



## Discussion with Treasury Secretary Hank Paulson

### About this document

On November 28, 2007, Henry (Hank) M. Paulson, Jr., Treasury Secretary of the United States joined members of the Audit Committee Leadership Networks in North America and Europe for a discussion of the competitiveness of global capital markets and its impact on large public companies. For further information about the network, see "About this document" on page 6.

During the meeting, Mr. Paulson provided an overview of the Treasury's priorities and engaged in a conversation with network members on the following topics:

- **The U.S. regulatory environment and its impact**
- **Additional current challenges to the competitiveness of capital markets**
- **What public companies can do to support the Treasury's efforts to improve the competitiveness of capital markets**

Network members participating in the meeting, who sit on the boards of over 40 large-, mid-, and small-cap public companies between them, included:

- Mr. Denny Beresford, Audit Committee Chair, Kimberly-Clark
- Mr. Per-Olof Eriksson, Audit Committee Chair, Volvo
- Mr. Gene Fife, Audit Committee Chair, Caterpillar
- Mr. Jan Hommen, Audit Committee Chair, ING
- Mrs. Judy Richards Hope, Audit Committee Chair, Union Pacific
- Mr. Laban Jackson, Audit Committee Chair, JPMorgan Chase
- Dr. DeAnne Julius, Audit Committee Chair, Roche Holding
- Mr. Oscar Munoz, Audit Committee Chair, Continental Airlines
- Mr. Chuck Noski, Audit Committee Chair, Microsoft and Morgan Stanley
- Ms. Pam Patsley, Audit Committee Chair, Texas Instruments
- Sir Ian Prosser, Audit Committee Chair, BP
- Ms. Guylaine Saucier, Audit Committee Chair, Areva
- Dr. Klaus Schlede, Audit Committee Chair, Lufthansa and Deutsche Telekom
- Mr. Gerhard Schulmeyer, Audit Committee Chair, Zurich Financial Services

Ernst & Young partners participating in the discussion included:

- Mr. Tom Flannery, Americas Director, Audit Committee Communication
- Mr. Steve Howe, Americas Managing Partner
- Mr. Tom McGrath, Managing Partner, Northern Europe, Middle East, India, and Africa Client Service
- Mr. Christian Mouillon, Managing Partner, Continental and Western Europe Client Service
- Mr. Jim Turley, Global Chairman and CEO

*ViewPoints* reflects participating networks' use of a modified version of the Chatham House Rule whereby names of members, guests, and company affiliations are a matter of public record, but comments made by

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members before and during meetings are not attributed to individuals or corporations. However, Secretary Paulson has given permission for his comments to be attributed.

## Executive summary

The second Audit Committee Leadership Summit brought together the European and North American Audit Committee Leadership Networks to make progress in their mission to help enhance trust in the world's capital markets. Members were joined by Mr. Hank Paulson, Treasury Secretary of the United States, and discussed the following topics:

- The need for U.S. regulatory reform, with a blueprint expected from the Treasury by early 2008
- The study currently under way to address the challenges of restatements
- The litigious nature of the U.S. capital markets and the Treasury's support for reform
- The need for a transatlantic dialogue to promote regulatory harmonization
- The importance to the capital markets of a sustainable accounting profession
- Actions public companies can take to support the competitiveness of capital markets, including taking a more proactive approach with the U.S. government and regulatory bodies

These ideas are discussed in more detail on pages 2-5. For a short biography of Secretary Paulson, see the appendix on page 6.

## The U.S. regulatory environment and its impact

Pursuing a modernized regulatory structure is one of Secretary Paulson's priorities in his overall work to improve the competitiveness of U.S. capital markets.<sup>1</sup> Speaking at the summit, Secretary Paulson said, *"When you step back and ask what the real issues are, it's the regulatory environment and mind-set. Over the course of our nation's history, we have added multiple regulators to respond to the issues of the day. Our regulatory system has adapted to the changing market by expanding, but perhaps not always focusing on the broader objective of regulatory efficiency so there is a patchwork quilt ... At the Treasury, we're spending a lot of time on a regulatory blueprint for the next century."*

An October 11 Treasury press release seeking public comment on the blueprint stated, "The blueprint, set for release early next year, will seek a more effective regulatory structure that can adapt to the dynamic U.S. marketplace while improving oversight."<sup>2</sup> It will take into consideration all types of financial institutions, including commercial banks, insurance companies, securities firms, futures firms, and other types of financial intermediaries.<sup>3</sup>

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<sup>1</sup> Department of the Treasury, "Paulson Announces Next Steps to Bolster U.S. Markets' Global Competitiveness," press release, June 27, 2007. Available at <http://www.treas.gov/press/releases/hp476.htm>.

<sup>2</sup> Department of the Treasury, "Treasury Requests Public Input on Review to Improve Regulatory Structure," press release, October 11, 2007. Available at <http://www.treasury.gov/press/releases/hp602.htm>.

<sup>3</sup> Ibid.

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Members also mentioned the challenge that the perceived aggressiveness of the Securities and Exchange Commission (SEC) presents to working with that agency, an ongoing theme of other network meetings.<sup>4</sup> Secretary Paulson reflected, *“Public companies should be able to work with regulators to resolve ambiguities and make the right decisions under appropriate regulatory guidance. The combination of enforcement and guidance is likely to be more effective and efficient than relying on enforcement alone, particularly in an environment in which there is a greater degree of trust between the regulators and the regulated.”* The benefits of a dialogue with the SEC were also discussed in an earlier summit session, at which former SEC commissioner Roel Campos and former heads of enforcement Steve Cutler and Bill McLucas were present.<sup>5</sup>

Not surprisingly, the current turbulence in the world’s financial markets provided an additional stimulus for discussion of the complexity of the regulatory environment in the United States and how that impacts the world’s financial markets. Secretary Paulson stated that, *“The subprime crisis demonstrates problems with this overlapping regulatory structure.”* Policy and regulatory responses are being put together to prevent a recurrence of this kind of crisis.

## **Additional current challenges to the competitiveness of capital markets**

Following Secretary’s Paulson’s opening remarks, the discussion moved on to members’ concerns about the ongoing challenges of restatements and materiality, litigation reform in the United States, the need for a transatlantic dialogue on regulation, and the sustainability of the auditing profession.

### **Restatements and the problem of materiality**

The volume of restatements continues to perplex the Treasury, network members, and other stakeholders in capital markets. Secretary Paulson called it *“a vexing problem.”* He mentioned that University of Kansas professor Susan Scholz is currently leading an investigation into the impact of and reasons behind public company restatements. Results are expected in early 2008. Secretary Paulson urged members to offer suggestions to help address the problem. Additional suggestions from Secretary Paulson can be found in the box on page 6.

Secretary Paulson agreed with members that, *“materiality has been a cause for concern.”* Currently, the Audit Process and Compliance Subcommittee of Robert Pozen’s Advisory Committee to Improve Financial Reporting (CIFiR) has, in its own words, *“concentrated its efforts on the subject of financial restatements and whether the provision of guidance with respect to the materiality of errors would be beneficial.”*<sup>6</sup> In November, a report from this subcommittee included a proposal to introduce a sliding scale for evaluating the materiality of errors based on the strength of quantitative and qualitative considerations. The report suggested, for example, that *“errors that amount to less than 5 percent of pretax earnings would have a rebuttable presumption that the error is not material, while errors that were in excess of 10 percent of pretax*

<sup>4</sup> See, for instance, Audit Committee Leadership Network, “A dialogue with John White,” *ViewPoints*, October 19, 2007. Available at [http://www.tapestrynetworks.com/documents/Tapestry\\_EY\\_ACLN\\_Oct07\\_View17.pdf](http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Oct07_View17.pdf).

<sup>5</sup> See Audit Committee Leadership Summit, “Working with the SEC,” *ViewPoints*, January 23, 2008. Available at [http://www.Tapestry\\_EY\\_Summit\\_View3\\_Jan08.PDF](http://www.Tapestry_EY_Summit_View3_Jan08.PDF).

<sup>6</sup> Audit Process and Compliance Subcommittee, “Report for Discussion at November 2, 2007, Full Committee Meeting,” 1. Available at <http://www.sec.gov/about/offices/oca/acifr/acifr-sc3-report.pdf>.

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earnings would have a rebuttable presumption that the error is material.”<sup>7</sup> The next full committee meeting will take place in early 2008.

## **Litigation reform in the United States**

Concern over the litigious nature of U.S. capital markets is another ongoing theme at network meetings. One audit chair asked Secretary Paulson, “*Does the regulatory blueprint consider the legal system and due process for the governance of regulators?*” Secretary Paulson responded, “*It is very important, but it has not been focused on. It is a complex legal system with different parts overseen by different regulators.*” The Treasury, while unable to direct change in this regard, has taken positions on certain cases. Secretary Paulson stated, “*We took a strong line on Stoneridge.*”<sup>8</sup>

It is rare that class action securities lawsuits reach a trial in the United States. According to NERA Economic Consulting, nearly 40% of all such lawsuits filed from 2001 to 2006 were dismissed; virtually all the others were settled, largely due to the magnitude of damages that would result.<sup>9</sup> For those that do reach trial, legal standards are tougher now as a result of the 1995 passage of the Private Securities Litigation Reform Act that was championed by then Representative Christopher Cox (now chairman of the SEC). A recent article in *Compliance Week* noted, “Lawyers also cite several recent Supreme Court cases that have made the pleading standard even more stringent and led to more cases being dismissed. In 2005, for example, the Supreme Court said that Dura Pharmaceuticals could not be sued for securities fraud, ruling that plaintiffs must prove that a company’s misrepresentation or other fraudulent conduct ‘proximately caused the plaintiff’s economic loss.’”<sup>10</sup>

## **The need for a transatlantic dialogue on regulation**

Audit committee chairs present at the summit suggested the need for a transatlantic dialogue to promote regulatory harmonization. A European audit chair noted, “*One promising outcome is mutual market recognition. There are promising starts with the [U.K.’s Financial Services Authority] FSA.*” Secretary Paulson commended SEC Chairman Christopher Cox for his work on mutual recognition: “*A promising approach is mutual recognition... The SEC is taking steps forward on this initiative. It’s not one size fits all.*”

One step in this direction was the creation, in April 2007, of the Transatlantic Economic Council, which is committed to deeper transatlantic economic integration. The Transatlantic Economic Council is co-chaired

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<sup>7</sup> Ibid., 5–6.

<sup>8</sup> “Stoneridge” refers to *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc. et al.*, a securities fraud class action case decided on January 15, 2008, by the Supreme Court. The investor group accused Charter Communications and two of its vendors, Scientific-Atlanta and Motorola, of entering into sham transactions that improperly inflated Charter’s reported revenues and cash flow. In a five-to-three decision, the Supreme Court dismissed the case, ruling that plaintiffs, when pursuing a lawsuit against secondary actors (vendors, accountants, lawyers, etc.) must be able to demonstrate that when making the decision to purchase the stock, the plaintiffs relied on the “deceptive, behind-the-scenes” behavior of these secondary actors. The Treasury Department sent a letter to the solicitor general’s office urging that companies be provided with clear guidelines indicating under what circumstances they could be sued over another company’s fraud.

<sup>9</sup> Stephen Taub, “Shocker! Class-Action Lawsuit Goes to Trial,” *Compliance Week*, November 20, 2007. Available to subscribers at <http://www.complianceweek.com/index.cfm?fuseaction=page.viewPage&pageID=448&nodeID=1>.

<sup>10</sup> Ibid.

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by Mr. Keith Hennessey, assistant to the president for economic policy and director of the National Economic Council, and Mr. Günter Verheugen, vice president of the European Commission.<sup>11</sup>

## Ensuring the sustainability of the accounting profession

Secretary Paulson identified the sustainability of the auditing profession as another important part of the capital markets competitiveness action plan. He asked former SEC chairman Arthur Levitt and former SEC chief accountant Don Nicolaisen to chair a nonpartisan committee that will study auditing profession concentration and consider how best to strengthen the profession's financial soundness and its ability to attract and retain qualified personnel.<sup>12</sup>

Secretary Paulson told members, *"The corporate scandals were accounting scandals. Auditors and audit committees were the focal points of the reforms. These changes were necessary to rein in abuses. But significant changes always cause stress. These changes have altered the relationship between the outside directors and the external auditor."* The Treasury advisory committee recently sought public comment through a discussion outline that included a list of audit issues and consideration points, such as human capital (including recruiting, training, educating, licensing, and retaining people), audit firm organization structure, governance, liability, insurability, communication, audit profession standards, globalization, and financial resources, among others.<sup>13</sup>

## What public companies can do to support the Treasury's efforts to improve the competitiveness of capital markets

At the summit, an audit chair asked Secretary Paulson, *"[Our companies] create millions of jobs and billions [of dollars] of revenue. What can we do to help get your agenda through?"* Suggestions centered on more engagement and communication with regulatory and legislative bodies (see box below).

### Actions to support the competitiveness of capital markets

- Encourage leaders of major public companies to meet with leaders on Capitol Hill, communicate concerns, and develop relationships.
- Ask management to encourage employees to write to Congress on important issues such as trade, investments, and corporate taxes.
- Be proactive about creating a relationship with the SEC and other regulatory agencies and work directly with your audit partners to build a constructive relationship with the SEC.
- Contribute ideas to help the Treasury Advisory Committee on the Auditing Profession.<sup>14</sup>

<sup>11</sup> The first statement by the co-chairs (then Mr. Allan Hubbard and Mr. Günter Verheugen) is available at <http://www.eurunion.org/News/press/2007/20070112.htm>.

<sup>12</sup> Department of the Treasury, "Financial Reporting Vital to US Market Integrity, Strong Economy," May 17, 2007. Available at <http://www.ustreas.gov/press/releases/hp407.htm>.

<sup>13</sup> The working discussion outline is available at <http://www.treas.gov/offices/domestic-finance/acap/agendas/outline-10-15-07.pdf>.

<sup>14</sup> Comments for the Advisory Committee on the Auditing Profession can be submitted at <http://comments.treas.gov/index.cfm?FuseAction=Home.ViewList>.

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## Appendix: Biography of Secretary Paulson

President George W. Bush nominated Henry M. Paulson, Jr., to be the 74th Secretary of the Treasury on June 19, 2006. The United States Senate unanimously confirmed Mr. Paulson to the position on June 28, 2006, and he was sworn into office on July 10, 2006, by Supreme Court chief justice John Roberts. As Treasury secretary, Mr. Paulson is the president's leading policy adviser on a broad range of domestic and international economic issues.

Before coming to the Treasury, Mr. Paulson was chairman and chief executive officer of Goldman Sachs. He joined Goldman Sachs in 1974 in the Chicago office and became a partner in 1982. From 1983 until 1988, Mr. Paulson headed up investment banking services for the Midwest region. He became managing partner of the Chicago office in 1988. In 1990, he was named co-head of the firm's investment banking division, and in 1994, he rose to the position of president and chief operating officer. In 1998, he was named co-senior partner, and with the firm's public offering in 1999, became chairman and CEO.

Prior to joining Goldman Sachs, Paulson was a member of the White House Domestic Council, serving as staff assistant to the president from 1972 to 1973 and as staff assistant to the assistant secretary of defense at the Pentagon from 1970 to 1972.

Paulson graduated from Dartmouth in 1968, where he was a member of Phi Beta Kappa and All Ivy, All East, and honorable mention All American for football. He received an MBA from Harvard Business School in 1970.

## About this document

The Audit Committee Leadership Networks in Europe and North America are groups of audit committee chairs drawn from leading global companies committed to improving the performance of audit committees and enhancing trust in financial markets. The networks are convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment.

*ViewPoints* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives this document may share it with those in their own network. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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