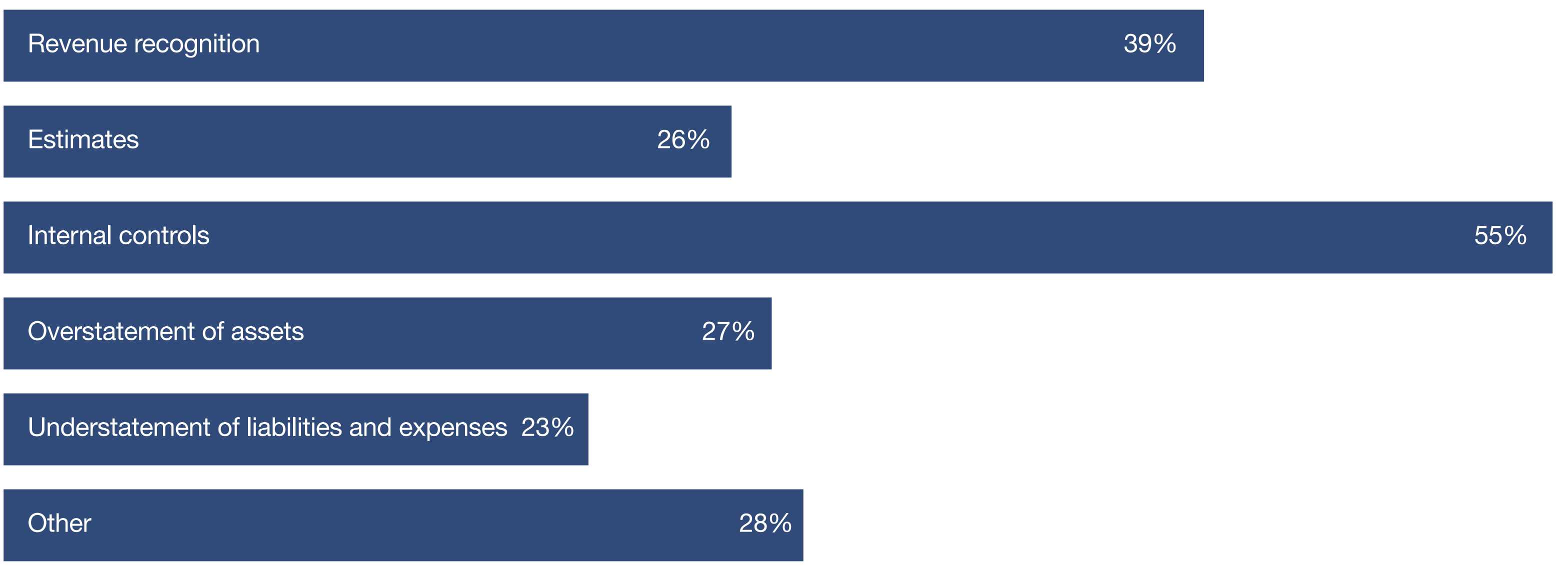
Percentage of accounting and non-accounting securities class action lawsuits filed per year[1]



Accounting lawsuits
Non-accounting lawsuits

1 Cases filed between 1996 and 2004 may have been updated with accounting allegations if the amended complaints allege accounting violations not previously recognized; 2005 cases reflect only initial case complaints.

Percentage of accounting cases with specific issues, 2005[1]



1 Some cases allege multiple accounting issues.

As reported in previous years, officers and directors continue to be named as defendants in the majority of all shareholder class actions. This year was no different for corporate executives, with CEOs being named in 96% of all cases. CFOs were defendants in 82% of cases, and the chairmen of the board were sued 72% of the time.

As in prior years, the largest number of 2005's cases were filed in the Second, Ninth, and Third Circuits. The Second Circuit remained stable with 40 cases filed, down only slightly from 44 cases in 2004. After being the runaway leader in 2004 with 63 case filings, the Ninth Circuit dropped off significantly with only 37 cases filed in 2005. This was the lowest total in more than ten years and a major drop from the circuit's average of 54 annual case filings since the passage of the PSLRA. With 21 filings in 2005, the Third Circuit continues to be the most consistent locale, marking its eighth straight year with total filings numbering between 20 and 26.

During 2005, the number of cases brought against Fortune 500 companies declined to 26 compared with 27 cases filed in 2004. Twenty such cases were filed in 2003, 60 in 2002, and 26 in 2001.

US securities class action lawsuits naming particular officers, 2002-2005[1]

Title	2002	2003	2004	2005
CEO	95	98	96	96
CFO	76	88	83	82
Chairman	82	69	72	72
President	68	77	71	57

1 Excludes “IPO Laddering,” “Analyst,” and “Mutual Fund” cases.

Number of US securities class action lawsuits by circuit, 2004-2005[1]

Number of cases	2004	2005
District of Columbia	1	1
First	8	9
Second	44	40
Third	21	21
Fourth	6	3
Fifth	17	11
Sixth	4	10
Seventh	11	8
Eighth	8	11
Ninth	63	37
Tenth	4	8
Eleventh	16	9

1 Excludes “Analyst” and “Mutual Fund” cases.

Securities class action lawsuits filed against Fortune 500 companies[1]

Year filed	Number of cases
2005	26
2004	27
2003	20
2002	60
2001	26
2000	24
1999	25
1998	16
1997	21

1 2001-2005 numbers exclude “IPO Laddering,” “Analyst,” and “Mutual Fund” cases.

Fortune rank

Year filed	Top 50	Top 100	Top 500
2005	2	7	26
2004	7	9	27
2003	1	3	20
2002	16	25	60
2001	5	10	26
2000	4	8	24
1999	3	8	25
1998	2	4	16
1997	3	6	21

2. Settlement values skyrocket.

Although the number of private securities litigation cases filed in 2005 was down compared to previous years, the amounts of major settlements and the average settlement values were dramatically higher. In the past, PricewaterhouseCoopers defined "high dollar" settlements as cases with settlements greater than $20 million, an amount that was above the median settlement value (and at the upper end of the average settlement value) of all settled cases reported in 2000-2004. However, the values of settlements have increased so drastically over the past two years that we have raised the threshold for high-dollar settlements to $60 million. Even using the new definition, the number of high-dollar settlements reported in 2005 was 20. Using the previous threshold of $20 million, the number of high-dollar settlements in 2005 was 30, compared to 23 in 2004.

"Mega-settlements" during 2005 included the continuing settlements of Enron and WorldCom, where settlements with financial institutions and other third parties have pushed total settlements for the cases up to $7.1 billion and $6.1 billion, respectively. Other settlements in the $100 million to $1 billion range include:

- Adelphia, $715 million (settlement with the SEC)
- AON Corporation, $190 million (with the State of New York)
- Broadcom Corporation, $150 million
- CVS Corporation, $110 million
- Deutsche Telekom AG, $120 million
- Dynegy Inc., $474 million
- HealthSouth, $100 million (settlement with the SEC)
- Marsh & McLennan Companies Inc., $850 million (with the State of New York)
- McKesson HBOC, $960 million
- Royal Ahold, $1.1 billion
- Time Warner, $2.5 billion, including $100 million contributed to the settlement by Time Warner's independent auditors (Ernst & Young) plus additional settlements of $150 million (with the DOJ) and $300 million (with the SEC)

In 2005, the average cost of a private securities litigation settlement rose to $71.1 million (excluding the mega-settlements in the Enron and WorldCom matters), up by a dramatic 156% from the 2004 average settlement value of $27.8 million. The average value of accounting cases in 2005 was $94 million, 178% higher than the $33.8 million average value in 2004. Such huge settlements can be associated with several factors: the enormous case-related economic losses (for example, the alleged $9 billion loss in the McKesson HBOC matter); the role of lead plaintiffs (many of which are now, after Sarbanes-Oxley and the PSLRA, institutions such as pension funds); the effect of Sarbanes-Oxley and its "Fair Funds for Investors" provision; and the fact that companies and other defendants must now deal not only with private securities litigation and settlements with private class-action plaintiffs, but with the SEC, DOJ, and various states' attorneys general, including New York Attorney General Eliot Spitzer.

Companies are now faced with securities lawsuits coming at them from every direction, and it's costing them more to settle.

Although product-efficacy cases are on the rise, settlements relating to such cases have remained relatively small. Since 1996 there have been 92 product-efficacy cases filed against pharmaceutical and healthcare companies, of which 43 cases currently are active. Twenty-three cases were dismissed, while 27 matters were settled for a total of $181 million (with average and median amounts of $6.7 million and $3 million, respectively). In 2005, ImClone paid $75 million in a product-efficacy case related to its cancer drug Erbitux—the largest single settlement to date in such a case.

1996-2005 Settlements[1]: all cases

Year settled	1996-2000	2001	2002	2003	2004	2005
Number of settled cases	248	108	106	116	106	108
Total settlement value	$6,812,800	$1,932,300	$2,104,900	$2,708,800	$5,491,600	$17,925,000
Total settlement value[2]	$3,626,800	—	—	—	$2,916,600	$7,603,000
Average settlement value[2]	$14,700	$17,900	$19,500	$23,400	$27,800	$71,100
Median settlement value[2]	$5,000	$5,500	$6,300	$5,600	$6,750	$9,250
Average settlement value for cases settled for $1 million or more, up to $50 million	$9,100	$10,800	$9,200	$9,800	$9,400	$9,900

Settlements in millions

1 Settlement year is determined by the year the settlement is disclosed. Settlements listed for 2005 include some that were announced and/or preliminarily approved in 2005. Settlement information reflects only cases filed and settled after passage of the PSLRA (12/22/1995). All figures are rounded and represent US dollars in millions.
2 Excludes Cendant, Enron, and WorldCom settlement values.

1996-2005 Settlements[1]: accounting cases

Year settled	1996-2000	2001	2002	2003	2004	2005
Number of settled cases	160	71	79	82	80	79
Total settlement value	$6,150,700	$1,685,800	$1,413,300	$2,181,500	$5,242,400	$17,656,600
Total settlement value[2]	$2,964,700	—	—	—	$2,667,000	$7,335,400
Average settlement value[2]	$18,600	$24,000	$17,400	$27,300	$33,800	$94,000
Median settlement value[2]	$6,500	$7,500	$7,500	$6,900	$7,750	$13,600
Average settlement value for cases $1 to $50 million	$10,600	$13,000	$10,400	$10,900	$10,380	$11,700

Settlements in millions

1 Settlement year is determined by the year the settlement is disclosed. Settlement information reflects only cases filed and settled after passage of the PSLRA (12/22/1995). All figures are rounded and represent US dollars in millions.
2 Excludes Cendant, WorldCom, and Enron settlement values.

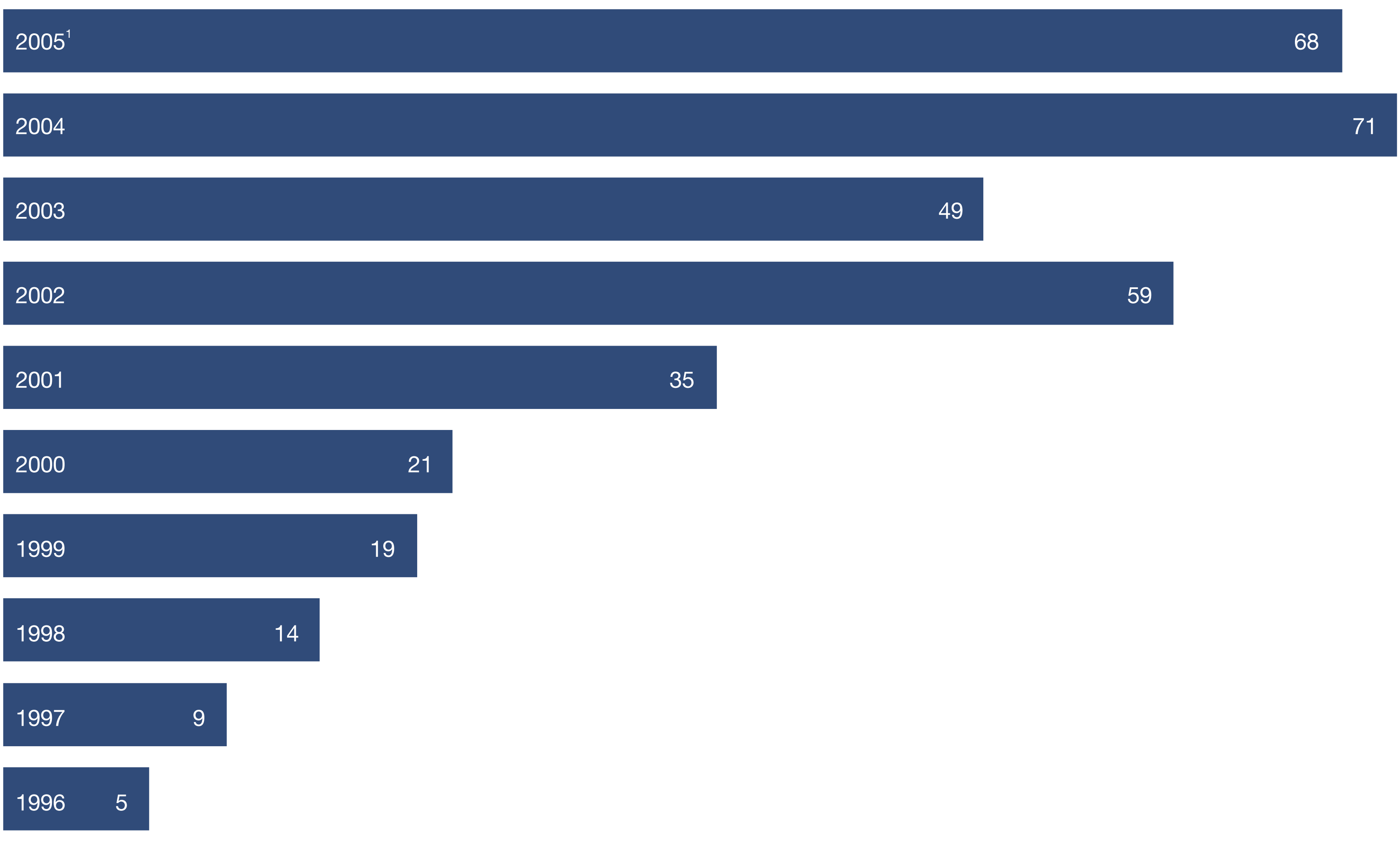
1996-2005 Settlements[1]: non-accounting cases

Year settled	1996-2000	2001	2002[2]	2003[3]	2004[4]	2005
Number of settled cases	88	37	27	34	26	29
Total settlement value	$662,100	$225,600	$691,600	$492,900	$249,300	$268,400
Average settlement value[2]	$7,500	$6,100	$25,600	$15,400	$9,600	$9,300
Median settlement value[2]	$3,900	$3,800	$4,800	$3,600	$4,600	$3,000
Average settlement value for cases $1 to $50 million	$6,300	$6,700	$6,000	$7,100	$6,700	$4,800

Settlements in millions

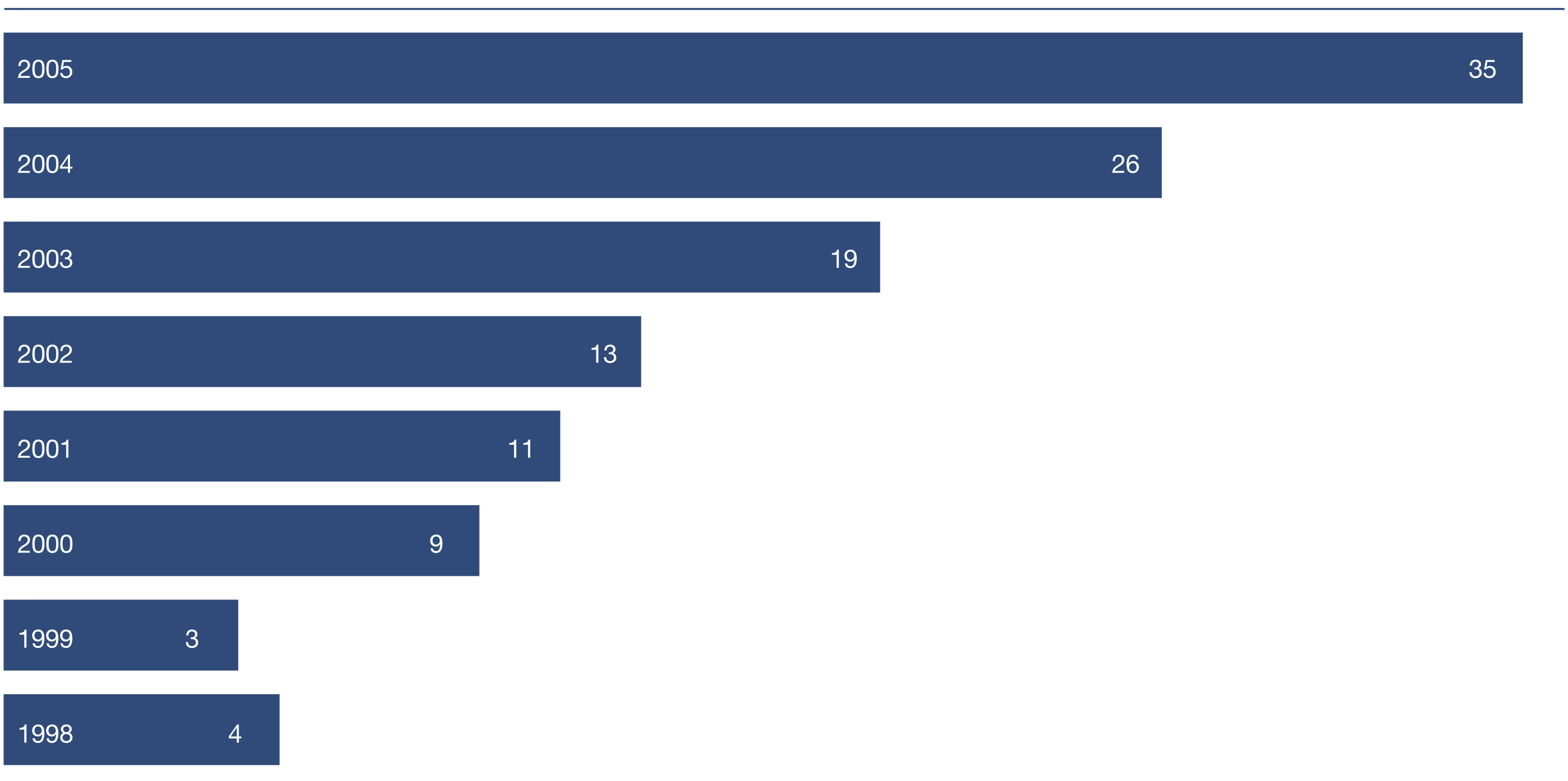
1 Settlement year is determined by the year the settlement is disclosed. Settlement information reflects only cases filed and settled after passage of the PSLRA (12/22/1995). All figures are rounded and represent US dollars in millions.
2 2002 non-accounting settlements include BankAmerica Corp. $490,000,000 and Bankers Trust $58,000,000.
3 2003 non-accounting settlements include DaimlerChrysler AG $300,000,000.
4 2004 non-accounting settlements include AT&T $100,000,000.

Number of cases filed with unions/pension funds as lead plaintiff



1 Final 2005 data is not available to date; therefore, the full-year projections are based upon the first 50% of the 168 filings for 2005.

Number of cases settled with unions/pension funds as lead plaintiff



Settlement breakdown for all cases filed and settled post-PSLRA[1]

Total settlement ($ millions)	1996-2004 %	2005 %
100+	4	11
50-99.99	4	8
20-49.99	11	8
10-19.99	16	22
5-9.99	22	18
2-4.99	25	16
0-1.99	20	17

1 Note: Totals may not add up to 100% due to rounding.

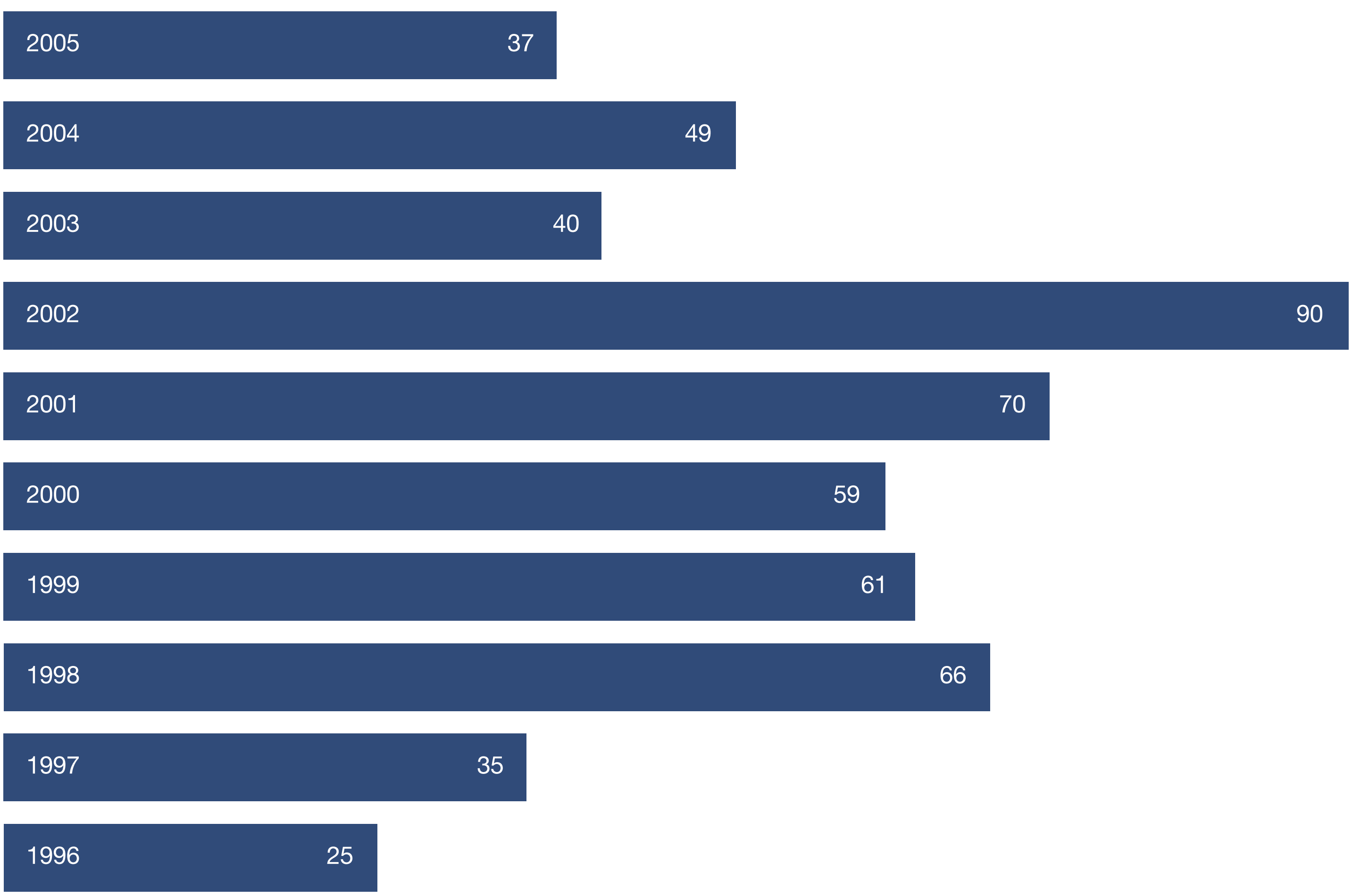
3. Restatements do not necessarily drive private securities class actions.

In 2004, the PricewaterhouseCoopers Securities Litigation Study looked into the purported correlation between restatements of companies' financial statements and ensuing private securities litigation, and found that the correlation was weak or non-existent. In approximately 83% of the restatements reported in 2004, it appears that private securities plaintiffs' lawyers did *not* subsequently file securities litigation. In 2005, Glass, Lewis & Co. reported that there were 1,295 restatements by companies.[1] However, only 37 of the accounting cases filed in 2005 involved a company that had announced a restatement of earnings. The graph on page 25 charts accounting cases involving restatements from 1996 to 2005.

What are the reasons for the apparent lack of correlation between restatements and private securities class actions? One reason is that many restatements do not result in significant stock-price drops. Another explanation is that many restatements are issued not to correct accounting errors or irregularities but for more benign reasons, such as changes in accounting principles. Securities plaintiffs file suits when they have suffered economic and financial losses; if little or no loss (i.e., due to any sharp stock-price drop) was involved in a restatement, the likelihood of litigation diminishes. Securities plaintiffs' lawyers need to attach effect to cause; if the subject restatement does not involve any instance of accounting error or irregularity, it is difficult to establish causation or prove liability, let alone intent.

1 "Getting It Wrong the First Time," Glass, Lewis & Co. (March 2, 2006).

Number of securities class-action lawsuits involving restatements, 1996-2005



4. Noteworthy trends that continued through 2005.

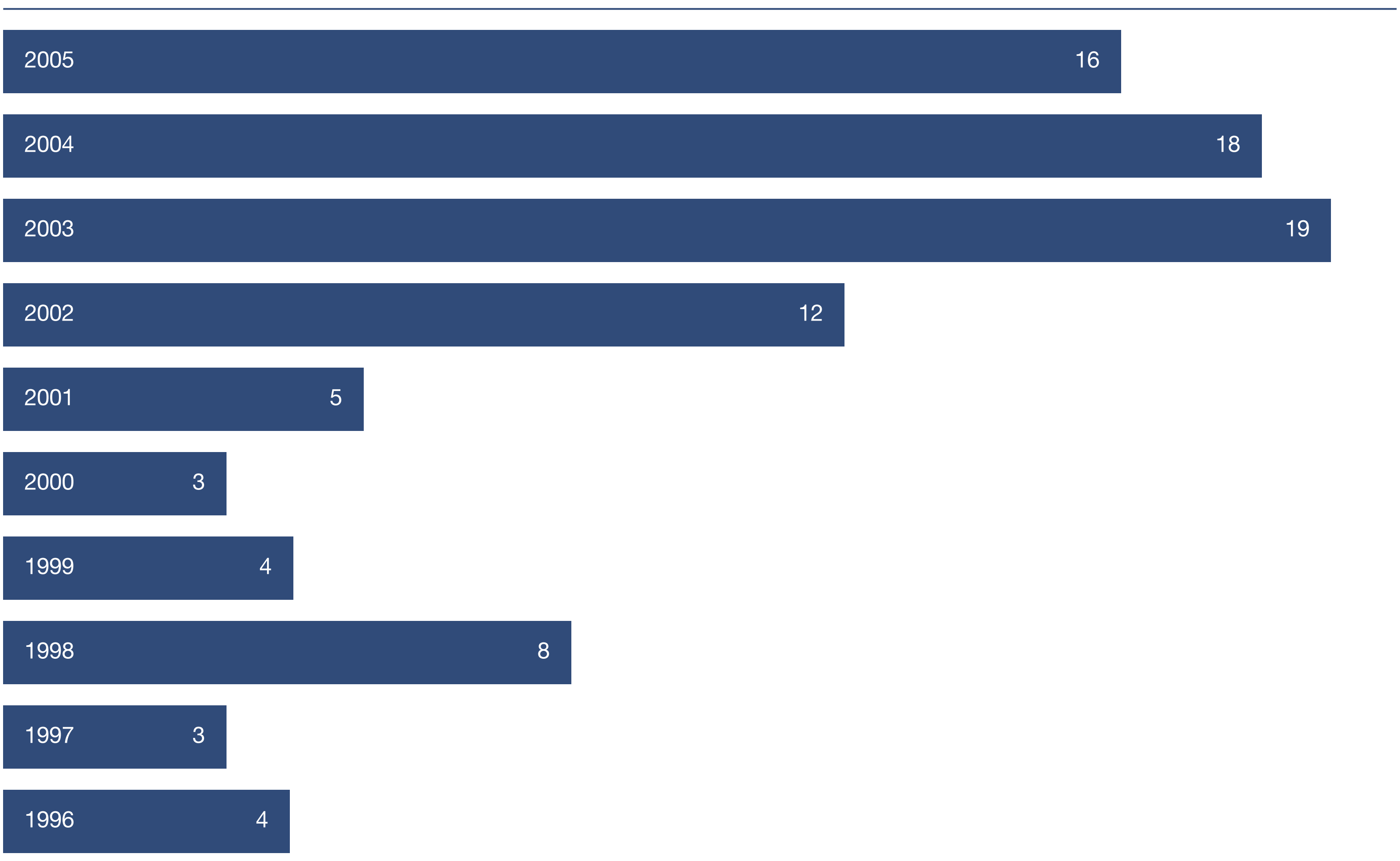
Trends in food

In November 2005, Royal Ahold announced that it had made a $1.1 billion settlement of a US private securities class action—the fifth largest private securities litigation settlement ever. Over the past several years, a number of food retailers, food distributors and food-services companies, and food products companies have been prosecuted by the SEC for various "vendor allowance" frauds, including improper accounting for (and reporting of) vendor allowances; collusion to misstate vendor allowance transactions; efforts to mislead independent auditors regarding vendor allowance amounts receivable by resellers and owed by manufacturers; and concealment schemes, including use of "side-letters" and falsification of receivables confirmations sent to auditors. Other food retailer frauds have involved misstatements of inventory and understatements of promotional expenses. On the SEC's grocery list of enforcement actions are companies such as Royal Ahold (US Foodservice), Aurora Foods, Dean Foods, Fleming, Kmart, Marigold Foods (Kemps LLC), and many former managers and employees from a number of major food products companies.

Trends in pharmaceuticals

For the fourth year in a row, the health services and pharmaceutical industries were plagued by private securities class actions, many of them product-efficacy disclosure cases. In 2005, another 16 pharmaceutical efficacy cases were filed by private securities plaintiffs, adding to the 49 private securities class actions filed between 2002 and 2004. Additionally, like all other industries, pharmaceutical companies have also been sued for accounting or disclosure violations. Some of the 2005 private securities litigation included claims filed against Able Laboratories, Inc.; Andrx Corporation; AstraZeneca PLC; Barrier Therapeutics, Inc.; Boston Scientific Corporation; Bradley Pharmaceuticals, Inc.; Cell Therapeutics, Inc.; Ciphergen Biosystems, Inc.; Elan Corporation PLC; EPIX Pharmaceuticals, Inc.; Forest Labs Inc.; GlaxoSmithKline PLC; Guidant Corporation; Immucor, Inc.; Inspire Pharmaceuticals Inc.; Isolagen, Inc.; Mannatech, Inc.; Martek Biosciences Corporation; OCA, Inc.; Pharmos Corporation; Possis Medical, Inc.; World Health Alternatives, Inc.; and Xybernaut Corporation. Legislation intended to immunize pharmaceutical companies against class actions (or at least minimize their exposure) is stalled in Congress.

US federal securities class action lawsuits involving pharmaceutical/health efficacy allegations



Trends in automotives

In 2005, the US automotive industry buckled under the combined weight of global competition, sharply higher gas-pump prices, high labor costs, and hugely underfunded and expensive pension and employee benefits plans. Targets of private securities litigation included Collins & Aikman Corporation; Dana Corporation; Delphi Corporation; Exide Technologies; General Motors Corporation; Harley-Davidson, Inc.; Tower Automotive, Inc.; and Visteon Corporation. Of particular note is the securities litigation claiming that Harley-Davidson, Inc. engaged in “channel-stuffing” and fraudulently inflated reported revenues and earnings. The collapses and bankruptcies of Collins & Aikman, Delphi, and Tower Automotive may signal an industry shake-out that will lead to more stock-price plummets, more business failures, and more related securities litigation.

Trends in electronics, high-technology, and software

In 2005, the electronics, high-technology, and software sectors once again led the list of industries being sued in private securities class actions, representing 29% of all such cases filed. Again, the most commonly alleged accounting irregularity was revenue recognition, involving violations of SEC Staff Accounting Bulletin No. 104, *Revenue Recognition in Financial Statements;* American Institute of Certified Public Accountants Statement of Position 97-2, *Software Revenue Recognition;* Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 48, *Revenue Recognition When Right of Return Exists;* and/or FASB Emerging Issues Task Force Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables.* As has been noted in previous annual issues of the PricewaterhouseCoopers Securities Litigation Study, the revenue recognition accounting rules affecting these tech sectors and types of transactions are complex, require significant judgment and estimation, and are susceptible to abuse. Also, the sectors are in a continual state of evolution, inventing new technologies, developing new products, and adopting new business models. This too contributes to volatility in companies’ stock prices, revenues, and earnings, and contributes to the frequency of securities litigation filed against the tech-sector companies.

Federal securities class action lawsuits by industry[1]

Industry	2003 % of total cases	2004 % of total cases	2005 % of total cases
High technology			
Computer services	15	18	16
Electronics	6	6	9
Telecommunications	5	6	4
	26	**31**	**29**
Health services	8	7	6
Pharmaceutical	15	13	13
Business services	5	5	5
Retail	5	4	4
Banking/brokerage, financial services, and insurance	13	10	13
Utilities: energy, oil, and gas	5	5	2
Other	23	25	28

1 Note: Totals may not add up to 100% due to rounding.

5. SEC examines hedge fund fraud.

The SEC has proposed new legislation and new regulation regarding hedge funds, and during 2005 reported 22 Litigation Releases concerning various hedge fund frauds and other securities violations. In a number of speeches, SEC representatives have hit on the lack of regulation of hedge funds and their managers and the need for legislation requiring that hedge funds and their advisors be registered with the SEC, and that they also be subject to certain reporting and compliance rules.

The total number of hedge fund enforcements through December 31, 2005, was 22 cases, some of which involved multiple enforcement actions against hedge funds, related parties, and hedge fund managers and advisors.

The risks of fraud in respect of hedge funds may be increased by several factors:

1. At present, hedge funds and their investment advisors are not required to register with the SEC, nor to file periodic financial statements with the SEC.
2. Hedge fund financial statements are not necessarily audited by independent auditors, and—if independent auditors are engaged by hedge fund managers—the firms may be small and/or not registered with the US Public Companies Accounting Oversight Board.[1]
3. Financial disclosures are not regulated by the SEC and may not be transparent to investors.
4. Environmental and operating factors may pose a higher risk of fraud.

Environmental factors may include concentration of controls and management in the hands of one person or a small number of individuals; absence of (or less) governance and oversight; and substantial portions of compensation to fund managers and investment advisors tied to *reported* performance and to commissions and fees on continued inflows of investor funds. Operating factors conducive to higher risk may include potential illiquidity (if investors seek returns of funds on disclosure of poor operating performance or losses); dealings with related parties; and lack of adequate controls over the security and use of investors' funds and the hedge fund's assets. If a hedge fund's management believes that disclosure of poor performance, significant losses, and/or substantial declines in asset values could lead to a "run" on the fund by investors, there may be increased temptation to issue to investors false and misleading financial information concerning the fund's financial condition and results of operations.

1 In the case of the Bayou Funds, the auditing firm "Richmond-Fairfield Associates" was entirely bogus and an invention of the funds' management. Apparently, Bayou Funds investors never thought to inquire as to Richmond-Fairfield Associates' bona fides with either the American Institute of Certified Public Accountants or any state board(s) of accountancy.

In a May 2005 speech, then US Federal Reserve Board Chairman Alan Greenspan estimated that hedge funds' assets under management had reached approximately $1 trillion.[2] Six months later, in remarks to the Banco de Mexico International Conference, in Mexico City, Mexico, Federal Reserve Vice Chairman Roger W. Ferguson Jr. observed that:

"Hedge funds have grown rapidly in recent years. Assets under management are estimated to have grown from $50 billion in 1993 to $600 billion in 2003 and close to $1 trillion today… with 8,000 hedge funds in existence, according to industry estimates…"[3]

And, in a July 2005 speech to the Managed Funds Association, SEC Commissioner Roel C. Campos remarked:

"*EuroHedge* reported that total assets managed by European single-manager hedge funds now exceed $150 billion, and industry assets at the end of 2004 totaled nearly $256 billion, an increase of more than 50% from $168 billion at the end of 2003.

"The value of hedge fund assets managed out of London more than tripled from $61 billion to $190 billion between 2002 and 2004. Globally, the UK capital's share of hedge fund assets increased from about 15% to 20% as growth in hedge funds outpaced the US, the leader in terms of fund activity. The industry is continuing to spread out across Europe, with over 100 single-manager funds now trading in France. Sweden and Spain have also established themselves as major continental locations for hedge fund management. Plus, the industry has its sights on Asia for the near future."[4]

The $1 trillion of total hedge fund assets is still relatively small compared to the approximately $27 trillion of total assets under management by all SEC-registered advisors; however, the hedge fund numbers have become substantial and they are growing at a faster rate than mutual funds' assets or direct inflows to the equity markets (estimated by the Federal Reserve Board to have doubled between 2001 and 2004, and estimated by the SEC to have grown by approximately 260% over the past five years). Hedge funds have become a significant and growing component of capital markets—and, with their growth, have attracted a growing number of frauds.

2 Remarks by Chairman Alan Greenspan to the Federal Reserve Bank of Chicago's Forty-First Annual Conference on Bank Structure, "Risk Transfer and Financial Stability," Chicago, Illinois (May 5, 2005).

3 Remarks by Vice Chairman Roger W. Ferguson Jr. to the Banco de Mexico International Conference, Mexico City, Mexico (November 15, 2005).

4 Remarks by Commissioner Roel C. Campos before the Managed Funds Association, London, England (July 12, 2005).

In September 2005, the Bayou Funds, a group of hedge funds operated out of Stamford, Connecticut, collapsed after disclosure of an alleged massive fraud.[5] Although the Bayou Funds scandal is one of the largest, it is not an isolated instance. In an Open Commission Meeting of the SEC in October 2004, the SEC Director of the Division of Investment Management, Paul F. Roye, reported that:

"In the last five years, the Commission has brought 51 cases involving hedge fund fraud, resulting in losses of more than $1.1 billion… In addition, we are seeing hedge funds used to defraud other market participants. Hedge fund advisors were key participants in the recent scandals involving mutual fund late trading and inappropriate market timing. We have counted almost 400 hedge funds and 87 hedge funds advisors involved in these cases."[6]

Commenting on the rise of frauds involving hedge funds in a September 2005 speech before the SIA–Hedge Fund Conference, SEC Commissioner Campos noted:

"Hedge fund fraud has been on the rise. This year the Commission has brought 11 cases against hedge funds directly and another 4 cases against broker-dealers tied to hedge funds. And there are several more cases in the pipeline. (Last year, the Commission brought 19 cases.)"[7]

The trend of frauds involving hedge funds appears to be on the rise, so starting with this year's 2005 edition, the PricewaterhouseCoopers annual Securities Litigation Study will begin tracking both SEC enforcement actions and private litigation involving hedge funds.

5 See SEC Litigation Release No. 19406 / September 20, 2005: "The Securities and Exchange Commission (Commission) today filed a civil injunctive action against Samuel Israel III of New York and Daniel E. Marino of Connecticut, the managers of a group of hedge funds known as the Bayou Funds (Funds), based in Stamford, Connecticut. The Commission's complaint alleges that, beginning in 1996 and continuing through the present, Israel and Marino have defrauded investors in the Funds and misappropriated millions of dollars in investor funds for their personal use… The Commission alleges in its complaint that from 1996 through 2005, investors deposited over $450 million into the Bayou Funds and a predecessor fund. During that period, Israel and Marino defrauded current investors, and attracted new investors, by grossly exaggerating the Funds' performance to make it appear that the Funds were profitable and attractive investments, when in fact, the Funds had never posted a year-end profit. The Commission's complaint further alleges that, in furtherance of their fraud, Israel and Marino concocted and disseminated to the Funds' investors periodic account statements and performance summaries containing fictitious profit and loss figures and forged audited financial statements in order to hide multi-million dollar trading losses from investors."

6 Open Commission Meeting: Considering Registration Under the Investment Advisors Act of Certain Hedge Fund Advisors, remarks by Paul F. Roye, Director, Division of Investment Management, US Securities and Exchange Commission, Washington, DC (October 26, 2004).

7 Remarks by Commissioner Roel C. Campos before the SIA–Hedge Fund Conference, New York, NY (September 14, 2005).

6. SEC continues pressure on Ponzi schemes and insider trading.

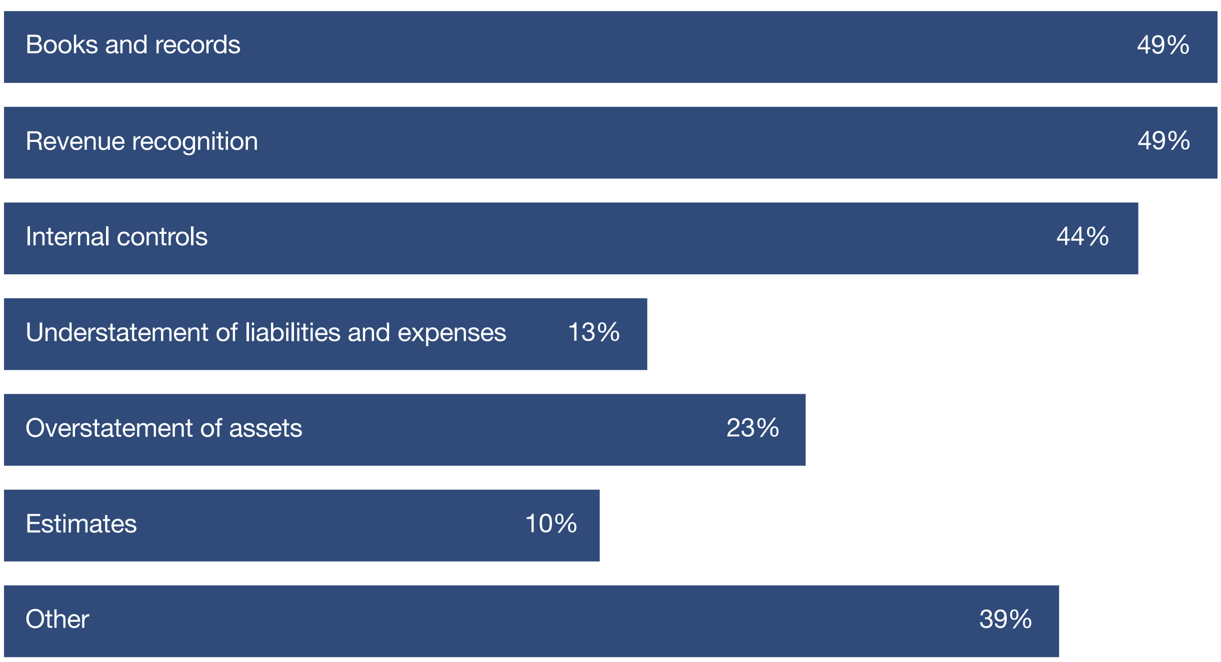
During 2005, the SEC maintained its enforcement pressure on “Ponzi,” “pyramid,” and so-called “prime-bank” schemes and frauds. Incredibly, in 2005 the Commission issued 22 Litigation Releases relating to different prime-bank schemes, along with eight additional Litigation Releases dealing with other types of Ponzi or pyramid schemes.

In 2005 the SEC instituted settlement proceedings against James J. McDermott Jr. (the former Chairman and CEO of Keefe, Bruyette & Woods, Inc.) and Kathryn B. Gannon based upon charges of insider trading and a final judgment in the matter entered by the US District Court. Other noteworthy cases of insider trading brought during 2005 by the SEC include: *in re. Zvi Fuks and Sabina Ben-Yehuda* (SEC L.R. No. 19456 / November 3, 2005), in connection with the ImClone insider trading matter that also snared former ImClone CEO Sam Waksal and style maven Martha Stewart; *in re. Guillaume Pollet* (L.R. No. 19199 / April 21, 2005), where a former Managing Director at SG Cowan & Co. was charged with trading on advance knowledge and information about private investment in public equity offerings; and *in re. Gary D. Herwitz and Tracey A. Stanyer* (SEC L.R. No. 19499 / December 19, 2005), in which the SEC alleged that Herwitz, the former President of the Mahoney Cohen accounting firm, engaged in illegal insider trading in connection with the purchase of Sirius Satellite Radio Inc. stock prior to the network’s October 6, 2004, announcement of its $500 million agreement with radio broadcaster Howard Stern. All told, in 2005 the SEC reported 39 Litigation Releases concerning alleged insider trading violations.

SEC Litigation Releases related to new accounting cases

	Number of releases
2005	39
2004	42
2003	52
2002	61
2001	32
2000	36
1999	29
1998	31
1997	40
1996	34

Analysis of accounting issues in 2005 SEC Litigation Releases[1]



1 Some cases allege multiple accounting issues.

Future Directions for SEC Enforcement

An Editorial

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The Securities and Exchange Commission's enforcement program has always been a leading force, a primary driver, shaping securities litigation. As the Survey has assessed the results of the past year in securities litigation it is well to pause a moment to consider certain SEC enforcement initiatives which will impact the results in years to come. Several trends are of note:

1) Criminalization of the Securities Law

As of this writing, the trial of former Enron CEOs Ken Lay and Jeff Skilling is moving forward. The collapse of Enron occurred in late 2001, and it is only now, in early 2006, that the government is able to try the alleged prime architects of the Enron fraud. Herein lies a lesson. While in the past, acting primarily through mutually agreed upon consent settlements, the SEC and its Division of Enforcement were able to move promptly to resolve major securities frauds, the new 21st century trend has been to elongate the process, through increased involvement of criminal authorities. The SEC is no longer the sole government decision maker with respect to enforcement of securities law violations. Both federal and state criminal authorities are interested in all aspects of securities fraud, and especially in the type of corporate accounting and financial reporting fraud that falls within the ambit of the President's Corporate Fraud Task Force. This has meant delay in the process, with SEC investigations stayed pending resolution of the criminal authorities' interest.

2) Rise in Restatements of Financial Statements

2005 was a banner year for restatements, in part due to SEC staff rigor on such matters as accounting for stock options (FAS 123R) and derivatives. In the past, any public company restatement was followed by an SEC enforcement inquiry. Not surprisingly, the number of enforcement investigations into suspected financial reporting or accounting irregularities is up substantially. These matters tend to evolve into securities class actions. Given the increase in restatements, a trend which appears to be continuing, the ultimate numbers of securities class actions involving allegations of financial reporting or accounting fraud will only increase.

3) Executive Compensation

The new SEC Chairman, Christopher Cox, has made reform of disclosure of executive compensation a priority for his Commission. A rulemaking proposal is out for comment, and the consensus view is that regulations substantially enhancing the required disclosure will be adopted. The Division of Enforcement is always cognizant of Commission priorities, and increased enforcement focus on existing executive compensation disclosure can be expected. Particular attention will be paid to related party disclosure, as this has been a focus for some time. The pleading standards for securities fraud are often met through allegations of self-dealing, so that any increase in investigative activity into executive compensation, and related party transactions, will inevitably translate into increased litigation exposure.

4) Hedge Funds

With nearly $2 trillion in assets, the hedge fund industry has moved into SEC enforcement focus. In cases against several blatant frauds in the past year (see Bayou Funds, a hedge fund which allegedly invented an accounting firm to certify its financials), the Division of Enforcement sought to bring increased attention to this area. More enforcement actions are on the horizon against hedge fund abuses.

5) Corporate Penalties

By a consensus vote, the SEC promulgated guidelines on the imposition of corporate penalties. These penalties have increased, especially in light of the “Fair Funds” provision of Sarbanes-Oxley, which allows the SEC to return monies received in penalties, in conjunction with disgorgements, to injured shareholders. The SEC guidance is significant in that a substantial penalty (in the multi-million dollar range) will continue to be applied against the company itself in instances of egregious wrongdoing. The civil litigation fallout is clear: Large monetary penalties will continue to carry a government-imposed stigma—even in settled SEC actions. The private plaintiffs will argue the SEC found bad behavior necessitating a monetary penalty.

6) Personnel Changes

Perhaps the most significant aspect of the Cox Commission to report at this juncture is its substantial turnover in high-level staff. With a new General Counsel, new Directors of the Division of Enforcement and Division of Corporation Finance, and slots to fill in Market Regulation, Investment Management, and the Office of Chief Accountant—to say nothing of the head of the Public Company Accounting Oversight Board—the Cox Commission has not yet taken shape.

The SEC will continue to provide leadership through its securities enforcement program in the manner in which securities law violations are policed. There is a healthy inventory of matters under investigation, including matters involving a surprisingly high percentage of the Fortune 500 and a growing number of large foreign private issuers (those foreign companies that file with the SEC due to their listing on US exchanges). Look for continued vigor in the SEC enforcement program.

7. SEC enforcement actions and DOJ prosecutions increase.

In 2005, 43 private securities class actions also involved either informal or formal SEC investigations or SEC enforcement actions.[1] Private securities class actions that intersected with DOJ criminal investigations, indictments, guilty pleas or convictions, deferred prosecution agreements, or DOJ settlements with companies comprised nine cases. As can be seen in the charts on pages 42, 43, and 44, the numbers of new and unique private securities litigation cases involving SEC enforcement activities and/or DOJ investigations or prosecutions declined in 2005.

During 2005 there was significant activity—on the parts of both the SEC and DOJ—relating to enforcement actions and/or criminal prosecutions of individuals who were former officers or management of companies involved in prior years' cases.

The DOJ continued its indictments and prosecutions of individuals involved in earlier corporate accounting scandals at Enron, WorldCom, Adelphia, Computer Associates, Dynegy, HealthSouth, Rite Aid, and other companies. Notably, former WorldCom CEO Bernie Ebbers was convicted at trial and sentenced to 25 years in prison; key Enron accountant Richard Causey took a plea agreement rather than face a possible sentence of 20 years or more; former Computer Associates CFO Ira Zar and General Counsel Stephen Wogin also entered into plea bargains and are awaiting sentencing; and former Rite Aid General Counsel Franklin Brown was convicted at trial and sentenced to ten years in prison.

During 2005, the DOJ also obtained a trial conviction of former Cendant Vice Chairman E. Kirk Shelton, who was sentenced to ten years for his role in the Cendant accounting fraud; announced a 42-count indictment against former Qwest CEO Joseph Nacchio on insider-trading charges in connection with the Qwest accounting scandal; obtained convictions against former Merrill Lynch Managing Directors Daniel Bailey and James Brown in connection with the Enron "Nigerian Barge" transactions; and initiated extradition proceedings against indicted former National Westminster Bank employees David Birmingham, Giles Darby, and Gary Mulgrew (all British citizens), also in connection with structured transactions at Enron.

1 Based on disclosures made by the companies involved; SEC policy is to make no comment regarding ongoing investigations.

The DOJ and the President's Corporate Fraud Task Force continue to pursue companies and individuals in connection with more than 400 cases. According to the latest Corporate Fraud Task Force Report to the US President (through July 2004), the DOJ has obtained more than 500 convictions or guilty pleas of companies or individuals, as well as charging more than 900 defendants and more than 60 corporate CEOs or Presidents with some type of corporate fraud crime.[2] In 2005, former Adelphia CEO John Rigas and his son, former Adelphia CFO Timothy Rigas, were sentenced respectively to 15 and 20 years in prison after their 2004 fraud convictions in connection with the Adelphia corporate scandal.

The US Fifth Circuit Court of Appeal did overturn what it deemed the unreasonable sentence of former Dynegy executive Jamie Olis, ordering the lower court to resentence Olis to a presumably shorter prison term. Former HealthSouth CEO Richard Scrushy was acquitted on all charges at his 2005 criminal trial. And, in a unanimous decision, the US Supreme Court overturned the conviction of Arthur Andersen LLP, the auditors of Enron.

New York State Attorney General Eliot Spitzer brought cases against Wall Street investment firms and analysts, mutual funds, former Tyco executives, and—most recently—AIG and the insurance and reinsurance industry. Marsh & McLennan paid $850 million to settle allegations of bid-rigging and conflicts of interest brought by Spitzer, while former Tyco executives Mark Swartz and Dennis Kozlowski were convicted on corporate theft charges and sentenced to 20 years and 8 years and 4 months in state prison, respectively. The mutual funds industry, meanwhile, paid $3.3 billion through 2005 in settlements of "market timing" and improper trading investigations.

2 Second Year Report to the President, Corporate Fraud Task Force (July 20, 2004).

US securities class action lawsuits involving SEC investigations[1]

Year filed	Informal investigation	Formal investigation	Action or settled	Closed	**Total cases**
2005	12	28	2	1	43
2004	13	30	10	8	61
2003	10	24	12	2	48
2002	11	29	62	0	102
2001	3	13	39	0	55
2000	1	5	38	0	44
1999	1	8	25	2	36
1998	1	5	30	4	40
1997	0	3	22	3	28
1996	1	0	22	4	27

1 Information is based on a review of press releases, SEC releases, and news articles.

US securities class action lawsuits involving criminal investigations[1]

Year filed	DOJ investigation/ criminal	Indictment	Guilt plea/ conviction	DOJ settlement	**Total cases**
2005	9	0	0	0	9
2004	18	2	4	3	27
2003	12	2	3	0	17
2002	20	6	28	2	56
2001	7	2	17	0	26
2000	8	6	7	0	21
1999	2	4	9	1	16
1998	5	4	8	1	18
1997	4	1	4	1	10
1996	3	1	4	1	9

1 Information is based on a review of press releases, SEC releases, and news articles.

US securities class action lawsuits involving both SEC and DOJ investigations[1]

Year filed	Accounting	Non-accounting	**Total cases**
2005	7	1	8
2004	20	3	23
2003	13	0	13
2002	48	6	54
2001	20	2	22
2000	19	1	20
1999	13	1	14
1998	12	0	12
1997	10	0	10
1996	6	1	7
Totals	**168**	**15**	**183**

1 Information is based on a review of press releases, SEC releases, and news articles.

8. The impact of Sarbanes-Oxley on corporate scandals.

Of all of the recent major corporate scandals, only HealthSouth has involved a DOJ prosecution that includes charges of fraud in connection with a violation of one of the provisions of Sarbanes-Oxley (the Section 302 certification provision).

As of the publication of this PricewaterhouseCoopers Securities Litigation Study, the US Corporate Fraud Task Force had not yet published its annual Report to the President (Third-Year Report). However, DOJ reports of significant corporate fraud-related prosecutions, DOJ press releases, and information published in the First-Year and Second-Year Corporate Fraud Task Force Reports identify 103 companies (or their current or former employees) that have either been charged with and/or were convicted of fraud-related crimes. Of these 100-plus unique matters, only seven (i.e., less than 7%) have involved either post-Sarbanes-Oxley alleged illegal acts or allegations of specific violations of one or more of the act's provisions. The First-Year Report of the Corporate Fraud Task Force stated that Sarbanes-Oxley "gave important new tools to prosecutors and regulators to improve corporate responsibility and protect America's shareholders and workers."[1] However, the criminal prosecutions reported to date by the Task Force and the DOJ, in the main, allege illegal activities that occurred prior to enactment of Sarbanes-Oxley, claim criminal violations under pre-Sarbanes-Oxley statutes, and involve criminal penalties that pre-date the toughening of penalties and sanctions provided for by Sarbanes-Oxley. This is true even of the indictments, prosecutions, and/or convictions or guilty pleas relating to Enron, WorldCom, Adelphia, Global Crossing, Dynegy, Computer Associates, Rite Aid, and other high-profile matters.

1 First-Year Report to the President, Corporate Fraud Task Force, Ch. 2, "Introduction," p. 4.

9. Foreign Corrupt Practices Act enforced.

Companies with global operations that are listed on US and other exchanges need to be aware of the risks associated with violations of the US Foreign Corrupt Practices Act (FCPA) and the Organization for Economic Co-operation and Development (OECD) Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (OECD Anti-Bribery Convention). Companies in violation risk damage to reputation, litigation and regulatory enforcement actions (by both US and foreign regulators and law-enforcement agencies), substantial penalties and sanctions (including, most recently, disgorgement of related profits), and disruptions of their business, employees, and foreign operations.

The FCPA, enacted in 1977 and amended in 1988, prohibits the payment of bribes to foreign officials and requires that companies maintain accurate books and records that reflect all significant transactions.[1] Besides the FCPA, companies may be subject to laws enacted in conformity with the OECD Anti-Bribery Convention that was adopted in 1998. As of January 2005, the Anti-Bribery Convention had been ratified by 36 countries, including Australia, Japan, the US, and the EU member states. Generally, the OECD Convention provides for the same types of prohibitions as the FCPA regarding improper payments to foreign officials.[2]

Annually, the organization Transparency International (TI) publishes its Corruption Perception Index, which now rates 158 countries by perceived levels of corruption, with scores reflecting a continuum from “highly clean” and “clean” down to “corrupt” or “highly corrupt.”[3] In the 2005 TI survey, for example, Argentina—where several recent FCPA violations by companies have occurred—is ranked 97th with a composite corruption perception score of 2.8 (where a 1.0 score is deemed “most highly corrupt”). In respect of two rapidly growing economies, India is ranked 88th with a score of 2.9, while China is ranked 78th with a score of 3.2.[4] These are some of the countries where FCPA and/or OECD Anti-Bribery Convention compliance risks are higher.

1 Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494, *as amended by* Title V of the Omnibus Trade & Competitiveness Act of 1988, Pub. L. No. 100-418, §§ 5001-03, 102 Stat. 1415, 1415-25 (codified as amended at 15 USC. §§ 78m(b)(2), 78m(b)(3), 78dd-1, 78dd-2, and 78ff (1994)).

2 Title I of the OECD Anti-Bribery Convention states: “Each Party shall take such measures as may be necessary to establish that it is a criminal offence under its law for any person intentionally to offer, promise or give any undue pecuniary or other advantage, whether directly or through intermediaries, to a foreign public official, for that official or for a third party, in order that the official act or refrain from acting in relation to the performance of official duties, in order to obtain or retain business or other improper advantage in the conduct of international business.”

3 Sources reported in TI’s 2005 Corruption Perception Index include: Columbia University, Economist Intelligence Unit, Freedom House—Nations in Transit, World Competitiveness Report of the Institute for Management Development, Political and Economic Risk Consultancy (Hong Kong), Gallup International (on behalf of Transparency International), Global Competitiveness Report of the World Economic Forum, and the World Markets Research Centre. The index ranks 158 countries in accordance with composite “corruption indices” on a scale from 1 to 10, with a 1 representing perceptions of “most highly corrupt” to a 10 representing perceptions of “highly clean.” The TI 2005 survey ranked Iceland as perceived to be least corrupt (with a composite score of 9.7) while Bangladesh and Chad were perceived to be most corrupt, tying for last place.

4 By comparison, the TI 2005 Corruption Perception Index ranked Australia, Belgium, Chile, Hong Kong, Japan, South Korea, Taiwan, the UK, Uruguay, and the US between 9th and 40th (with the US ranked 17th), generally indicating “clean” to “highly clean.”

Between 2000 and 2005 the following companies were cited for (or involved in) alleged FCPA violations: ABB, American Bank Note, American Rice, Baker Hughes, BellSouth, IBM, InVision, ITXC, Monsanto, Titan, Syncor International, and Schering-Plough. The countries in which improper payments were alleged to have occurred include familiar names on Transparency International's annual listing of corrupt business climates: Angola, Argentina, Benin, Brazil, China, Haiti, India, Indonesia, Kazakhstan, Nicaragua, Nigeria, the Philippines, and Thailand.

Some points for consideration relating to all of these cases are: (a) lack of sufficient diligence in knowing the counter-party (e.g., agent) and whether any part of the payment(s) made would be passed on to foreign government officials; (b) unsuccessful claims of reliance on an opinion by counsel or claims that the payments were "grease" (i.e., permissible "facilitating" payments); (c) the similar ways in which "books and records" provisions were alleged to have been violated; and (d) the relatively small amounts of the alleged improper payments.[5]

During 2005, the SEC brought cases against four companies and/or individuals employed by SEC registrants, charging them with various violations of the FCPA: Yaw Osei Amoako (formerly employed by ITXC Corporation); Titan Corporation; InVision Technologies, Inc.; and Monsanto Company. By comparison, in 2004 the SEC charged two companies with violating provisions of the FCPA: ABB Ltd. and Schering-Plough. There were 13 FCPA cases brought by the SEC between 2000 and 2005, and the average number of cases per year was approximately two. Whether the four cases brought in 2005 represents an increasing trend in FCPA enforcement actions by the SEC remains to be seen.

5 Under the FCPA, there is no threshold of "quantitative" immateriality; the FCPA and the OECD prohibit any corrupt offer (of payment), payment, or authorization of payment—of money, gifts, or anything of value. In some of the recent FCPA cases, the amounts of improper payments alleged were as small as $10,000 or $15,000. The Private Securities Litigation Reform Act of 1995 (PSLRA), Title III (Section 10A of the Securities Exchange Act of 1934), requires that auditors determine if it is likely that an illegal act has occurred "whether or not perceived to have a material effect on the financial statements of the issuer."

The FCPA Internal Controls Provisions—A Sleeping Giant Awakes

An Editorial

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The Foreign Corrupt Practices Act, or FCPA, has principally been seen as a criminal anti-corruption statute. And, indeed, the criminalization of corrupt efforts to influence foreign government officials has, for many years, been the leading enforcement focus of the government agencies that share responsibility for enforcing the law—the Department of Justice and the Securities and Exchange Commission. While those agencies, of course, continue to bring anti-bribery cases, we are seeing a tectonic shift in enforcement focus toward an emphasis on the FCPA's internal controls provisions.

In addition to criminalizing foreign official bribery, the FCPA requires issuers[1] to comply with certain "accounting provisions": (a) the "books and records" provisions require issuers to keep and maintain accurate books and records;[2] and (b) the "internal controls" provisions require issuers to devise and maintain an adequate system of internal accounting controls.[3] The FCPA does not spell out in any detail what constitutes an adequate system of internal controls. Instead, the statute rather generally speaks in terms of controls "…sufficient to provide reasonable assurances that—(i) transactions are executed in accordance with management's general or specific authorization; (ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets; (iii) access to assets is permitted only in accordance with management's general or specific authorization; and (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences."[4]

Importantly, an issuer is responsible for the adequacy of its own internal controls as well as for the internal controls of any subsidiary or joint venture in which it has at least 51% of the voting control.[5] Moreover, issuers are obligated to use good faith efforts to cause minority-owned affiliates to devise and maintain adequate accounting records.[6]

1 An issuer is a company subject to the registration or reporting provisions of the Securities Exchange Act of 1934.
2 15 U.S.C. § 78m(b)(2)(A).
3 15 U.S.C. § 78m(b)(2)(B).
4 Ibid.
5 15 U.S.C. § 78m(b)(6).
6 Ibid.

These internal controls provisions have recently become a focus of DOJ/SEC enforcement. As Paul Berger, an Associate Director of the SEC's Division of Enforcement, has said: "At the end of the day, the FCPA is about books and records and internal controls… From an enforcement perspective—that is kind of the core of what we do. And so, internal controls, for us, is at the heart of the FCPA."[7] Mark Mendelsohn, the lead FCPA prosecutor in DOJ's Criminal Division, concurred: "…we've been trying to send a message for quite some time that we care very much about the absence of internal controls, and like the SEC, it's a subject matter that we're going to inquire about from the very beginning of an investigation."[8]

And this is exactly what is happening in our experience—and as evidenced by publicly reported cases. We know from cases in which we are involved that both the DOJ and the SEC are, at the early stages of an investigation, asking companies to brief them on the company's overall control environment with particular emphasis on "tone at the top" and substantive nitty-gritty anti-corruption controls. Both the DOJ and the SEC are looking for robust FCPA compliance programs that exist not merely on paper, but in reality. Where a company can demonstrate that it has devised and implemented proactive internal controls and backed the program with a commitment of appropriately substantial resources, enforcement authorities have tended to be more lenient in exercising their prosecutorial discretion. On the other hand, where a corruption problem arises in an issuer that has neglected to fulfill its obligation to implement a "living, breathing" compliance program, enforcement dispositions have been far harsher. (Obviously, other factors—such as cooperation with the investigation and the nature of the conduct under investigation—also bear on governmental charging decisions.)

This trend is also on display in reported cases. The SEC, for example, recently charged The Titan Corporation with violations of the FCPA internal controls provisions and, in its court complaint, harshly commented on alleged deficiencies in Titan's FCPA-compliance program.[9] Other recent SEC cases that have focused at least in part on internal controls issues include InVision Technologies, ABB, and Schering-Plough.[10] In several of these cases, the parent issuer was charged based on perceived deficiencies in the controls in affiliates in which the parent had majority voting control.

7 Roger M. Witten & Kimberly A. Parker, *Complying with the Foreign Corrupt Practices Act* at 10-36 (Business Law Monographs, 2005).
8 Ibid. at 10-37.
9 SEC v. Titan Corp., Civ. Act. No. 0411 (D.D.C. March 1, 2005).
10 SEC v. InVision, No. CV-05-0660 (N.D. Cal. December 3, 2004); SEC v. ABB Ltd., Case No. 1:04CV01141 (D.D.C. June 28, 2004) (Consent of ABB); SEC v. ABB Ltd., Case No. 1:04CV01141 (D.D.C. July 6, 2004) (Complaint); SEC v. ABB Ltd., Case No. 1:04CV01141 (D.D.C. November 30, 2004) (Final Judgment); SEC v. Schering-Plough Corp., Case No. 1:04CV00945 (D.D.C. June 9, 2004).

The DOJ also has the power to bring criminal charges to enforce the internal controls provisions of the FCPA. It has never done so, although in the Titan case, the criminal information included non-charging passages detailing alleged deficiencies in Titan's internal controls and the non-prosecution agreement in InVision contained similar commentary on internal controls weaknesses.[11]

Another aspect of recent DOJ/SEC emphasis on internal controls is the emergence of the "FCPA monitor" as an almost *de rigeur* element of any FPCA case disposition. Typically, now, the DOJ/SEC insist in settlements that the settling company appoint an independent FCPA consultant or monitor who has responsibility for analyzing and recommending any needed improvements to a company's anti-corruption controls.[12] Companies who have appointed FCPA monitors have complained that they are quite intrusive, burdensome, and expensive.

The DOJ/SEC's enforcement emphasis on internal controls is a shrewd effort to project their enforcement reach beyond the capacity of their resource-constrained staffs. There are simply not enough "cops" to police the regulated community. By threatening to hold, and holding, companies civilly and perhaps criminally responsible for deficiencies in internal controls, the DOJ/SEC are successfully "deputizing" company legal and compliance personnel, as well as their outside advisors, in the fight against foreign official corruption. Not only does this multiply the enforcement agencies' impact, it focuses in a constructive way on prophylaxis. It is probably not irrelevant that internal controls cases may be easier for the SEC/DOJ to prove than complex foreign bribery cases, where the evidence is often difficult to access.

The lesson for the regulated community is clear: When it comes to FCPA compliance, the enforcement agencies are putting the onus on companies to devise and implement "living, breathing" anti-corruption controls, and are using the threat of civil and criminal liability, as well as compliance monitors, to incentivize companies to do so. Issuers with international operations who do not devise and implement appropriate controls are at serious risk, even if in the end the SEC/DOJ cannot prove that the control deficiencies led to provable acts of foreign bribery.

11 See, e.g., United States v. Titan Corp., No. 05CR0314 (S.D. Cal. March 1, 2005); SEC v. Titan Corp., Civ. Act. No. 0411 (D.D.C. March 1, 2005); Agreement between Department of Justice and InVision Technologies, Inc. (December 3, 2004).

12 Monitors were required in the Titan, InVision, and ABB cases, among others.

10. Global securities litigation and regulation.

In each of the past several years, securities regulators in the US, the UK, other EU countries, and other nations (such as Canada and countries in the Asia-Pac and South and Central America) have improved coordination of their regulatory and enforcement policies and activities. This is a recent trend and it bears watching. The SEC has expended significant effort through its Division of Enforcement and its Division of Corporation Finance to coordinate with other countries' securities regulators and law-enforcement agencies and to develop mutual cooperation agreements and protocols. Recent cases—such as Royal Dutch/Shell, Royal Ahold, and Parmalat S.p.A.—have involved significant cooperation between regulators in the US and other countries. And—grudgingly, but inexorably—foreign private issuers and their countries' regulators are coming to grips with Sarbanes-Oxley.

11. Noteworthy events for foreign issuers.

Although 2005 brought some relief for foreign private issuers in terms of private securities litigation and SEC enforcement actions, the year did have its share of noteworthy events. While the EU nations and other countries (including Japan, China, Russia, and India) labored to comply with IFRS obligations, foreign issuers in general made efforts to address execution issues in anticipation of the compliance deadline for Sarbanes-Oxley Section 404 (S404)—though they also waited expectantly for the SEC to grant another extension. Though most foreign issuers have shown resigned acceptance of the need to comply, the provision continued to have its critics, and deregistration remained a hot topic amid threats of delisting and moves by major former Eastern Bloc companies (such as steelmaker Novolipetsk and energy producer Novatek) to embrace the LSE and other foreign exchanges rather than US exchanges. Despite such issues, US exchanges continued to trade nearly half the world's equity shares by market capitalization in 2005, and non-US investors had approximately $4.5 trillion invested in US stock markets.

SEC Chairman William Donaldson began the year on a conciliatory note with his January 25, 2005, speech at the London School of Economics and Political Science. At that time, Mr. Donaldson observed how all regulators have much to learn from their foreign counterparts, stating that:

"…while the SEC is proud of the regulatory system in the United States and the work we do to maintain and constantly improve it, I am the first to acknowledge we don't have all the answers. We are anxious to listen to, and learn from, ideas advanced by other regulators, which is one reason why the SEC is an active member of IOSCO, the International Organization of Securities Commissions. In the same vein, we also seek to hear from all manner of interested parties, to advance a constructive dialogue and to maintain strong and vibrant capital markets…"

At the same time, Mr. Donaldson expected the introduction of several initiatives aimed at easing some of the concerns of foreign private issuers in relation to reforms being implemented in US markets. As it transpired during the year, Mr. Donaldson's expectations were more akin to predictions. In the wake of the strong criticisms leveled at US corporate governance measures in previous years (particularly Sarbanes-Oxley and the deregistration process), the US spent 2005 extending olive branches to foreign private issuers.

On March 2, 2005, the SEC published an extension of the S404 deadline for foreign private issuers, requiring compliance for fiscal years ending on or after July 15, 2006. For the majority of companies with year-ends falling on December 31, this effectively means compliance is pushed off until 2007. In arriving at its determination, the SEC acknowledged that it had heard and considered the challenges faced by many foreign private issuers in complying with IFRS. Subsequently, on September 22, 2005, the SEC published a further extension for non-accelerated filers, including foreign private issuers that are not accelerated filers, requiring compliance with S404 requirements in the first fiscal year ending on or after July 15, 2007.

On April 12, 2005, the SEC made a one-time accommodation for foreign private issuers whose financial statements are being prepared for the first time in accordance with IFRS, and whose financial years end before or beginning on January 1, 2007. The accommodation allows eligible foreign private issuers to file only two years of income statements, changes in shareholders equity, and cash flows, as opposed to the three years that are normally required.

Continuing the spirit of cooperation, on December 23, 2005, the SEC proposed new rules making it easier for companies to deregister their securities and terminate their reporting obligations under the Securities Exchange Act of 1934. In its release, the Commission noted the difficulties existing rules placed on foreign private issuers seeking to terminate their registration and reporting obligations, a situation it acknowledged as a possible disincentive to foreign private issuers. Thresholds established under the proposed new rules provided a set of alternative benchmarks based on whether the issuer is a well-known seasoned issuer (as defined by Securities Act Rule 405: 17 CFR 230.405) and not on a record holder count (as is currently the case). According to the SEC, the proposed new rules should make foreign private issuers more willing to access US capital markets.

During 2005, several positive regulatory and accounting developments trended towards convergence and equality of corporate governance regulations, both between foreign jurisdictions and between foreign jurisdictions and the US. Beginning April 6, 2005, the United Kingdom's Financial Reporting Review Panel (FRRP) received new powers to demand information from companies and auditors under the Companies (Audit, Investigations and Community Enterprise) Act 2004. The FRRP commented: "These measurements are a significant step in ensuring the co-ordination of accounting enforcement activities in the United Kingdom for which the Panel and FSA [Financial Services Authority] share responsibility, so as to comply with standards set by the Committee of European Securities Regulators."[1] In June, convergence between the International Accounting Standards and US Generally Accepted Accounting Principles moved one step forward with the issuance of the first draft standard by the International Accounting Standards Board and the US Financial Accounting Standards Board. The draft standard deals with business combinations.

The European Union auditing directive was passed during 2005, though pressure brought to bear on the directive resulted in the dilution of two proposed provisions: (1) the provision requiring the introduction of mandatory audit committees for all listed companies was made applicable only in situations where no national rules exist; and (2) the required rotation of audit partners was increased from the suggested five years to seven years. Despite this perceived softening, the directive still represents an effort to affect positive changes to the regulatory and oversight systems, with the aim of ensuring the protection of investors. In anticipation of the audit directive, the chief executive of the UK's Financial Reporting Council warned that his agency would have difficulty coping with the directive's requirement that the FRC inspect the work of all overseas audit firms that serve UK-listed companies.

1 Alice Nixon, "FRRP: New Powers to Demand Company Information," *Accountancy Magazine* (June 4, 2005).

12. Securities litigation against foreign private issuers.

The spirit of generosity infects the plaintiffs' bar… mildly

In 2005 the number of securities class actions filed against foreign issuers fell by 34%, from 29 in 2004 to 19 in 2005. This would appear to signal that the plaintiffs' bar had given in to a generous impulse; however, it is worth noting that 2004 was a bumper year for actions against foreign issuers, with an all-time record number of class actions filed. Other than the 23 cases filed in 2002, the 19 class actions filed in 2005 actually represent the third-highest number in the past ten years, and an increase on the nine-year average of 16 cases. Any generosity, then, was of a mild form. The 19 foreign issuers against which cases were filed included GlaxoSmithKline PLC, AstraZeneca PLC, and Elan Corporation PLC, which were caught up in product-efficacy litigation. Other cases brought in 2005 included Helen of Troy Limited; RenaissanceRe Holdings Ltd.; Lazard Ltd.; China Aviation Oil (Singapore) Corporation Ltd.; Sierra Wireless; Tyco International, Ltd.; DRDGOLD Limited; Gravity Co., Ltd.; ATI Technologies Inc.; Workstream Inc.; and Rhodia, SA.

In all, the 19 cases from 2005 were directed at foreign issuers from 11 different countries, and continued the trend of most previous years in that the majority of litigation (79%) was directed at non-European companies. In 2004, 72% of the total foreign issuers sued were non-European companies, and the ten-year average was 70%. Apart from Bermuda and Canada (which each had four companies sued), no single country was more prone to lawsuits than any other.

Putting the overall number of cases filed against foreign issuers into perspective, the 19 cases filed in 2005 represent less than 2% of the total 989[1] foreign issuers. Similarly, the 149 cases filed against domestic companies in 2005 also represented 2% of domestic issuers.

In addition to the drop in the number of securities class actions filed against foreign issuers, the number of SEC enforcement actions against foreign issuers also fell. In both 2003 and 2004, the SEC issued seven Litigation Releases reporting civil penalties, injunctive relief, or settlements of enforcement actions against foreign registrants. In 2005 the number of SEC enforcement actions against foreign registrants fell to 2002 levels, with actions leveled against the following three companies:

L.R.-19022	January 4, 2005	TV Azteca, SA de CV; Azteca Holdings, SA de CV
L.R.-19066	February 8, 2005	Elan Corporation PLC
L.R.-19501	December 20, 2005	Compania Internacional Financiera SA

TV Azteca and Elan Corporation were both charged with disclosure failures. Compania Internacional Financiera was charged with illegally covering short sales with offering securities.

1 Research Insight—CompuStat (1/19/06).

Foreign cases[1]

Year filed	Europe	Other	Total
2005	4	15	19
2004	8	21	29
2003	7	8	15
2002	9	14	23
2001	3	13	16
2000	5	9	14
1999	3	8	11
1998	5	13	18
1997	2	4	6
1996	2	7	9

1 Excludes “IPO Laddering,” “Analyst,” and “Mutual Fund” cases.

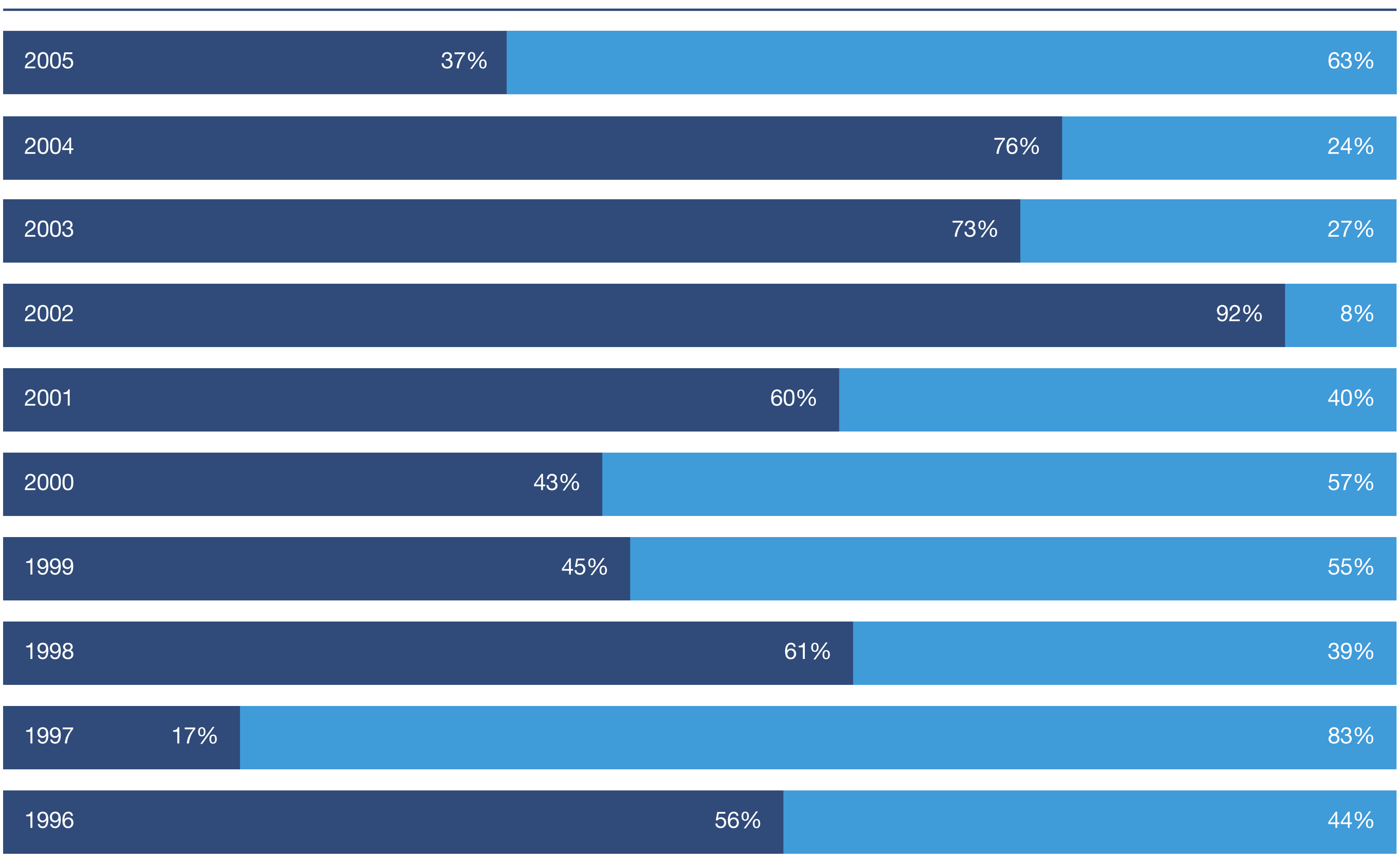
Accounting trends

In 2005, for the first time in five years, the number of non-accounting-related cases represented the majority of cases filed against foreign issuers. The percentage of accounting cases fell to 36%, the lowest since 1997 and lower than the 65% average of nine years since 1996. Such decline in foreign issuer accounting cases is in line with the decline in accounting cases overall, which fell to a 46% low since 1996. Restatements for foreign cases have also been on the decline since 2001, numbering two, four, and two (respectively) in 2003, 2004, and 2005. This of course would substantiate our position, regarding all issuers, that there does not appear to be any obvious correlation between restatements and the occurrence of securities class actions.

Overall the allegations directed toward foreign issuers in 2005 ranged from disclosure violations (including those involving pharmaceutical-efficacy matters) to accounting violations (including revenue recognition), understatement of liabilities, and internal control deficiencies.

The technology industry continued to be the most-targeted industry, representing 37% of total class actions directed at foreign issuers—an increase from the 31% of actions filed in 2004. The pharmaceuticals industry also experienced an increase, from 7% reported in 2004 to 16% in 2005.

Percentage of foreign accounting and non-accounting securities class action lawsuits filed



Accounting lawsuits
Non-accounting lawsuits

Onwards and upwards

Settlement amounts continued to increase in 2005, with total settlements reaching more than $1.35 billion (compared to more than $633.7 million in 2004 and more than $494 million in 2003). Two of the foreign settlements—Deutsche Telekom AG's $120 million settlement at the beginning of the year and Royal Ahold's $1.1 billion settlement toward the end—were among the ten largest settlements for both domestic and foreign issuers during the year, with Ahold's being the third largest for all issuers. Both matters involved accounting issues. Other settlements of $15 million or more were made by the Asia Pulp and Paper Company Ltd. ($46 million), the Vodafone Group PLC ($24.5 million), and Ashanti Goldfields Ltd. ($15 million).

Overall, 12 foreign issuers settled during 2005 compared with a total of ten in 2004. The 2005 average settlement of $112.7 million exceeded the previous year's high of $63.4 million, but, if the Ahold matter is excluded, the average drops to $23 million, less than the 2004 average.

Top settlements for foreign companies

Royal Ahold NV[1]	Netherlands	2005	$1,100,000,000
Global Crossing Ltd.[2]	Bermuda	2004	$345,000,000
DaimlerChrysler AG	Germany	2003	$300,000,000
Deutsche Telekom AG [1]	Germany	2005	$120,000,000
Lernout & Hauspie Speech Products NV [1]	Belgium	2004	$115,000,000
Alcatel	France	2001	$75,000,000
Elan Corporation PLC	Ireland	2004	$75,000,000

1 Partial settlements.
2 The Global Crossing Ltd. settlement was settled in two parts over three years.

Some Observations for Foreign Issuers

An Editorial

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At first glance, the fall in the number of securities class actions brought against foreign private issuers (FPIs) in the US in 2005 seems noteworthy. However, when the number is viewed in the context of the ten-year trend, and after considering that it comes on the heels of the record number of cases filed in 2004, the reduction appears less remarkable. This past year also happened to be the third largest year in ten years in terms of the number of securities class actions filed against FPIs. Drawing from the statistics themselves, therefore, it seems that the overall trend does not indicate any long-term shift from the increasing numbers experienced in prior years. Nor do any of the current environmental and regulatory events indicate that foreign issuers should expect to be any less subject to securities litigation than their US counterparts in the coming year.

If there was any doubt in the minds of US capital market investors as to the accountability of foreign issuers, the increased cooperation among global regulators and the increased focus by the SEC on foreign issuer related matters should serve to confirm that US domestic companies and foreign issuers are equally accountable. Notwithstanding the conciliatory actions on the part of the SEC during 2005, the SEC consistently stated that such actions were approved only after ensuring that the interests of US investors were not compromised. The regulators were also quick to remind all issuers accessing US capital markets that they would continue to be subject to the same standards of corporate governance, and the SEC reiterated its commitment to pursue increased cooperation with foreign regulators, not least through its membership in the International Organization of Securities Commissions.

By mid-2006, FPIs will have begun to file IFRS-based financial statements with the SEC, and during the second half of 2006, the SEC plans to begin analyzing such filings. The practical ramifications of these events for FPIs include not only the increased scrutiny and exposure for their financial statements and disclosures, but also the attendant risks that may result therefrom. The newly prepared IFRS-based financial statements are more likely to draw more attention from users generally, especially in areas where dramatic differences between past and current results are identified. Moreover, the required reconciliations between IFRS-based results and US GAAP-based results will similarly attract additional scrutiny from users and regulators, such that any unexpected discrepancies between them will be identified and examined thoroughly. If issues surface during the IFRS conversion process (such as accounting errors or irregularities) not only are they more likely to attract the SEC's attention, but the plaintiffs' bar can be counted on to exploit such deficiencies, as well as any restatements that may result.

During 2005, much criticism was directed at the US regulatory environment and in particular its high cost of compliance and burdensome delisting rules. This criticism provoked much speculation that existing foreign issuers would delist from US capital markets, and that new foreign issuers would avoid the US capital markets in favor of non-US capital markets. However, according to the SEC's Performance and Accountability Report 2005, an increased number of new foreign companies registered their securities with the SEC, and the dollar value of such securities increased as compared to previous years. And while some high-profile securities listings went to non-US capital markets in 2005, there were other companies that chose to delist from non-US exchanges while maintaining their US listings. For example, in December 2005, NEC announced that it resolved to apply for delisting of its ordinary shares and depositary receipts from the London, Euronext Amsterdam, Franfurt, and Swiss stock exchanges.

In the coming year, it will be fascinating to follow the response of foreign issuers to the proposed new deregistration rules and, if they are enacted, whether FPIs will choose to avoid or delist from the US capital markets. The SEC acknowledges in its release[1] that some amount of attrition will take place, but the SEC's view is that the proposed rules should make the US markets more attractive to FPIs. There is no denying that the changes in the proposed rules attempt to address some of the concerns of potential foreign issuers whose reticence to joining US markets is based solely on the difficulties associated with delisting from US markets. Whether these changes will be sufficient to encourage more new foreign listings than delistings remains to be seen. Since many non-US companies, particularly European companies, claim that it is the onerous provisions of Sarbanes-Oxley that discourage them from seeking new US listings, it is difficult to envision the new provisions causing any seismic change in the positions of these companies, especially since they already have access to liquid capital markets closer to home.

1 SEC Release 34-53020, International Series Release No. 1295: Termination of a Foreign Private Issuer's Registration of a Class of Securities Under Section 12(g) and Duty to File Reports Under Section 15(d) of the Securities Exchange Act of 1934.

The year 2006 is shaping up to be an intriguing year because of the potential responses of issuers to potential changes in the regulatory environment, as well as the repercussions associated with the rapidly developing issues and events mentioned above. Depending on the results of SEC reviews of IFRS-prepared filings, FPIs could find themselves in the sights of the US plaintiffs' bar in the short term. On the other hand, the proposed deregistration rules may ultimately lead to a net reduction in the FPI population and fewer future securities litigation actions filed against FPIs.

Methodology

The PricewaterhouseCoopers' Securities Litigation Database contains shareholder class actions filed since 1994. The focus of this study is on all cases filed after the PSLRA. PwC tracks all cases filed and more than 50 data points related to each case, including: court, circuit, company location, SIC code, class period, stock exchanges, GAAP allegations, earnings restatements, SEC investigations, DOJ investigations, and lead plaintiff type.

PwC also analyzes a variety of issues, including: whether the case is accounting-related, breakdown of accounting issues, and settlement data.

Sources: case dockets, news articles, press releases, claims administrators, SEC filings.

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