SUBJECT: Creating a corporate integrity unit in the Attorney General's Office

COMMITTEE: State Affairs — committee substitute reommended

VOTE: 7 ayes — Marchant, Madden, J. Davis, B. Cook, Elkins, Gattis, Goodman

0 nays

2 absent — Lewis, Villarreal

SENATE VOTE: On final passage, April 10 — voice vote

WITNESSES: For — Michael Chatron, Texas Building Branch, Associated General Conmtractors; William Cunningham, Special Situations Funds; Tom "Smitty" Smith, Public Citizen; *(Registered but did not testify:)* Luke Metzger, Texas Public Interest Research Group

Against — None

On — *(Registered, but did not testify:)* Tom Harrison, Texas County and District Retirement System; Martha McCabe, State Auditor's Office; Karen Pettigrew, Office of the Attorney General; Joel Romo, Texas Municipal Retirement System

DIGEST: CSSB 1059 would create a corporate integrity unit (CIU) in the Office of the Attorney General (OAG), contingent on funding in the general appropriations act for fiscal 2004-05. The CIU would have to:

- help district and county attorneys investigate and prosecute fraud or other illegal activities by corporations, limited liability companies, and registered limited liability partnerships;
- help state agencies investigate complaints and administrative enforcement actions for corporate fraud violations, including the assessment of administrative penalties or sanctions; and
- serve as an information clearinghouse for the investigation and prosecution of corporate fraud and other similar illegal activities.

State agencies and local law enforcement agencies would have to cooperate with the CIU to the extent allowed by law by providing requested information needed to carry out the unit's stated purpose. Shared information would be confidential and not subject to the Public Information Act.

CSSB 1059 also would amend the Texas Pawnshop Act to prohibit a licensed pawnshop from entering into a transaction of more than $10,000 with an interested party — a controlling owner, a member of the business's governing body, an executive officer, an immediate family member, or an affiliate — without prior approval of a majority of the holders of all outstanding shares of capital stock or ownership interests voting together as a single class.

The bill would take effect September 1, 2003.

SUPPORTERS SAY:

CSSB 1059 would focus Texas' investigation and enforcement capability within the OAG, ensuring close cooperation with other state agencies and local law enforcement. In the Enron, WorldCom, and Xerox scandals, insufficient coordination and disjointed investigation existed at both the federal and state levels. President Bush has proposed similar federal legislation to create a "financial crimes SWAT team" under the Department of Justice. In Texas, at least five agencies have investigatory powers relating to corporate fraud. CSSB 1059 would increase the efficiency of these investigations and would result in faster and more detailed responses from the attorney general to prosecutors and other concerned state agencies.

The bill also would prevent a single stockholder of a licensed, publicly traded pawnshop from making unapproved transactions of more than $10,000. For example, some publicly traded companies have both voting and nonvoting stocks. A person who owns 100 percent of all the voting stock but less than 51 percent of the total stock can perform large-dollar transactions with interested parties without the approval of other stockholders. That person's decisions can supersede the best interests of the majority of stockholders. CSSB 1059 would ensure that the total value of all stock would establish the threshold for determining who has controlling interest and who may perform interested-party transactions in excess of $10,000 on behalf of the company. So long as there was a good economic argument for the transaction, it would not be difficult or expensive to meet this requirement, because a single line in a routine annual proxy statement could explain why it was in the firm's best

interest to approve the interested-party transaction. A theme running through many of the high-profile ethical breakdowns in corporate America is that private executives seem to consider their firms as private companies structured to benefit themselves, rather than as public companies with fiduciary responsibilities to their shareholders.

The Senate engrossed version of SB 1059 would have subjected businesses that contract with the state for $25,000 or more to annual certified audits. This would be an unreasonably low threshold for requiring a certified audit, which can cost a company $15,000 or $20,000. Most companies that do business with the state already conduct their own in-house audits, and while these companies support the goal of public disclosure, they already perform most of what the Senate version of the bill would require. SB 1952 by Ellis would set a more reasonable threshold, requiring certified audits only for state contracts that exceeded $1 million.

OPPONENTS SAY:

The House committee substitute for SB 1059 would omit critical portions of the Senate engrossed version that would strengthen the state's capacity to combat corporate fraud.

The bill should require businesses to disclose their financial history when entering into contracts with the state for more than $25,000. Annual certified audits should be required with regard to a company's use of state funds, and those who violated this requirement should be subject to criminal and civil penalties. Also, the state should be able to withhold contracts from businesses that violate state or federal laws. In its current form, CSSB 1059 would put no teeth in state law to compel timely and accurate disclosure.

The bill should require investment managers who exercise discretion over state pension and investment funds to comply with ethics rules and standards of conduct. Advisors doing business with the state should have to report any hidden client relationships that could influence their recommendations. The state of Texas has $180 billion in investments and pensions. When corporate scandal caused the value of WorldCom stock to drop from $8.35 to 22 cents per share, the Teacher Retirement System lost $93 million, the Employees Retirement System lost $64 million, the University of Texas lost $65 million, and the Permanent School Fund lost $55 million. Addressing potential

conflicts of interest in investments is critical to minimizing the potential losses affiliated with a collapse brought on by corporate fraud.

The bill should subject corporate officials to state-jail penalties for knowingly submitting false or misleading financial statements. Misrepresentation of earnings was at the heart of the problems revealed in the Enron, WorldCom, and Xerox cases. The state should have clear and specific authority to investigate and bring civil lawsuits to recover funds lost not only by any state retirement system but also by Texas citizens.

OTHER OPPONENTS SAY:

Creation of the CIU would depend on a specific appropriation to the OAG for fiscal 2004-05. At this point, it appears that no money will be appropriated to create the CIU, and since CSSB 1059 would authorize the attorney general to implement the program only if funding were specified for it, the CIU is destined to die. If the state wants to show a commitment to fighting corporate fraud, the bill should put the CIU in statute so that it could be activated in the future when and if money became available.

NOTES:

The Senate engrossed version of SB 1059 would not have amended the Texas Pawnshop Act. In addition to creating the CIU, it would have:

- required companies that do business with the state to reveal financial irregularities, submit to regular certified audits, and face penalties for violations;
- prohibited investment managers and advisors doing business with the state from having any hidden client relationships with other businesses that could influence their investment recommendations;
- required investment managers and advisors doing business with the state to report client relationships and other financial data that could affect the advice they gave to the state; and
- subjected corporate officials responsible for financial statements and licenses who attested to those statements to felony penalties for knowingly signing false and/or misleading financial reports.

SB 1059 is part of a three-bill package addressing corporate fraud. SB 1060 by Ellis, amending regulation of investment advisers, was signed by the governor on May 20 and took effect immediately. HB 2040 by Marchant (companion to SB 141 by Ellis), authorizing certain state agencies to share

information for investigative purposes, passed the House on May 9 and was considered in a public hearing by the Senate Jurisprudence Committee on May 21.

SB 1952 by Ellis, an omnibus government reorganization bill containing financial disclosure requirements for companies that contract with a state governmental entity for more than $1 million, was placed on the Senate Intent Calendar for May 21.