

# CRS Report for Congress

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## Securities Litigation Reform: Unfinished Business?

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### **ABSTRACT**

This report discusses legislation, H.R. 1653, H.R. 1689, and S. 1260, which would extend the reach of the Private Securities Litigation Reform Act of 1995 (P.L. 104-67) to state courts. Enacted in 1995, P.L. 104-67 attempts to make it more difficult for frivolous securities class action suits to access the federal courts. This report will continue to track the ongoing legislative developments in this area.

# Securities Litigation Reform: Unfinished Business?

## Summary

In December 1995, overriding a presidential veto, Congress enacted H.R. 1058, the Private Securities Litigation Reform Act of 1995 (the Reform Act) as P.L. 104-67. The law was a congressional response to concerns that shareholder suits claiming violations of the Securities Act of 1933 and the Securities Exchange Act of 1934 (especially section 10(b), the antifraud provision of this law) were increasingly unjustified and frivolous. Among other things, the Reform Act attempted to curtail frivolous securities suits before the federal courts by: 1) having the court designate the lead plaintiff in such cases; 2) providing for a safe harbor from legal action for predictions about future corporate performance; and 3) providing for proportionate liability wherein a defendant judged not to have knowingly committed the fraud shall only be liable for the part of the judgement in accord with his overall responsibility.

About a year after the passage of the Reform Act, concerns began surfacing in the corporate community (particularly high tech-related firms) that the state courts were increasingly being used to circumvent that law. In the interest of stymying the migration of frivolous securities suits into the state courts, H.R. 1653, H.R. 1689, and S. 1260 extend the reach of the Reform Act to the states. Opposition to the uniform standards legislation derives from a number of concerns, including: 1) the perception that the uniform standards legislation represents an assault on our tradition of state/federal "federalism"; and 2) the view that key elements of the Reform Act are still undergoing interpretation in the courts and thus it would be imprudent to try to extend such an "unfinished" statute. After espousing the latter view, in March 1998, the SEC gave its support to S.1260 after the bill's sponsors agreed to say in the bill's legislative history that the Reform Act did not represent an attempt to impose more difficult plaintiff pleading standards than had existed already. However, there is some skepticism about the effectiveness of this approach. On May 13, 1998, S. 1260 passed the Senate following Banking Committee markup on April 29.

Proponents of uniform standards legislation say that the existence of substantive differences between state and federal courts (such as the fact that state courts do not tend to have stay of discovery when a defendant's motion to dismiss a case is pending) helps foster the filing of state-based frivolous "strike suits" largely waged to "extort" negotiated settlements from firms. But, others focus on the primacy of the rights of the legitimately defrauded investor and support a "wait and see" approach to the current legislation. There is concern about the extent to which the courts may subsequently interpret the Reform Act's key provisions in a manner that further restricts legitimately defrauded plaintiffs' opportunities for redress. To the extent that these evolving court-based interpretations could have significant impact on the cost/benefit equation for defrauded investors (and given what appear to be credible doubts about the willingness of the courts to uniformly comply with clarifying statements in current legislative history about congressional intent on pleading standards in the Reform Act), the "wait and see" perspective would appear to have potential legitimacy. However, the costs and benefits of extending the various features of the Reform Act to the states may vary. Section 102, the provision on safe harbors for forward-looking statements, would appear to have comparatively greater potential for providing significant benefits to issuers and their shareholders

while not substantially trading off defrauded investors' chances for legal and economic redress.

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# Securities Litigation Reform: Unfinished Business?

## Introduction

In December 1995, overriding a presidential veto, Congress enacted H.R. 1058, the Private Securities Litigation Reform Act of 1995 (the Reform Act) as P.L. 104-67. The law was a congressional response to concerns that shareholder suits claiming violations of the Securities Act of 1933 and the Securities Exchange Act of 1934 (especially section 10(b), the antifraud provision of this law) were increasingly unjustified and frivolous. The Reform Act attempts to curtail securities suits before the federal courts by, among other things, 1) having the court designate the lead plaintiff in such cases; 2) prohibiting a person from serving as a plaintiff in more than 5 class action suits over a three-year period; 3) eliminating coverage of securities fraud by the Racketeer Influenced and Corrupt Organizations Act (RICO); 4) providing for a safe harbor from legal action for predictions about future corporate performance; 5) providing for proportionate liability wherein a defendant judged not to have knowingly committed the fraud shall only be liable for the part of the judgement that corresponds to his percentage of overall responsibility; and 6) providing for auditor disclosure of corporate fraud.<sup>1</sup>

Months after the Reform Act's enactment, there were growing perceptions that the law was not having the desired effect of curtailing the overall number of (what many presume to be significantly frivolous) class-action securities suits due in large part to the increased use of filings in state courts.

For example, Denise Amatena, a partner in the law firm of Wilson, Soneini, Goodrich & Rosati (a law firm that defends corporate defendants), observed that, as of July 1996, California defense lawyers were seeing three times as many securities class-action suits brought in California courts as in federal courts since P.L. 104-67's enactment.<sup>2</sup>

In addition, a study done in late 1996 by the National Economic Research Associates (NERA), a consulting firm, found that between April 1 and October 31,

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<sup>1</sup>This section derives from: U.S. Library of Congress. *Private Securities Litigation Reform: P.L. 104-67*. CRS Report 96-238 A, by Michael Seitzinger. Washington, 1996. 9 p. For a discussion of the federal securities laws as they relate to issues of mandated disclosure and charges of shareholder fraud, see: U.S. Library of Congress. *Uniform Standards in Private Securities Litigation: Limitations on Shareholder Lawsuits*. CRS Report 98-164 A, by Michael Seitzinger. Washington, 1998. 5 p.

<sup>2</sup>Sclafane, Susanne. Securities Reform Has Unintended Consequences. *National Underwriter*, September 16, 1996. p. 34.

1996, 81 securities class-action suits were filed in federal courts — the same number filed in the same period in the previous year before P.L. 104-67's enactment. However, NERA also found that in the first 10 months of 1996, the number of class action securities suits filed in state courts nearly doubled from the same period in 1995, going from 48 to 79. This was nearly double the average number of state filings in the previous 5 years.<sup>3</sup>

Joseph Grundfest (a former SEC Commissioner) and Michael Perino, both of whom teach law at Stanford University, run an internet site for the law school which lists class-action-related litigation documents, and which has allowed them to monitor the ongoing effect of the Reform Act. Based on their research in this area, they found that from the time of the Reform Act's enactment in the beginning of 1996 up to June 30, 1997, the aggregate number of class-action securities filings in both federal and state courts appeared to be “roughly equivalent” to the rate of filings during the pre-Reform Act period of 1991 to 1995.<sup>4</sup>

The Stanford professors concluded that in the Reform Act's debut period there appeared to be little correlation between the existence of the law and a decline in the overall number of class-action securities suits. However, hidden beneath these apparently stable pre- and post-Reform Act, aggregate filing rates was a “significant shift of activity from federal to state court.” This “substantial increase in state court litigation” was, they say, chiefly driven by 3 things: 1) a “substitution effect” in which either: a) plaintiffs' lawyers file in state courts when the facts of their cases would appear unable to meet the more stringent new federal pleading requirements brought in by the Reform Act or b) plaintiff lawyers simply attempt to circumvent the Reform Act's substantive or procedural demands; or; 2) plaintiff lawyers make greater use of parallel state and federal litigation for purposes of avoiding “federal discovery stays” or 3) plaintiff lawyers use alternative state venues for settling federal claims.<sup>5</sup>

Somewhat echoing Grundfest and Perino's findings, were parts of an April 1997 report on the Reform Act's first year that was done by the Securities and Exchange Commission (SEC). It reported that the most significant post-Reform Act development may have been the apparent increase in the number of securities actions filed in state court. The SEC report also observed that many of the state cases had been filed simultaneously with similar case filings in federal courts probably in order

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<sup>3</sup>Starkman, Dean. Securities Class-Action Suits Seem Immune to New Law. *Wall Street Journal Interactive*, November 12, 1996. p. 1.

<sup>4</sup>Joint Written Testimony of Joseph Grundfest and Michael Perino before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs on July 24, 1997. p. 3-4.

<sup>5</sup>*Ibid.* The Stanford professors also found that prior to the Reform Act, the vast majority of cases securities class-action cases filed in state courts alleged fraudulent activity in connection with buying or selling stocks of non-publicly traded companies. But, after the Reform Act, the vast majority of filings involve stocks traded on national securities markets and allege fraud due to the presence of artificially inflated initial stock prices caused by corporate misrepresentations or omissions.

to circumvent some of the Reform Act's procedural hurdles such as that of the discovery stay pending a motion to dismiss a plaintiff's case.<sup>6</sup>

## **P.L. 104-67's Safe Harbor Provision**

There is some evidence that companies which make credible, publicly disclosed corporate projections may not only be providing investors and stock markets with more meaningful and relevant information, but they may be also helping to lower their cost of capital.<sup>7</sup>

In the interest of making it easier for companies to voluntarily provide corporate projections on future performance with a credible basis, the Reform Act gives companies a safe harbor from legal action in the federal courts for such forward-looking statements if they are accompanied by "meaningful cautionary" statements that identifies key variables that could cause actual results to differ substantially from the predictions. (Examples would be unpredicted changes in the economy or supplier problems.)<sup>8</sup>

On April 10, 1997, 181 high-tech companies signed a letter that was sent to House Commerce Committee Chairman Bliley by the American Electronics Association (composed of electronic, software, and information technology companies) noting that safe harbor protections were generally not provided in state courts. And as a consequence, the letter argued that its signatory companies were not able to provide the public with as "much voluntary information as possible." And due to those concerns, the letter urged that the Reform Act be extended to the state courts.<sup>9</sup>

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<sup>6</sup>SEC Office of the General Counsel. *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995.* p. 2.

<sup>7</sup>For example, see: Skinner, Douglas. Do the SEC's Safe Harbor Provisions Encourage Forward Looking Disclosures? *Financial Analysts Journal*, July/August 1995.

<sup>8</sup>The forward-looking statement is also acceptable if the plaintiff fails to prove that if the statement was made by a natural person, it was made with actual knowledge by that person that the statement was false or misleading or, if made by a business, was made by or with the approval of an executive officer and made or approved by the officer with actual knowledge that the statement was false or misleading. (U.S. Library of Congress. *Private Securities Litigation Reform P.L. 104-67* by Michael Seitzinger. CRS Report 96-238 A. March 7, 1996. p. 3.)

<sup>9</sup>*Ibid*, p. 23. A number of Wall Street observers say that it is possible for companies who are being sued for fraudulently using forward-looking statements to win veritable "safe harbor" status in cases before the state courts by relying on the common law "bespeaks caution" doctrine. (For some observers, eligibility for "bespeaks caution" status requires that a company regularly informs Wall Street analysts about the possible risk factors involved in investing in the company.) But, even with "bespeak caution" immunity, companies can still face the costly prospect of discovery. (See: Molthrop, Morgan. Navigate this "Safe Harbor" with Caution. *The Georgeson Report*, February 1998. p. 5-7.

The April 1997 SEC report included a review of the impact of the Reform Act's safe harbor provision. Based on discussions with corporate officers and corporate issuers' outside counsels, as well as its review of post-Reform Act forward-looking corporate statements, the report observed that in the period after passage of the Reform Act, companies seemed to be no more willing to provide significant more forward-looking disclosures than they were before the enactment of the Reform Act. Two likely explanations were suggested: 1) the safe harbor provisions were still new and companies were proceeding cautiously in using them pending a clearer understanding of how courts were interpreting the law; and 2) the existence of significant corporate anxiety over the threat of possible liability in state courts for forward-looking statements that did not pan out because of the law's general inapplicability in those venues.<sup>10</sup>

Many of the supporters of the current securities reform litigation say that the willingness of various state courts to accept securities claims alleging that specific forward-looking corporate statements are fraudulent, is having a chilling impact on their willingness to provide forward-looking commentary in their public releases. For example, a 1997 survey of several hundred venture-capital-backed, largely high-tech companies found that 60% of the respondents continue to be reluctant to provide forward-looking statements for fear of being sued in state courts.<sup>11</sup>

Representative Anna Eshoo, a co-sponsor of H.R. 1689, testified that she had received hundreds of letters from business leaders, saying that they would not provide forward-looking disclosures until the threat of litigation not covered by the Reform Act's safe harbor is eliminated.<sup>12</sup>

## Legislation

On May 16, 1997, responding to concerns that the Reform Act's restricted reach was permitting numerous (and, some, think frequently unwarranted) securities class action cases to employ the alternative venues of the state courts, Representative Campbell introduced H.R. 1653, the Securities Litigation Improvement Act of 1997.

The bill (which Stanford University law professor and former SEC Commissioner Joseph Grundfest helped draft) was referred to the Subcommittee on Finance and Hazardous Materials of the House Committee on Commerce. It amends the Securities Act of 1933 and the Securities Exchange Act of 1934 by banning private civil actions in state courts that allege: 1) that there was misrepresentation or omission associated with the buying or selling of securities that are sold on national markets; or 2) that the defendant was manipulative or deceptive in connection with

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<sup>10</sup>SEC Office of the General Counsel, *Report to the President*. p. 2.

<sup>11</sup>High Growth Companies Muzzled by Threat of Strike Suits. *U.S. Newswires*, October 20, 1997. p. 2.

<sup>12</sup>*Testimony of Hon. Anna Eshoo during the Hearing on Securities Litigation Reform held on October 29, 1997, by the Senate Banking Subcommittee on Securities.*



such a transaction. While banning such civil securities suits from state courts, the bill also gives federal district courts sole jurisdiction over such suits.

In “Dear Colleague” letters sent out a few weeks before H.R. 1653's introduction, Representative Campbell stated that the bill's goal of a federal preemption of securities action filings was necessitated by the threat of a “state by state” reversal of the Reform Act's benefits. These are threats that Representative Campbell sees principally coming from either the actions of plaintiff lawyer-friendly state legislatures, or the spread of state proposals that are similar to the defeated November 1996 California initiative, Prop 211.<sup>13</sup>

On May 21, 1997, Representatives White and Eshoo introduced H.R. 1689, the Securities Litigation Uniform Standards Act of 1997. The bill was also referred to the Subcommittee on Finance and Hazardous Materials of the House Commerce Committee. It amends the Securities Act of 1933 and the Securities Exchange Act of 1934 by disallowing private class action civil suits of more than 25 persons in state court or under state law, including a pending state claim to an action under federal law, which alleges either: 1) an untrue statement or omission in connection with the purchase or sale of a covered security; or 2) or that the defendant used manipulative or deceptive tactics in connection with the purchase or sale of any security.<sup>14</sup>

On October 7, 1997, Senator Phil Gramm, Chairman of the Senate Committee on Banking, Housing, and Urban Affairs Securities' Subcommittee, introduced S. 1260, the Securities Litigation Uniform Standards Act of 1997. The bill's cosponsor is Senator Christopher Dodd, the subcommittee's ranking minority member. S. 1260 has received strong support from a coalition of high-tech companies, venture capitalists, securities firms, and accounting firms, as has H.R. 1689 to which it is very similar. However, H.R. 1689 would preempt state law with respect to a security that is not traded on a national exchange if its corporate issuer has an outstanding security that is traded nationally. But, S. 1260 provides for federal preemption of class- action suits in which the involved security is itself traded on a national exchange.

The press release accompanying H.R. 1689 stated that the bill would “ensure that remedies available to purchasers and sellers of nationally traded securities would be uniform and not vary depending upon the state in which the purchasers or sellers

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<sup>13</sup>Prop 211, or Proposition 211 was a failed initiative on the November 1996 California ballot which had significant support from the securities' plaintiff bar, and provoked widespread opposition from the business community. Generally, the initiative would have made it easier to file shareholder suits by, among other things: 1) allowing California courts to consider a doctrine known as “fraud on the market,” which allows shareholders to sue companies for securities fraud without having to cite specific examples of fraudulent information on which they may have relied in buying the stock; and 2) mandating that the cost of defending company executives and directors charged with securities fraud cannot be picked up by their company. (The cost could still be picked up by insurance companies, which tend to pay about half of the monetary damages.)

<sup>14</sup>This section largely derives from: U.S. Library of Congress. *Uniform Standards in Private Securities Litigation: Limitations on Shareholder Lawsuits*. CRS Report 98-164 A, by Michael Seitzinger. Washington, 1998. p. 4.

reside.”<sup>15</sup> In his introduction of S. 1260, Senator Gramm stated that while Congress had hoped that the Reform Act would deal with frivolous class-action lawsuits through the federal courts,” [we are] seeing a migration of these lawsuits to State courts with a real effort and apparently successful effort to circumvent what we had done [through the Reform Act]. . .”<sup>16</sup>

On April 29, 1998, the Senate Banking Committee voted to report S. 1260 to the full Senate. A substitute amendment was used as a markup vehicle in lieu of the pre-markup version of S.1260.

During the markup, the committee included a number of changes to the legislation that in late March, the committee’s leaders had promised the SEC would eventually be added to the legislation. The changes included insertion of language into S. 1260’s legislative history indicating that the congressional intent in the Reform Act was that the standard of liability in the federal securities laws for corporate defendants’ should be reckless misconduct per se. (For a full discussion of this issue, see the section below, **Wait and See?**) The committees’ leaders had also promised the SEC that S. 1260 would eventually include language that, unlike the original version of the bill, no longer blocked certain shareholder lawsuits against corporate directors for breach of fiduciary duty of disclosure under state courts, such as that of the key Delaware chancery courts. (For a fuller discussion of this issue, see footnote 34.) The substitute amendment to S. 1260 that the committee marked up contained these changes.

The marked up, substitute version of S. 1260 also “tightened up” the definition of “class action” contained in the original legislation by allowing various legal actions that are deemed to be beyond the bill’s ambit like suits against rogue brokers — to proceed in the state courts.

About the same time that S. 1260 was being marked up by the Senate Banking Committee, the White House gave the bill its support. On May 13, 1998, S. 1260 passed the Senate.

On June 24, the House Commerce Committee passed H.R. 1689.

## Is Legislation Necessary?

As Congress considers legislation that would preempt state laws pertaining to securities class-action cases, the basic question is: what are the various costs and benefits of the proposed uniform standards legislation?

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<sup>15</sup>See: Zeigler, Luther. Plugging A Leak. *Legal Times*, June 23, 1997.

<sup>16</sup>The Securities Litigation Uniform Act of 1997. *Congressional Record*, October 7, 1997. p. S10475.

## Updating the Numbers

In the summer of 1997, the National Economic Research Associates (NERA) released an update of its earlier study on the impact of the Reform Act. It found that in the first 5 months of 1997, 78 securities suits were filed in federal district courts compared with 47 filings during the same period in 1996. It also found that through from the beginning of 1997 to April of that year, there were 19 securities class actions filed in state courts. That figure represented more than half of the 40 filings done in the same period during 1996.<sup>17</sup>

In analyzing these findings, a NERA official observed that it appeared that plaintiff lawyers were realizing that “there’s no significant advantage to filing in state court [relative to federal district courts].”<sup>18</sup> The NERA findings of a drop in the number of class action state filings between early 1996 and early 1997 were echoed in a study released by Price Waterhouse in 1998 which found a 40% drop in class action filings before the state courts between 1996 and 1997.<sup>19</sup>

In early 1998, an informal SEC study found that 175 companies had been sued in securities class-action suits during all of 1997 compared to the 105 suits in 1996 and the 158, 221, and 153 in the pre-Reform years of 1995, 1994, and 1993 respectively. It also found that 20 of the 175 federal suits in 1997 were accompanied by parallel state filings (some perhaps being done to avoid the Reform Act’s ban on the plaintiff exercising discovery if the defendant has a pending motion to dismiss the case). This is in contrast to the 31 parallel state filings that accompanied the 105 securities class filings in federal court in 1996.<sup>20</sup>

A representative of the Uniform Standards Committee, a group of accountants, securities, venture capital, and high-tech firms that support uniform standards legislation responded that the NERA findings are essentially irrelevant because the mere threat of one state securities class-action case filing has a chilling effect on the use of forward-looking statements since many states do not provide immunity to corporate projections as does the Reform Act does.<sup>21</sup>

## The Need for Federal and State Uniformity

Since the introduction of uniform standards legislation in the first part of 1997, the focus of the debate on the legislation appears to have increasingly shifted from a discussion of whether or not there have been numerical gains in the volume of

<sup>17</sup>See: Starkman, Dean. Securities Class Action Suits are Making a Comeback. *Wall Street Journal Interactive Edition*, July 9, 1997. p. 1

<sup>18</sup> Ibid.

<sup>19</sup>Cited in: What’s the Rush? *National Law Journal*, March 30, 1998. p. 2.

<sup>20</sup>SEC Finds Number of Class Actions Rise in 1997 to Pre-Reform Act Levels. *Securities Regulation & Law Report*. February 20, 1997. p. 1.

<sup>21</sup>Coalition of Business Interests Promotes Securities Litigation Reform Legislation. *Securities Regulation & Law Report*, February 6, 1998.

state-based class action filings after the Reform Act — to a discussion of whether or not there is a need for federal/state uniformity per se in the area of securities class actions.

For example, in separate testimony during July 24, 1997 hearings before the Senate Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs Hearings, Stanford University's Grundfest and California Corporations Commissioner Keith Bishop disputed the SEC's assertion that it was too early in its life to speak of extending the Reform Act to the states. They both also claimed that the real issue is not whether there has been increased utilization of the state courts, but that the Reform Act cannot be effective per se until there is federal and state uniformity in the treatment of securities.<sup>22</sup> Professor Grundfest also questioned the wisdom of individual states being allowed to impose individual jurisdiction over our essentially national capital markets.<sup>23</sup>

And, after about a year of being noncommittal in its support of uniform standard legislation (due in part to the view that the Reform Act was still evolving in the interpretive eyes of the courts and that extending it to the states was thus premature), on March 24, SEC Chairman Levitt lent the agency's support to S. 1260, observing that "dual standards in state and federal courts are wrong."<sup>24</sup>

In introducing S. 1260, Senator Christopher Dodd said that the legislation would "maintain uniformity and certainty" in the U.S. securities' market, thus enabling our markets to keep their competitive edge over rival securities markets in, for example London, Frankfurt, and Tokyo. Former SEC Commissioner, Steven Wallman (now with the Brookings Institute), has argued that the continued existence of state laws that permit plaintiffs to circumvent the Reform Act's provisions relating to the discovery stay or the safe-harbor for forward-looking statements create fragmented legal terrain that injects additional uncertainty into the corporate decision-making process.

Others like Michael Perino of Stanford University Law School argue that the most compelling reason for adopting uniform standards legislation has nothing to do with the issue of the Reform Act's impact. Support for uniform standards, he argues, should be driven by the prospect that under the currently fragmented state and federal system, a company such as IBM can be confronted with unsettling and costly uncertainties that come with facing a host of similar securities suits simultaneously coming at it from dozens of disparate state courts.

Opponents of uniform standards marshal a number of arguments to rebut the claims that uniform state and federal standards would be socially optimal. One argument invokes the historical notion that the U.S. was built on a tradition of

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<sup>22</sup>Congress Urged to "Close Loopholes" Adopt Uniform Standards Legislation. *Securities Regulation & Law Report*, July 25, 1997. p. 1.

<sup>23</sup>Ibid.

<sup>24</sup>SEC Throws Weight Behind Reform Bill; Levitt Praised at Renomination Hearing. *Daily Report for Executives*, March 26, 1998. p. A-26. For details on the "conditional" nature of the SEC's support, see the next section in this report, **Wait and See?**

federalism and the states retain their rights to protect investors from securities fraud, an entitlement that uniform standards would abridge.<sup>25</sup> A more functionally oriented response to the pro-uniform standards perspective is based on concerns that as the current bull market fosters increases in direct and public and private retirement plan-based investments in our secondary markets, the amount of investment fraud is growing apace. Given this current reality, they argue that abridging investors' access to state-based remedies for fraud through imposing uniform standards is bad public policy.<sup>26</sup>

Others such as Representative Edward Markey, the ranking minority member on the House Commerce Committee Subcommittee on Finance and Hazardous Materials, have questioned whether uniform standards might be legislative "overkill" given the fact that the preponderance of both state and federal securities class actions are filed in a single state, California.<sup>27</sup>

## Wait and See?

In the wake of the passage of the Reform Act, a number of legal scholars predicted that, given the ambiguity of its various provisions, the Reform Act's ultimately interpreted shape and thus its ultimate impact would not be known for a while. The essential view was that these ambiguities would take some time to be "worked out" as the various cases wend themselves through federal district and perhaps appellate courts.

Provisions in the Reform Act that are frequently identified as being legally ambiguous and that are predicted to go through a series of judicial testing and refinement include: 1) the issue of the allowable plaintiff pleading standards, 2) the discovery stay provision, and 3) the "meaningful cautionary language" section in the

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<sup>25</sup>See: Gramm Predicts Passage of Bill, February 27, 1997. p. 1.

<sup>26</sup>For example, see the summary of the testimony given by J. Harry Weatherly of the Government Financial Officers Association in: Gramm Predicts Passage of Bill to Federalize Securities Class Action Suits. *Securities Regulation & Law Report*, February 27, 1998. p. 1. There are a few aspects of jurisprudence in the federal courts vis a vis that which is found in state courts that appears to be more pro-plaintiff. For example, federal courts have generally been more disposed to recognizing the "fraud on the market" theory in securities which is predicated on the idea that in pricing securities, securities markets are efficient in assimilating all public information germane to the financial prospects of firms whose securities are traded on them. Consequently, one who buys or sells a security is generally presumed under fraud on the market theory to have relied on the market price as an indication that all material information has been disclosed. As such, investors are seen largely relying on the integrity of the efficient markets' pricing mechanism in their decisions to buy or sell securities and when corporations either omit or misrepresent material data about themselves to the SEC, they are seen to be fraudulently misinforming the markets, and thus the investors as well. Financial economists are increasingly divided on the credibility of the concept of market efficiency.

<sup>27</sup>For example, see: Levitt Eschews Broad-Based Preemption of Private Securities Litigation. *Securities Regulation & Law Report*, October 24, 1997. p.1.

provision on providing safe harbors for forward-looking corporate statements provision.<sup>28</sup>

In testimony in July of 1997 before the Senate Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, the SEC's Levitt said that it was premature to make any definitive statements about the impact of the Reform Act since insufficient time had elapsed in the wake of the law's passage to allow for both meaningful patterns of experience with the law's provisions and the courts to clearly interpret it. The SEC chairman also commented that since the passage of the Reform Act, no case had made it to the jury stage and appellate courts have had little opportunity to interpret the Reform Act, and relatively few motions to dismiss had been decided. Likewise, he also observed that very few settlements had yet to emerge.<sup>29</sup>

The chairman also acknowledged that some parts of the Reform Act were not having the effect that Congress had intended<sup>30</sup> and he also expressed his willingness to support some narrow, targeted changes to the law. However, he warned that absent solid evidence that the historically viable system of federal-state regulation had "broken down"— he could not lend his support to broad-based legislative measures that would undo the present system.<sup>31</sup>

During subsequent testimony in late October 1997 before the House Commerce Committee's Subcommittee on Securities and Hazardous Materials Subcommittee, the SEC Chairman reiterated the view that there was insufficient evidence on the Reform Act's impact to allow for a reasonable determination that legislation which would preempt state laws or that would provide for "uniform standards" is currently required. He predicted that in a year (October 1999), a clearer picture on the impact

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<sup>28</sup>For example, Columbia University Law Professor John Coffee wrote: "Much commentary about the Reform Act is, for better or for worse, a *fait accompli*— that is, legislation whose meaning is fixed and whose impact, while desirable, is not contingent on future events...[but] the Reform Act is more like wet clay that has been shaped into an approximation of a human form by an apprentice craftsmen and has now been turned over to the master sculptor for the details that spell the difference between art and merely competent mediocrity. Legislation, like art, requires interpretation, and until that interpretive process is further along, the Reform Act must be regarded as still in its early formative period... Congress has simply left too many ambiguous gaps and statutory hiatuses for the Reform Act's impact to be reliably assessed at this point." (Coffee, John. *The Future of the Private Securities Litigation Reform Act: or Why the Fat Lady Has Not Yet Sung*. *Business Lawyer*, August 1996. p. 975.)

<sup>29</sup>Congress Urged to "Close Loopholes" Adopt Uniform Standards Legislation. *Daily Report for Executives*, July 25, 1997. p. 1.

<sup>30</sup>These included the willingness for institutional investors to take the roles of lead plaintiffs in securities class actions and the extent to which companies were willing to provide forward-looking disclosures.

<sup>31</sup>Beckett, Paul. Levitt Urges Caution as Senate Group Mulls Securities Reform. *Wall Street Journal Interactive*, July 24, 1997. p. 1.

of the Reform Act would probably emerge.<sup>32</sup> He commented that he was willing to work with both the House Commerce and the Senate Banking committees “to try to respond to some of the problems that we see with the present [securities litigation statutory] formulation.”<sup>33</sup>

On October 21, before the House Commerce Subcommittee on Securities and Hazardous Materials, Chairman Levitt reiterated his earlier view that there still was not sufficient evidence on the Reform Act’s full impact to allow for a reasonable determination that legislation to preempt the state laws or that would provide for “uniform standards” is currently required.<sup>34</sup> During the hearing, Mr. Levitt also let it be known that he was willing to work with both the House Commerce and the Senate Banking committees “to try to respond to some of the problems that we see with the present [securities litigation statutory] formulation.”<sup>35</sup>

Of particular concern to the SEC Chairman has been the manner in which the courts have and would be interpreting the Reform Act’s pleading standard (the level of fraudulent misconduct that must be alleged in order that a suit be found acceptable by the presiding judge). The Reform Act stated that investors must allege that a complaint “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”

This language has resulted in varying interpretations by different federal courts. The essential interpretive differences have been over whether plaintiffs can simply demonstrate that corporate defendants were reckless per se (for example in misrepresenting information or not disclosing information to investors in a timely fashion) or that a demonstration of mere recklessness is not sufficient; certain courts have demanded that the plaintiff also demonstrate that the omission or misconduct was done consciously or deliberately. Other courts have also examined the

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<sup>32</sup> Witmer, Rachel. Levitt Eschews “Broad-Based Preemption” of Private Securities Actions Under State Law. *Securities Regulation & Law*, October 24, 1997. p. 1-2. By that time, the 105<sup>th</sup> Congress should have effectively finished its legislative agenda.

<sup>33</sup> *Ibid.*

<sup>34</sup> Chairman Levitt also stated that the proposed legislation to preempt state laws in the area of securities actions could have “unintended consequences” by undermining critical state-based corporate governance provisions. Specifically, Mr. Levitt observed that the legislation could produce the harmful impact of preempting the filing of cases involving disputes having to do with corporate governance in state courts such as Delaware that “have developed expertise and a coherent body of case law, which provides guidance to companies and lends predictability to corporate transactions ... [thus] diminish[ing] the value of this body of precedent as a tool for structuring corporate transactions and resolving corporate disputes.” (Litigation-Reform Measures Could Backfire, Levitt Says. *Wall Street Journal Interactive*, October 21, 1997. p. 1.) However, on March 24<sup>th</sup> the SEC Chairman agreed to lend the agency’s support to S. 1260 after (among other things) the bill’s sponsors agreed to amend the bill at markup so that state corporate governance claims will not be preempted from state courts. The version of S. 1260 that was marked up by the Senate Banking Committee on April 29, 1998, included such a provision.

<sup>35</sup> Levitt Eschews Broad-Based Preemption of Private Securities Actions Under State Laws. *Securities Regulation & Law Report*, October 24, 1997. p. 1..

defendant's motives and opportunity as salient issues in their determination of whether allegations of recklessness should be dismissed.<sup>36</sup>

In the past, Chairman Levitt has often spoken of the agency's concern that, as in some of the aforementioned court interpretations, any interpretations of the Reform Act's pleading standards that go beyond asking that a plaintiff merely plead that the defendants recklessly defrauded him or her, may run the risk of not providing investors with sufficient protection from securities fraud.<sup>37</sup> In conjunction with a securities case that is being appealed, the SEC recently filed an amicus brief in which it protested a California district court's departure from the recklessness standard in the initial ruling in the case.<sup>38</sup>

During a March 24 renomination hearing for his SEC chairmanship before the Senate Banking Committee, Chairman Levitt (in what some observers described as a surprising "turnaround") announced that the SEC's would support S. 1260. It was support that appeared to be highly contingent on an agreement between the SEC and Senators D'Amato (the Chairman of the Banking Committee), Gramm, and Dodd (the bill's co-sponsors) that during the bill's markup they would insert language into S.1260's legislative history, making it clear that it was their intent in enacting the Reform Act in the 104<sup>th</sup> Congress that the Act should adopt the *recklessness pleading standard* that was applied some years earlier in the Second Circuit.<sup>39</sup>

In the wake of the new developments, Chairman Levitt said that S. 1260 was not "perfect," but that it offered investors "basic protections." Some reports have indicated that Chairman Levitt would have preferred to have altered the relevant statutory language to expressly communicate the primacy of the recklessness standard

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<sup>36</sup> *Testimony of Arthur Levitt Before the House Commerce Subcommittee on Finance and Hazardous Materials*, October 21, 1997. p. 16. The critical role that the pleading standards may play in vetting class action cases has also been noted by well known plaintiffs' attorney, William Lerach. Mr. Lerach thinks that the pleading standards are the most significant part of the Reform Act. And he characterizes them as "a gate that allows hostile judges assisted by clever lawyers with a weapon to block any case, however meritorious." (Panelists Dispute Reform Laws Impact on Private Class Securities Fraud Litigation, August 15, 1997. *Securities Regulation & Law Report*. p. 1)

<sup>37</sup>Testimony of Arthur Levitt, October 21, 1997. p. 16.

<sup>38</sup>Silicon Graphics, Inc. Sec. Lit., 1996 U.S. Dist. LEXIS 16989, 1996 WL 664639 (N.D. Cal. 1996) (reaffirmed on motion to reconsider at 1997 WL 285057). (See: *Testimony of Professor Richard Painter, Cornell Law School Before the Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Securities on February 23, 1998*. p. 7)

<sup>39</sup>See: the March 24, 1998 letter from Senators D'Amato, Gramm and Dodd to Chairman Levitt and the March 24, 1998 letter from Chairman Levitt and Commissioners Hunt and Unger to Senators D'Amato, Gramm and Dodd. Three of the five SEC commissioners voted to support the bill. One commissioner did not vote, and one commissioner, Norman Johnson, placed a dissenting vote. In doing so, Commissioner Johnson claimed that "the proponents of further litigation reform have not demonstrated the need for preemption of state remedies or causes of action at this time...[and] much more conclusive evidence than currently exists should be required before state courthouse doors are closed to small investors through the preclusion of state class actions for securities fraud." (March 24, 1998 letter from Commissioner Norman Johnson to Senators D'Amato, Gramm and Dodd.)



for class action securities suits.<sup>40</sup> But as it currently stands, the “agreement” between the SEC and the 3 aforementioned members of the Senate Banking Committee would use the legislative history of S.1260 to express the fact that Congress did not intend to “alter the recklessness standard when it enacted the Reform Act.”<sup>41</sup>

A number of observers, however, are concerned that there be some significant differences in the public policy outcomes that would derive from the “legislative history language” approach agreed to between the SEC and the aforementioned members of the Senate Banking Committee and an approach based on changing the relevant language in federal securities law to explicitly say that it is acceptable for plaintiffs to bring suits alleging that defendants simply acted recklessly. For example, during the March 24 renomination hearing for Chairman Levitt, Senators Bryan and Reed indicated that they were both skeptical about the efficacy of placing language in legislative history as a tool for directing the courts to comply with certain standards: Senator Reed observed that 11 of 27 federal district courts have failed to accept the authority of language on “the recklessness standard” in the legislative history of other laws. And, Senator Bryan asked Chairman Levitt whether simply changing the relevant statutory language would be a far better approach to making sure that the courts complied with the “recklessness standard.”<sup>42</sup>

In the aftermath of the SEC’s support for S. 1260, Richard Painter, a visiting professor of securities law at Cornell University, observed that if Congress is truly serious about preserving the recklessness standard, it could do either of 2 things: 1) Amend Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) by expressly inserting the recklessness standard as the standard of culpability or; at the very minimum 2) enact statutory language that says that the Reform Act does not change the aspects of the Section 10(b) of the Exchange Act that relate to plaintiffs’ pleading standards. Professor Painter cites a number of cases that have been before the Supreme Court which he says indicates the court’s general historical indifference to non-statutory attempts by subsequent congresses to redefine laws passed by earlier congresses.<sup>43</sup>

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<sup>40</sup>For example, see: Eaton, Leslie. Bill Further Limits Class-Action Lawsuits. *New York Times*, March 26, 1998. p. D-7.

<sup>41</sup> See: the March 24, 1998 letter from Chairman Levitt and Commissioners Hunt and Unger to Senators D’Amato, Gramm and Dodd.

<sup>42</sup>SEC Throws Weight Behind Reform Bill, *Daily Report for Executives*. p. A-26.

<sup>43</sup>Phone conversations between CRS and Professor Painter. For example, he cites *Central Banks of Denver, N.A. v. Interstate Bank of Denver, N.A.* (511 U.S. at 164) as a fairly recent illustration of the Supreme Court’s unwillingness to look at the intent of a subsequent Congress in its interpretation of the acts of a previous Congress in a securities fraud case. He also cites the Supreme Court’s handling of a 1997 insider trading securities case, the *United States v. O’Hagan*, to also show how the court ignored Congressional attempts in 1984 and 1988 to define insider trading under Section 10(b) of the Securities Exchange Act of 1934 through the mechanism of committee prints. (Painter, Richard, Kimberly Krawiec, and Cynthia Williams. Don’t Ask, Just Tell: Insider Trading After *United States v. O’Hagan*. *Virginia Law Review*, (continued...))

As indicated earlier in the report, on April 29, 1998, the Senate Banking Committee marked up a substitute amendment in lieu of the original version of S. 1260. The new version of S. 1260 contained the agreed-upon language (per discussions between the committee and the SEC) that the intent of Congress in passing the Reform Act was not that of changing the previously existing pleading standards for securities cases before the federal courts.

There is additional skepticism over the efficacy of the SEC-supported “legislative history” approach to communicating to the courts the proper approach to dealing with the issue of pleading standards. For example, after the SEC gave its support to S. 1260, Barbara Roper, director of Investor Protection for the Consumer Federation of America (a national consumer advocacy group), criticized the SEC’s chairman for abandoning his “courageous” position on the uniform standards legislation, saying that the agency had reversed its previous position in exchange for “cosmetic changes.”<sup>44</sup>

Additional arguments that have also been marshaled in support of a general “wait and see” approach on the impact of the Reform Act, have included observations that: 1) a handful of states (Arizona, Montana, and Ohio) have already passed legislation akin to the Reform Act, and the possibility exists that others may as well; and 2) the California Supreme Court has a case pending before it, *Pass vs. Diamond Multimedia*, in which the court will have to decide whether California’s securities laws have applicability to securities transactions occurring outside of the state. Chairman Levitt of the SEC previously argued (before lending the agency’s support to S. 1260) that if the California Supreme Court eventually rules in favor of the corporate issuer/defendant in the case, nationwide class action suits would be unavailable in California. As a consequence, Chairman Levitt argued that plaintiff lawyers would generally be uninterested in pursuing the state court option since the nationwide class action was unavailable.<sup>45</sup>

Some of the criticism of the “wait and see” approach has resembled the arguments employed (and discussed in the previous section, **The Need for Federal and State Uniformity**) to support the notion that an unfragmented, uniform state and federal judicial apparatus for securities class actions is socially optimal, notwithstanding the Reform Act’s ultimate impact. There has also been criticism that the “wait and see” approach is essentially a strategic tack to delay the enactment of uniform standards legislation by those who are concerned that the courts will continue to interpret various parts of the Reform Act in increasingly restrictive and undesirable ways (from the plaintiff’s perspective).

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<sup>43</sup>(...continued)  
March 1998. p. 200-204.)

<sup>44</sup>*Statement of Barbara Roper Director of Investor Protection for the Consumer Federation of America (March 1998).*

<sup>45</sup>*Testimony of Arthur Levitt before the Commerce Committee’s Subcommittee on Finance and Hazardous Materials, October 21, 1997. p. 23.*

Although the SEC's decision to support S. 1260 appears to signal this very important player's abandonment of its "wait and see" position on uniform standards legislation, we have noted that some observers express significant doubts about the extent to which the courts will comply with the type of plaintiff's pleading standard that the agency has maintained is critical for helping to ensure that investors are properly protected from fraud.

## **Framing the Issues**

At least one observer has commented that, to a large extent, the combatants on the two sides of the debate over uniform standards legislation are mirroring the roles that they played during the earlier debate surrounding the legislation that would become the Reform Act. And, with some exceptions,<sup>46</sup> the observation appears to be a fairly legitimate one. High-tech companies, venture capital firms, manufacturing firms, and accounting firms were a significant part of the support for legislation that became the Reform Act. Now, they are a major part of the constituency for the uniform standards bills. Interest groups significantly composed of non-corporate lawyers,<sup>47</sup> state officials, and consumer advocacy groups tended toward opposition to the Reform Act and its precursors. They also have tended toward opposition to the uniform standards legislation.

These fairly consistent patterns of support and opposition are not surprising. The members of these two different groups tend to attach different weights to different aspects of the securities litigation reform debate. (Or as an economist would say, they have different utility functions in terms of the securities litigation reform outcomes that would most satisfy them.) Many of the supporters of the legislation that became the Reform Act legislation tended to regard any new federal class action shareholder suit as having a high likelihood that it was frivolous, and essentially mercenary, and which was probably being spearheaded by a plaintiff's attorney in pursuit of the windfall from a negotiated settlement. In addition, many of the proponents of securities litigation reform have also expressed some concerns over the tendency for plaintiffs' attorneys to extract what many perceive to be excessively high percentages of plaintiffs' recoveries.<sup>48</sup> (This is a concern that the Reform Act has attempted to at least partially address.)

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<sup>46</sup>For example, the North American Securities Administrators Association (an organization of state and provincial securities regulators) is taking a neutral stance on uniform standards legislation as states' securities regulators in various states appear to be divided in their opposition and support of the legislation.

<sup>47</sup>In the case of the American Bar Association, the litigation section basically opposed the Reform Act while the business section was essentially supportive of it.

<sup>48</sup>For example, see: Macey, Johnathan and Geoffrey Miller. *The Plaintiffs' Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform.* *University of Chicago Law Review*, vol. 58, 1991. p. 8 and Coffee, John. *Understanding Plaintiffs Attorney: The Implications of Economic Theory for the Enforcement of Class and Derivative Actions.* *Columbia Law Review*, vol. 86, 1986. p. 714-720. Some research indicates that class action attorney's fees normally range between 30% and 50% of the total settlement amount.

Often underpinning this perception appeared to be a general preoccupation with the potential corporate costs that can be associated with meritless suits. These are costs that could include: litigation-related dollar costs to the company; lower returns for shareholders as settlement cost eat into profits, and corporate opportunity costs from corporate officials who are diverted from normal duties.<sup>49</sup> Many of the firms are high-tech firms whose survival is dependent on their ability to continue fruitful research and development operations. Litigation-related costs may have a potentially deleterious impact on the capital that is available for such research and development.

Many of the interests currently backing the uniform standards bill tend to believe that there is a *strong likelihood* that any given state-based shareholder suit will be similarly frivolous and mercenary. As a consequence, many companies publicly support uniform standards legislation because it promises to reduce the role that states courts play as perceived conduits for shareholder suits seen to have a high likelihood of being frivolous. Also, from a cost minimization perspective, companies should also be as concerned about meritorious<sup>50</sup> suits as they are concerned about the frivolous ones. Thus, firms may actually have the incentives to support policies such as those contained in the uniform standards bills — policies that carry the promise of curtailing the flow of class action securities suits of all types.

Many of the detractors of both the Reform Act and its legislative precursors tend to see any new shareholder class-action lawsuits in the context of its *potential* to be a fully warranted legal pursuit on the part of a investor/plaintiff who feels that he or she had been has been genuinely deceived and financially harmed by a corporate misrepresentation or omission. It is a perspective that is frequently underpinned by a central focus on the primacy of the individual's right to redress legitimate wrongs, specifically corporate-inflicted damage to shareholders.

In this context, opposition to the Reform Act, and current opposition to uniform standard's legislation can be seen to come largely from concerns that additional restrictions (imposed on the federal courts in the case of the Reform Act and imposed on state courts in the case of uniform standards' bills) on plaintiff access to the courts would and will abridge the opportunities that *potentially* aggrieved shareholders have to pursue economic redress.<sup>51</sup>

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<sup>49</sup>For example, does the price of the products that are offered to consumers incorporate an expected corporate cost for coping with legislation without merit?

<sup>50</sup>This of course assumes that companies acknowledge that certain suits have merit. In addition, to the extent that (all things being equal) cases with real merit should on average have a marginally better chance of garnering bigger recoveries than frivolous ones, companies may have heightened "bottom line-based" concerns over them. Sometimes, this may manifest itself in a company paying particular attention to the need to "self police" itself against fraud to minimize the number of defrauded investors.

<sup>51</sup>Some observers have also argued that, when cases with merit do succeed (whether this is defined as a certain amount of out of court or trial-based recovery), the society as a whole may receive additional benefits via the deterrent effect that the case's success may have on future corporate wrongdoing. This is a difficult proposition to either prove or disprove.

Part of the catalyst for the introduction of the uniform standards bills is the widely held perception that after the passage of the Reform Act's enactment, the number of shareholder suits in state courts began to mushroom, a behavior perceived to be tied to class action securities filings that bypassed the plaintiff impediments that the Act imposed on federal courts through the use of state filings. However, as 1997 progressed, newer information indicated that state filings were not continuing to grow at a significant pace. There were, however, indications that the number of state-based suits filed parallel to similar federal filings had grown to levels that were much higher than before the Reform Act. The difference between these two types of filings is discussed below.

But, the real insight here is that there is actually no insight. Even under the best of conditions,<sup>52</sup> there are simply not enough years of annual post-Reform Act state filing data to allow for the construction of a credible, predictive trend line at this point time.

More importantly, one should be aware of the fact that increases in the number of state filings or the percentage of state filings filed parallel to federal filings need not necessarily translate into increases in the absolute number or the percentage of frivolous class actions filed in the state courts. They may possibly translate into increases in the number or percentage of baseless lawsuits, but we do not really know for sure. As we alluded to earlier, there are some good, strategically optimal reasons why plaintiffs with credible cases might choose a state venue over or in addition (in the case of parallel filings) to a federal venue in the post-Reform Act era. Moreover, it must be remembered that the Reform Act's essential goal was that of curtailing the flow of frivolous law suits, not the outright curtailment of legitimate class-action suits.<sup>53</sup>

Much of the concern on the part of advocates of uniform standards legislation over the migration of cases from the federal courts to the state courts, is over the parallel filings in state courts that do not have stay of discovery provisions like the one that the Reform Act imposed on the federal courts.<sup>54</sup> Parallel state filings can enable plaintiffs to circumvent the federal stay of discovery rules that allows courts to freeze pre-trial discovery until a judge can rule on the defendant's motion to dismiss the case.

There certainly have been and there probably will continue to be a number of baseless and opportunistic shareholder "strike suits" that use pre-trial discovery (sometimes the costliest part of the litigation process) to make burdensome demands of time and resources on corporate defendants to ultimately force them into a negotiated settlement (which the firm may perceive to be a less costly alternative to

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<sup>52</sup>If the post-Reform Act state filing data begins to resemble the seemingly scattershot annual state filing data in the years leading up to the Reform Act, trend lines may still have little real predictive value.

<sup>53</sup>For example, see: U.S. Library of Congress. *Uniform Standards in Private Litigation: Limitations on Shareholder Lawsuits*. CRS Report 98-164 A, by Michael Seitzinger. p. 2.

<sup>54</sup>In its study, the SEC found that parallel state filings constituted a significant number of the state shareholder filings that it sampled.

going to trial.)<sup>55</sup> And, to the extent that these kinds of “bad” cases use parallel state filings to avoid the stay of discovery in federal courts, there should be no net social benefits, but we would expect some net social costs.

But, contrary to what some of the proponents of uniform standards legislation suggest, it is quite easy to conceive of situations in which the “migration” of certain securities cases to state courts via parallel filings is essentially a recovery optimizing strategy for plaintiffs who believe that they have legitimate claims.<sup>56</sup>

For example, the federal court’s stay of discovery may result in plaintiffs who believe that they have been defrauded being unable to pursue potentially critical and revealing search of the defendant’s documents if the defendant’s motion to dismiss the case is pending. But, filing a similar case in a state court could allow the plaintiff to circumvent the federal stay of discovery, enabling him or her to pursue the potentially pivotal search for evidence.

Also, the stay of discovery can impede the legal progress of plaintiffs who are trying to address legitimate claims, but who have had their suits dismissed because of the heightened pleading standards that were imposed by the Reform Act. In the event of such a dismissal, plaintiffs can try to amend their complaints before the court. But, this amendment process might require some evidence that is itself foreclosed by the existence of a stay of discovery.<sup>57</sup>

Chairman Levitt has indicated that to the extent that parallel state filings are done to circumvent the Reform Act’s stay of discovery, the intentions behind the Act are undermined. And, this is probably correct. But, some observers claim that the essential goal of the Act’s stay of discovery was to make it harder for the wielders of strike suits to use the leverage of the potentially costly discovery phase to force defendants into a negotiated pre-trial settlement. In this context, one could argue that both the wielders of legitimate and the wielders of bogus securities class-action claims may have strong incentives to make parallel filings in state courts in order to try to better accomplish their ends. But, what is not known is the extent to which these kinds of filings are frivolous or credible.<sup>58</sup>

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<sup>55</sup>Some meritorious cases are also settled out of court.

<sup>56</sup>However, the SEC also has observed that the stay of discovery “imposed by the Act during the pendency of a motion to dismiss, coupled with the heightened pleading standards that the Act imposes has made it more difficult for plaintiffs [presumably those with baseless as well as those with legitimate claims] to bring and prosecute securities class action lawsuits. . .” (Report to the President and the Congress on the First Year of Practice under the Private Securities Litigation Reform Act of 1995. *SEC Office of the General Counsel*, April 1997. p. 2.

<sup>57</sup>For example, see: the SEC staff commentary in: Report to the President and the Congress on the First Year of Practice under the Private Securities Litigation Reform Act of 1995. *SEC Office of the General Counsel*, April 1997. p. 2.

<sup>58</sup>In addition, the various partisans in the securities litigation reform debate would no doubt attach different weights to their importance.

Some supporters of uniform standards legislation speak of the legislation's importance in enhancing the global competitiveness of the U.S. capital markets by providing a relatively more transparent, seamless, and unfragmented, unified court system. But, a perusal of the financial press and academic studies on the pivotal impediments facing foreign issuers interested in tapping into the U.S. financial markets, provides little evidence that this country's bifurcated state and federal court structure is regarded as a significant barrier<sup>59</sup>. It is certainly possible that the relative uncertainties inherent in a federal/state court system may pose some problems for some prospective foreign issuers. But, given the widely acknowledged allure of the U.S. capital markets, these concerns would currently appear to, at best, have marginal importance.

Some of the proponents of the uniform standards legislation also describe the legislation as an antidote to the plausible threat in which firms may simultaneously confront similar securities suits from as many as 50 states. They also argue that this kind of situation would generate substantial corporate costs and would significantly complicate the already formidable process of corporate-decision making, while producing no visible societal benefits.

Although undeniably possible, the notion that domestic companies can realistically expect to simultaneously contend with dozens of similar state-based securities class actions is probably weakened by the reality that the vast majority of securities class actions at both the state and the federal level are based in a single state, California.<sup>60</sup> Being simultaneously besieged by a constellation of similar suits from dozens of state courts is certainly possible. But, it would appear to be far removed from the norm. The alarming description basically appears to depict a kind of "worst case" low-probability scenario that might occur over time, but most likely in isolated situations.

The California basis of the majority of securities suits has caused other concerns to be raised about the necessity of uniform standards legislation. For example, Representative Edward Markey, has asked whether the broad-based bills make fundamental sense given the strong California basis of much of the nation's securities litigation.<sup>61</sup>

As mentioned earlier in this report, a number of the supporters of uniform standards legislation agree with the view that it is too early in its judicially interpreted life to attempt any meaningful analysis of the Reform Act's probable impact. But, they also say that this fact is of very little consequence because the creation of a single securities class-action judicial venue *per se* is clearly socially optimal. But, this view may have a number of weaknesses. A central problem is that the arguments that have been employed to demonstrate that uniform standards would

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<sup>59</sup>A central concern is that foreign companies must go from native accounting standards that tend to yield corporate disclosures that are comparatively less forthcoming and more opaque than those that are provided by U.S.

<sup>60</sup>The state is the major location for the nation's high-tech companies whose characteristically volatile stock makes them attractive targets of shareholder suits.

<sup>61</sup>See: Securities Regulation & Law Report, *Congress Urged to "Close Loopholes."* p. 1.

be socially optimal, tend to be fashioned exclusively from the perspective of corporate issuers.

A theoretically sound argument can also be made that the presence of an unfragmented judicial system could reduce some of the uncertainties of corporate decision-making, lowering overhead (by reducing some of the costs associated with decision-making) possibly increasing profits which could redound to corporate investors as increased stock returns. But, it is conceivable that some of the investors who are the real victims of corporate fraud (as well as investors who falsely allege fraud) could be economically disadvantaged from the loss of (federal/state) choice to pursue the optimal strategy of legal redress.

The nature of the potential economic benefits of providing (where statutorily permissible) defrauded investors with a choice between or (as in the case of parallel filings) among state and federal venues in securities class-action filings appear to be strongly connected to the extent to which the courts interpret key provisions in the Reform Act more restrictively (for plaintiffs) in the months to come.

Some of the proponents of the “wait and see” approach will probably have less interest in supporting legislation for uniform standards if court interpretations “down the road” produce a Reform Act that they perceive to further limit plaintiffs’ opportunity for redress. Indeed, there are some indications that at least some of the adherents of this “wait and see” approach are already basically opposed to the uniform standards bills.

From the cost/benefit perspective of legitimately aggrieved investors, the effects of the Reform Act are not known until more court interpretation is forthcoming. (And, to the extent that there are credible doubts over the ability of the aforementioned SEC-supported “S. 1260 legislative history” approach to direct the courts to comply with pleading standards that are more investor protection oriented, a reasonable case can be made that the Reform Act’s final import may also not be known in this key area.) For these individuals, the economic consequences of the Reform Act, therefore, are not yet known. It then follows that an application of the Reform Act to state securities litigation — before these interpretations are forthcoming — has the effect of magnifying this uncertainty, becoming an additional and potentially credible argument for the wait-and-see approach.

However, the costs and benefits of some features of the Reform Act are less ambiguous than others. Section 102, the safe harbor for forward-looking statements, appears to have significant potential for providing benefits to issuers and their shareholders without significantly reducing defrauded investors’ opportunities for legal redress.

Section 102 in the Reform Act applies to the Securities Act of 1933 and the Securities Exchange Act of 1934 and provides that liability will not be imposed upon a person concerning any-forward-looking statement if either of the following certain conditions are met: 1) the forward-looking statement identifies important factors that could cause actual results to differ materially from those in the forward-looking statement or 2) the plaintiff fails to prove that the forward-looking statement, if made by a natural person, was made with actual knowledge by that person that the



statement was a false or misleading or, if made by a business, was approved by the officer with actual knowledge that the statement was false or misleading.<sup>62</sup>

The courts are still working out the specific meaning of “meaningful cautionary statements” in the safe harbor provision and the SEC staff has been divided over the preferred interpretation of that language. Still, compared to other key provisions in the Reform Act, the safe harbor section appears to have the greatest potential for providing significant benefits to issuers and their shareholders that are not substantially gained at the expense of defrauded investors’ opportunities for economic redress.

The idea of a safe harbor for forward-looking corporate statements has received support from an unusually disparate array of entities and interest groups. This would include groups or entities generally aligned with corporate issuers such as the American Electronics Association (composed of electronic, software, and information technology companies) as well as investor-oriented entities like the National Association of Investors Corporations, (a coalition of more than 700,00 individual investors and 33,000 investment clubs)<sup>63</sup> and the SEC.<sup>64</sup>

Nonetheless, some observers believe that the provision of legal safe harbors for forward-looking statements is of little consequence because the predictive financial data that is being (and presumably would be) issued is “low-quality or dubious, at best”<sup>65</sup>. Others claim that safe harbors may have only a tenuous effect on the willingness of some firms to provide forward-looking data: firms are seen occupying a continuum between those who willingly disclose and thus may experience higher (short-term) stock prices and those who are less willing to disclose due to concerns over the competitive implications of this kind of information sharing.<sup>66</sup> Others are concerned that the safe harbor “allows individuals to disseminate information they know to be false by surrounding such information with cautionary language....”<sup>67</sup>

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<sup>62</sup>See: CRS Report, *Private Securities Litigation Reform*: P.L. 104-67. p . 6-7.

<sup>63</sup>For example, see: *The testimony of Thomas O’Hara founder of the National Association of Investors’ Corporations before the Senate Securities Subcommittee of the Committee on Banking, Housing, and Urban Affairs on October 29, 1997.* p. 1.

<sup>64</sup>For many years prior to the enactment of the Reform Act, the agency pursued the idea of broadening the exemption from liability for certain forward-looking statements.

<sup>65</sup>For example, see the summarization of the statement by Michael Dye, project manager for the National Association of Securities and Commercial Attorneys (NASCLA) in: Hersch, Warren. *Investors, Tech Companies Back Bill; Attorneys, Consumer Advocates Opposed — Congress to Weigh Limit on Securities Suits.* *Computer Reseller News*, August 18, 1997. p. 37.

<sup>66</sup>For example, see: Seligman, Joel. *The SEC’s Soft Information Revolution.* *Fordham Law Review*, May 1995. p. 1975.

<sup>67</sup>Spencer, Steven. *How Congress Learned Its Lesson: A Plain Meaning Analysis of the Private Securities Litigation Reform Act of 1995.* *St. John’s Law Review*, Winter 1997.p. 99.

Concerning the idea that some companies may simply not have the proper incentives use the safe harbors, it is important to remember that the federal safe harbors are voluntary and to the extent that companies do not use them, attendant concerns about their potential social costs (in the form of badly misled or defrauded investors) simply become moot.

On the view that predictive disclosures tend to be of generally dubious value, there is empirical evidence which appears to suggest otherwise: among other things, there is evidence that earnings-related projection disclosures tend to affect stock prices, suggesting that such managerial disclosures provide investors with credible, and value-relevant information.<sup>68</sup> The evidence also suggests that increased voluntary predictive disclosures appears to help lower a firm's capital costs.<sup>69</sup>

The argument against safe harbor for forward-looking disclosures that carries the most weight is that they tend to encourage companies to deliberately lie about their financial prospects. How strong this incentive would be is unknown. The incentive to misrepresent would be weakened by market mechanisms (in addition to the threat of litigation) that discipline (and thus deter) firms inclined to knowingly make overblown projections. Generally, publicly owned companies who return to the marketplace for capital can ill afford to squander their credibility in the eyes of creditors, financial peers, and security analysts. In effect, the market is seen rewarding firms that meet their projections and punishing firms that do not,<sup>70</sup> although, clearly, this incentive does not eliminate the potential for fraudulent statements.

There is widespread disappointment over the limited use of safe harbor disclosures in the Reform Act. The continued acceptance of forward-looking shareholder suits in many state courts may be one of a number of reasons why companies have been loath to take advantage of the safe harbor provision in the Reform Act. Again, some empirical evidence exists which indicates that in the pre-Reform Act era, companies who regularly made forward-looking disclosures tended *not to make them* in periods before they made public stock offerings (when the threat of disclosure-related shareholder litigation is highest).<sup>71</sup> This strongly suggests that the threat of litigation — any litigation — may have a chilling effect on the willingness to make forward-looking disclosures.

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<sup>68</sup>See: Skinner, Douglas. Does the SEC's Safe Harbor Provision Encourage Forward-Looking Disclosures? *Financial Analysts Journal*, July/August 1995. p. 23.

<sup>69</sup>Ibid.

<sup>70</sup>See: Phelps, Richard and Gilbert Miller. Private Securities Litigation Reform Act of 1995. *Business Lawyer*, August 1995. p 1020. The reader may want to look at the *Fortune* cover story for October 27, 1997, which chronicles the growing power over the short-term stock price behavior of their designated companies that is appears to be held by a number of brokerage firm securities' analysts. (Nocera, Joseph. The Analysts: Who Really Moves the Market? Securities Analysts: Securities Analysts are Wall Street's New Stars: They Bring in Banking Deals, Make the Calls that Move Billions in and out of Stocks. *Fortune*, October 27, 1997. p. 90.)

<sup>71</sup>Skinner, *Does the SEC's Safe Harbor Provision Encourage Forward-Looking Disclosures?* p. 23

Consequently, an additional legislative option presents itself. In addition to the choice of extending or refusing to extend the Reform Act to the states, or of waiting-to-see before making a choice or extension, it is also possible to extend only part of the Reform Act, such as the forward-looking statement safe harbor.