Private Securities Litigation Reform Act: A Post-Enron Analysis

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The Federalist Society for Law and Public Policy Studies

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Private Securities Litigation Reform Act: A Post-Enron Analysis

By Professor Richard Painter*, Ms. Megan Farrell**, and Mr. Scott L. Adkins***

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BACKGROUND

In the aftermath of the collapse of Enron, Congress is considering various proposals that purportedly would protect investors against securities fraud. Some seek to enhance the power of the Securities and Exchange Commission (SEC) to enforce the securities laws, a workable step if accompanied by a corresponding increase in the SEC's budget.[1] Other proposals, however, would empower the plaintiffs' bar to file more lawsuits against issuers, directors and officers, underwriters, and auditors in a wider range of circumstances.

Part A of this report examines statistical data on private securities litigation in the years since Congress enacted the 1995 Private Securities Litigation Reform Act (PSLRA) to curb abusive practices in securities class actions. Part A discusses statistics such as the number of securities class actions filed in federal court, the number of suits dismissed on the pleadings prior to discovery, the amounts that suits typically settle for, the allegations contained in suits and which lawyers most often represent the plaintiff class. This data should give the reader some idea as to whether private securities litigation has been stifled by the PSLRA, and whether collateral parties such as auditors are being made to pay when found to have participated in securities fraud. This data should also shed light on the amount of money involved in private securities litigation and which plaintiffs' lawyers are most likely to get a share of it.

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[1] To the extent more vigorous criminal prosecution of securities fraud is called for, funding should also be provided for U.S. Attorneys' offices to hire lawyers with expertise in securities law.

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Part B of this report then examines various proposals under consideration in Congress. The objective is to discern how these proposals might affect current federal securities doctrine and litigation trends.

PART A: STATISTACAL ANALYSIS OF SECURITIES AFTER THE PRIVATE SECURITIES LITIGATION REFORM ACT

In preparing this report, we examined securities class action filing data from four sources: Stanford Law School Securities Class Action Clearinghouse (in cooperation with Cornerstone Research) (Stanford/Cornerstone), Woodruff-Sawyer & Co., National Economic Research Associates (NERA) and PricewaterhouseCoopers. While the numbers differ from one provider to another based on different statistical techniques used by each, the trends we observe are remarkably consistent. Highlights from this data are discussed in more detail below.

I. Number of Federal Filings

Available data on the number of securities class actions filed in federal court show that the PSLRA has had little lasting impact on the frequency of class action litigation. The number of suits filed indicates that the courthouse door has remained wide open for plaintiffs after the PSLRA.

A. Stanford/Cornerstone

1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
164	202	163	231	188	111	175	233	205	213	478

See Securities Class Action Clearinghouse, at http://securities.stanford.edu (Apr. 23, 2002) As of April 23, 2002, the total number of federal filings for 2002 was equal to 69, indicating a probable decline from 2001 levels back to 1998-2000 levels. See id.

IPOs accounted for a very large percentage of the suits filed in 2001. Of the 478 suits filed in 2001, 139 contained IPO allocation allegations only, 167 contained IPO allocation and other allegations, and only 172 contained no IPO allegations. See id.

B. Woodruff-Sawyer

According to Woodruff-Sawyer, the number of federal filings since 1993 has been as follows:

1993	1994	1995	1996	1997	1998	1999	2000	2001
148	211	177	98	169	233	204	207	471

Woodruff-Sawyer's numbers are slightly lower than the Stanford/Cornerstone numbers because Woodruff-Sawyer is very conservative about counting suits, for example only counting suits involving directors and officers of an issuer. The number of filings is counted by issuer (two filings against the same issuer at about the same time are counted only once)).

A Woodruff-Sawyer report dated January 7, 2002 summarizes: "The number of federal cases filed peaked in 1994 at 211, dropped to 98 in 1996, and increased in 1998 to 233 cases. . . . These data would suggest that there was a rush to the court house just prior to the effective date of the Reform Act. With the upswing in federal case filings after 1996, these data also suggest that the Reform Act has not deterred plaintiffs attorneys from filing cases."

Of the 471 suits in 2001, 164 did not involve allegations over alleged fraudulent conduct in IPOs. The rest did. As of March 2002, the total number of federal filings according to Woodruff-Sawyer was 57, once again suggesting a drop off from 2001 (probably because there have been relatively few IPOs in the past year).

Woodruff-Sawyer also interpreted the impact of the Ninth Circuit's Silicon Graphics decision (issued on July 2, 1999 and departing from some other circuits in holding that pleading deliberate recklessness is required to meet PSLRA pleading standards). The following chart compares the average number of cases filed monthly for the 18-month period preceding and the full period following the publication of Silicon Graphics (excluding IPO allocation suits).

	Preceding Decision	Following Decision	Change
Ninth Circuit	5.2	3.6	-30%
All Other Circuits	14.4	11.5	-20%

C. NERA

Avg. (1991-1995)	1996	1997	1998	1999	2000	2001
191	127	193	269	240	223	498

The NERA report, dated January 2002, states that "[w]hile federal filings of securities class actions fell in the months just after the passage of PSLRA, suggesting that the law may have been achieving one of its objectives, they more than recovered from this initial lull." Todd S. Foster, et al., National Economic Research Associates, Inc., "Recent Trends VII: PSLRA, Six Years Later" at 1 & Fig. 1A (Jan. 2002) ("NERA Report"). The study notes that the highest number of cases was filed in 1998, followed by a slight drop in 1999 and 2000, though filings remained in line with pre-PSLRA levels. These figures are consistent with those from the other data providers, except that the NERA figures show the number of 2000 filings as slightly lower than the 1999 filings, whereas the Woodruff-Sawyer and Stanford/Cornerstone figures show the 2000 filings to be slightly more than those in 1999.

One of the most interesting conclusions from the NERA study is that the large increase in filings in 2001 was attributable to claims that broker dealers engaged in "laddering" to increase artificially the aftermarket trading price of IPOs ("laddering" is the practice of bestowing generous allocations of shares sold in the IPO to buyers who commit to buy additional shares in the aftermarket at inflated prices). Most of these suits are filed in the Second Circuit, the broker-dealers involved being headquartered in New York. Thus, although the total number of filings rose dramatically in 2001, the number of filings in 2001 was 198 if "laddering" cases are excluded. See id. at 1.

The NERA report goes on to state that the Silicon Graphics decision (issued on July 2, 1999) is a reasonable explanation for the decline in non-laddering cases from 1998 to 2001. "In the first six months of 1999, 23 cases were filed per month (implying approximately 280 filings for the year); following the SGI decision, the monthly filing rate dropped by approximately 6 cases to 17 per month (bringing the actual filings to 240 for the year). Similarly, the number of ninth circuit filings declined in 1999 and again in 2000, resuming their pre-Silicon-Graphics level in 2001." Id. at 1-2 & Fig.1B.

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
2d Circuit	36	35	35	52	27	22	32	65	37	47	344*
9th Circuit	44	66	57	70	71	35	66	67	58	47	61

*2001 (excluding laddering claims) = 44

D. PriceWaterhouseCoopers

1996	1997	1998	1999	2000
122	169	247	207	201

See PricewaterhouseCoopers, "2000 Securities Litigation Study," at 1 available at http://www.10b5.com Again, the PricewaterhouseCoopers numbers differ slightly from the other data providers' numbers, but show the same general trend, i.e., the number of filings peaked in 1998 and has since declined slightly (except for IPO cases in 2001). (Note that additional data from Pricewaterhouse Coopers is not used, because it includes state as well as federal information).

E. General Observations

Several observations can be made from the data collected by all of these providers. First, the PSLRA had relatively little impact on the number of filings, although some suits that could have been filed in 1996 were filed in 1995 to avoid the Act. By 1998, the total number of filings was back to 1994 levels. Second, the Ninth Circuit's decision in Silicon Graphics interpreting the PSLRA pleading requirements appears to have had more impact than the PSLRA itself, at least in the Ninth Circuit. Third, as can be seen from the 2001 statistics, market fluctuations are a large variable determining the number of filings. Almost immediately after a sharp downturn in stock prices (e.g., the last quarter of 2000 and the first three quarters of 2001), the number of filings skyrocketed to a level more than double the number of filings when there was a robust stock market (e.g., 1999 and early 2000). The lag time between the market drop and surge in filings was only a few months. Finally, much of this new litigation alleged that broker-dealers artificially inflated the prices of IPOs through "laddering" and other fraudulent techniques.

Market conditions, more than legal environment or anything else, thus determine the amount of securities litigation in federal courts and the type of allegations made in plaintiffs' complaints. This could be because more fraud is exposed in market downturns (or because more fraud is committed in the immediately preceding bull markets). It could also, however, be that plaintiffs' lawyers know that in bear markets at least one element of their claim (damages) will be easier to prove and that courts are more likely to sympathize with investors.

II. Number of Federal Dismissals

Stanford/Cornerstone and Price Waterhouse do not keep track of dismissal rates in federal court, but Woodruff-Sawyer and NERA do. Their data is summarized below.

A. Woodruff-Sawyer

Woodruff-Sawyer has compiled data from 1993 to March 2002 showing the number of (1) settled cases (further broken down as cases settled before trial, cases tried and later settled, and cases dismissed and later settled); (2) tried cases (with judgments in favor of plaintiffs or defendants); and (3) dismissed cases (further broken down as cases dismissed before trial, and cases tried and later dismissed). Interestingly, as shown in the chart below, no case has been tried since the PSLRA went into effect; all have either been settled or dismissed.

Non-voluntary dismissals as a percentage of cases disposed were as follows:

1993	1994	1995	1996	1997	1998	1999	2000	2001
14.4%	12.2%	7.4%	18.2%	16.2%	23.8%	31.0%	45.5%	22.2%

The average rate of these dismissals for cases from 1993-1995 was 11.2%, whereas the average rate of these dismissals for cases from 1996-2001 was 25.1%, showing an increase in dismissal rates after the PSLRA (the most significant jump being from 1995 to 1996). Still, however, in all years but 2000, close to seventy percent of cases were not involuntarily dismissed.

The chart below again illustrates that "the trend following reform is toward more dismissals and fewer settlements." Woodruff-Sawyer opines that the reasons for this trend are that courts are better informed, and post-PSLRA pleading standards are more difficult for plaintiffs to meet.

Year	Settled	Tried	Dismissed	Withdrawn
1993	88.8%	1.4%	8.4%	1.4%
1994	88.3%	1.2%	8.8%	1.8%
1995	85.7%	1.1%	12.0%	1.1%
1996	81.6%	.7%	14.0%	3.7%
1997	85.5%	.7%	13.0%	.7%
1998	78.6%	.9%	16.1%	4.5%
1999	73.9%	0.0%	22.7%	3.4%
2000	75.5%	0.6%	23.3%	.6%
2001	73.6%	0.0%	24.3%	2.0%

The following chart compares the percentage of cases dismissed (relative to all disposed cases) for the 18-month period preceding the Silicon Graphics decision and the 30-month period following Silicon Graphics:

	Preceding Decision	Following Decision	Change
Ninth Circuit	10.7%	21.4%	+100%
All Other Circuits	17.9%	26.2%	+46%

B. NERA

Dismissals of Federal Securities Class Actions Have Increased Post-PSLRA:

Pre-PSLRA	12% Dismissals as a % of Dispositions
Post-PSLRA	24% Dismissals as a % of Dispositions

See NERA Report at Fig. 12. The NERA report finds a "marked increase in the percentage of cases dismissed. Excluding voluntary dismissals, dismissals as a percent of dispositions have approximately doubled with the PSLRA's heightened requirement to plead with particularity a likely contributing factor. Prior to the PSLRA, dismissals comprised 12% of dispositions; this rose to 24% in the post-PSLRA period. However, many of these recent dismissals allowed plaintiffs to replead, so the ultimate disposition of these cases is unknown. In the post-PSLRA era, cases as a percentage of filings, are also being dismissed at a higher rate." Id. at 3-4.

NERA also "analyzed the length of time cases took to reach settlement or disposition (including judgments, dismissals and voluntary dismissals). Of pre-Reform Act cases filed, about 59% were disposed of within three years of filing. Only 39% of post-Reform Act filings were disposed of within that length of time. We hypothesize that this trend is the result of the PSLRA provisions regarding the selection of lead plaintiff and the automatic stay of discovery while a motion to

dismiss is pending." Id. at 3. Thus, while the PSLRA leads to higher dismissal rates, disposition of case under the PSLRA apparently takes longer:

Cases Filed After Passage of the PSLRA are Taking Longer to Reach Disposition:

Percentage of Cases Disposed

	By 1st Year	By 2d Year	By 3d Year
Pre-PSLRA	13%	38%	59%
Post-PSLRA	8%	26%	39%

Id. at Fig. 11.

III. Number and Size of Settlements

As illustrated below, there is some disagreement among different data providers on figures for settlements and conclusions that can be drawn from these figures.

A. Stanford/Cornerstone (settlement data through year-end 2001)

	Pre-Reform (N=125)	Post-Reform (N=303)
Minimum	$80,000	$100,000
Median	$4.0 million	$5.5 million
Average	$7.8 million	$24.9 million (including Cendant; $14.4 million excluding Cendant)
Maximum	$67.5 million	$3.19 billion

See Cornerstone Research, "Post-Reform Act Securities Case Settlements: Cases Reported Through December 2001," at 4 (2002), available at http://securities.com ("Cornerstone Report").

Distribution of Settlement Amounts by Percentage of Cases (up to $9.9 million):

	Pre-Reform	Post-Reform
Less than $1 million	about 9%	about 9%
From $1 to $4.9 million	about 50%	about 35%
From $5 to $9.9 million	about 22%	about 22%

See id. As the above chart shows, most cases settled for less than $10 million, both before and after the Reform Act. The remainder of the chart shows that the number of cases settling for more than $10 million, however, is higher Post-Reform (34%) than it was Pre-Reform (19%). See id. The PSLRA does not appear to have separated the plaintiffs in meritorious high-damages cases from their money.

B. Woodruff-Sawyer

The Woodruff-Sawyer figures for pre- and post-Reform Act settlements are similar to Cornerstone's, but slightly lower.

	Pre-Reform (372 settlements where terms are known)	Post-Reform (345 settlements where terms are known, including Cendant)
Median	$3 million	$4.3 million
Average	$6.67 million	$21.365 million (including Cendant; $12.164 million excluding Cendant)

A Woodruff-Sawyer study also considers market capitalization as a relevant factor in evaluating settlement amounts. Because settlement is a business decision, the Woodruff-Sawyer study presumes settlement size alone to be an unreliable guide for determining whether a suit is meritorious. Rather, settlement size for a given market capitalization is considered a more reliable guide.

A Woodruff-Sawyer chart "compares average cash settlement values by market cap ranges for pre-reform and post-reform settlements. Generally, the size of the average settlement grows with the size of the market cap except for the dip at the $5 - $10 billion range. The chart omits only the Cendant Corp. cash settlement of $3.1865 billion." (Woodruff-Sawyer's bar chart is not reproduced here).

Similar charts "show the relationship between Pre-Reform and Post-Reform settlements by market capitalization -- based on 342 post-reform cases." Set forth below is the chart excluding the Cendant settlement:

Market Capitalization $ Million	Pre-Reform Avg. Cash Settlement ($ Million)	Post-Reform Avg. Cash Settlement ($ Million)	Ratio of Post-Reform to Pre-Reform
0-25	1.467	2.337	1.59
25-50	3.691	3.214	0.87
50-100	3.332	4.495	1.35
100-250	5.114	5.384	1.05
250-500	6.690	8.371	1.25
500-750	8.360	17.529	2.10
750-1,000	9.003	9.582	1.06
1,000-2,500	14.318	20.911	1.46
2,500-5,000	19.796	30.212	1.53
5,000-10,000	7.594	18.233	2.40
OVER 10,000	53.500	91.810	1.72
Overall Average	6.746	12.271	1.82

For every category of market capitalization except one (issuers with a $25-50 million market capitalization), settlement amounts are up, and in many market-capitalization categories settlement amounts are up by 50% or more.

C. NERA

Like Stanford/Cornerstone and Woodruff-Sawyer, NERA concludes that "[a]verage settlements increased significantly since the Reform Act was passed." NERA Report at 4.

	Filed Pre-Reform	Filed Post-Reform
Average Settlement	$8.4 million	$31.7 million
Average Settlement (Excluding Cendant)	$8.4 million	$13.3 million

The NERA report concludes that the PSLRA has caused a reduction in nuisance suits. "Settlements for values under $2 million dropped precipitously since the passage of the Reform Act. About 27% of pre-Reform Act settlements were for under $2 million. Only 12% of post-Reform Act settlements were valued in that range." Id. at 4 & Fig. 16. These findings are reflected in Figure 16 of the NERA report, which is not reproduced here.

Further, NERA concludes that "[f]or suits filed *before* the PSLRA was passed, the value of settlements that occurred within a year were about 23% below those that took longer to settle. We posit that prior to the Reform Act, defendants

were not optimistic about getting 'nuisance suits' dismissed, instead choosing to settle them quickly and for low values." Id. at 6.

Also interesting is NERA's conclusion that settlements are 33% higher for cases that settle after a motion to dismiss has been denied. That chart, Figure 18, compares the settlement cost of cases in which a motion to dismiss is denied, with the settlement cost of other cases. Id.

The NERA report notes the correlation between settlement size and market capitalization, but does not consider it to be as significant as Woodruff-Sawyer considers it to be. "The capitalization of the defendant company at the end of the alleged class period is associated with a modest, but statistically significant, increase in settlement values. We posit this variable may proxy for the solvency of the company and the assets available for settlement funds." Id. at 5-6.

IV. Accounting and Restatement of Earnings Cases

All of the reports note a significant number of cases involving accounting and restatement of earnings allegations, and at least one of the reports (the NERA study) shows an increase in such allegations after the PSLRA. There also appears to be a corresponding increase in settlement amounts for such suits.

A. Woodruff-Sawyer (excludes IPOs)

Year of Suit	Total Cases	Accounting	Restatement
1996	98	54	19
1997	169	84	24
1998	233	124	40
1999	204	110	48
2000	207	109	46
2001	264	93	48
3/2002	57	35	8

Allegations	Average Settlement ($ Millions)
Insider Trading	$16.060 (w/out Cendant) $33.291 (w/Cendant)
Accounting Violations	$15.811 (w/out Cendant) $28.859 (w/Cendant)
Restatement of Financials	$18.341 (w/out Cendant) $45.419 (w/Cendant)
Both Insider Trading **And** Accounting Violations	$20.893 (w/out Cendant) $46.893 (w/Cendant)
Neither Insider Trading **Nor** Accounting Violations	$14.311
Alleging **Either** Insider Trading **Or** Accounting Violations	$13.893 (w/out Cendant) $24.363 (w/Cendant)

Clearly, allegations over accounting violations and restatements of financials, like allegations of insider trading by an issuer's officers or directors, make a case more valuable from a settlement perspective. If justified by the factual circumstances (and perhaps even if not justified) such allegations are likely to be included in the complaint with an eye toward maximizing settlement value.

B. Stanford/Cornerstone

The Stanford/Cornerstone data also indicate a high settlement value of accounting allegations, as well as claims under Section 11 of the 1933 Securities Act (under which intent to deceive or recklessness need not be shown) and claims against am underwriter. These claims all increase a settlement amount in relation to the total amount of damages alleged by the plaintiff class.

Median Settlements as a Percentage of Estimated Damages by Existence of Certain Allegations (Post-Reform Act Sample)

GAAP Allegations	5.9%
No GAAP Allegations	4.1%
Restatement of Financials	7.0%
No Restatement	4.1%
Accountant Named	7.3%
No Accountant Named	4.7%
Section 11 Claim	6.3%
No Section 11	4.9%
Underwriter Named	9.6%
No Underwriter	4.8%

See Cornerstone Report at 6.

C. NERA

The NERA study most clearly identifies the marked increase in accounting fraud allegations from the pre-PSLRA to the post-PSLRA litigation environment. "The percentage of securities class actions involving allegations of accounting fraud increased substantially since passage of PSLRA. In the five years preceding the PSLRA an average of 38% of all cases involved accounting fraud. This average jumped to 51% in the 6 years following the Act's passage." NERA Report at 2 & Fig. 4. Restatements of earnings have been at the core of many of these cases. "Many of these accounting cases involve restatements. While the growth in restatement cases occurred both before and after the passage of PSLRA, the percentage of cases involving a restatement has grown from 9% pre-PSLRA to 20% post-PSLRA." Id. at 2 & Fig. 5.

It is also clear that accounting cases settle for more money, an added incentive for plaintiffs to include accounting allegations in their complaints. Settlement value of course increases dramatically if an accounting firm is actually named as a codefendant and even more if there is a finding of accounting irregularities. Thus, on average, controlling for the amount of investor losses and market capitalization of the issuer, settlements are higher by the following percentages if a case includes:

- Allegation of accounting fraud 29%
- Accounting codefendant 79%
- (But, accounting firm pays only 32% of settlement)
- Finding of accounting irregularities 90%

Id. at Fig. 17. The last statistic -- that settlements with findings of accounting irregularities are 90% higher – supports the hypothesis that meritorious claims (many of which are likely to include accounting irregularities) are proceeding after the PSLRA, and settle for higher amounts. Culpable accountants and others involved in financial fraud are clearly being made to pay.

Another development has been plaintiffs' use of insider trading allegations to meet standards for pleading scienter. The Second Circuit and other circuits allow the pleading standard to be met by pleading specific facts showing that the defendants had both a "motive and opportunity" to commit fraud. The defendants' own trades in the issuer's stock can be the purported motive for them to misrepresent facts to investors or unlawfully delay disclosures, and the defendants' control over the issuer's disclosure policies or over trading in the issuer's stock can provide the purported opportunity to defraud. Thus "probably as a result of the strengthening of the scienter requirements by the Reform Act, the number of complaints that plead insider trading appears to have increased. Plaintiffs often look for a pattern of officers and directors liquidating their ownership positions during the class period to plead motive and opportunity. A sample of post-PSLRA filings shows that about 53% of post-PSLRA complaints contain insider-trading allegations." Id. at 2 & Fig. 6.

V. Milberg Weiss as Lead Counsel

A. Stanford/Cornerstone

Stanford/Cornerstone breaks down settlements, as a percentage of all settlements post PSLRA, according to the law firm representing the plaintiff class, as follows:

Milberg Weiss	51.5%
Non-Milberg Weiss	48.5%

See Cornerstone Report at 8.

B. Woodruff-Sawyer

Woodruff-Sawyer reports that "Milberg Weiss has been continually increasing their penetration into the securities litigation field." The following table demonstrates this steady increase, excluding IPO allocation cases:

Time Period	Percentage of Cases Involving Milberg Weiss
Pre-Reform cases filed before 1993	27%
Pre-Reform cases filed 1993-1995	45%
Post-Reform cases	64%

Woodruff-Sawyer also notes a change in venue lead by Milberg Weiss, apparently in response to the Silicon Graphics decision in the Ninth Circuit. "It is most interesting to note that the involvement of Milberg Weiss in non-California cases has increased by 77%. It appears that Milberg Weiss is currently leading the trend in moving out of the Ninth Circuit to other circuits, probably partly as a result of the Ninth Circuit Appellate Court decision affirming the Silicon Graphics dismissal, and partly as a result of the IPO allocation cases currently being filed in the USDC New York Southern District."

Milberg Weiss Involvement	Pre-Reform % of Total Cases Filed	Post-Reform % of Total Cases Filed	Change
California	71.3%	76.3%	+7%
All Other States	34.3%	60.7%	+77%

This development has been confirmed in law review commentary, some of it by Milberg Weiss lawyers themselves. Milberg securities partner Bill Lerach (now lead counsel in the Enron securities fraud class action) stated that prior to the passage of the Reform Act, Milberg Weiss appeared in approximately 31% of securities fraud class actions, whereas after the Act's enactment this increased to 59%. See William S. Lerach, "The Private Securities Litigation Reform Act of 1995 -- 27 Months Later:" Securities Class Action Litigation Under the Private Securities Litigation Reform Act's Brave New World, 76 WASH. U. L.Q. 597, 606 (1998).

Professors Randall Thomas and Stewart Schwab also found shortly after passage of the PSLRA that "[i]n a small data set that we gathered for post-Reform Act cases, we found that this firm was named lead counsel in forty-one of sixty-three cases (about sixty-five percent) where we could determine who was appointed lead counsel. Milberg Weiss's success in obtaining the role of lead counsel has been accompanied by significant growth in the size of this law firm. In other words, Milberg Weiss has been able to capture a larger share of the bigger jobs and appears

to have expanded its firm so that it can handle this work internally." Randall S. Thomas, et al., "Megafirms," 80 N.C. L. REV. 115, 194 (Dec. 2001).

VI. Conclusions

The statistical data discussed above comes from four different providers, and, despite some differences in the figures, demonstrates remarkably consistent trends. First, there are as many securities class action filings now as before the PSLRA (far more if 2001 suits alleging fraud in connection with IPO's are taken into account). The courthouse door thus remains wide open for plaintiffs. Second, while dismissal rates rose slightly after the PSLRA and again after the Ninth Circuit's decision in Silicon Graphics, over seventy percent of suits still are resolved through settlement. Third, settlement amounts are higher now than they were before the PSLRA, even controlling for the market capitalization of the issuer. Fourth, allegations over accounting violations and earnings restatements are probably more common in complaints now than they were before the PSLRA. Suits that allege accounting violations, and suits that name accountants as defendants, also settle for more money. Accountants and their insurers end up paying substantial portion of these increased damages. Finally, market concentration among the plaintiffs' bar has grown significantly since the PSLRA, with one law firm now accounting for over half of securities class action litigation. If this concentration results in lack of competition for the lead plaintiffs' role in securities fraud suits, this is a worrisome trend for investors who want the best legal representation at the lowest cost (or the highest possible recovery net of legal costs).

PART B: DOCTRINAL ISSUES ARISING UNDER VARIOUS PROPOSALS TO AMEND THE FEDERAL SECURITIES LAW

This section of our report evaluates federal-securities doctrines that might be affected by various legislative initiatives proposed since the collapse of Enron. These proposed changes include a major new exception to the PSLRA discovery-stay provision; imposing joint and several liability on defendants regardless of their degree of fault; imposing liability for aiding and abetting securities law violations as well as for breach of common law duties and corporate fiduciary duties; imposing on issuers new disclosure requirements including an ongoing duty to update; and a proposal that the SEC engage in merits-based analysis of securities or their issuers.

One of the most intrusive bills is the Comprehensive Investor Protection Act of 2002, H.R. 3818, proposed by Representative LaFalce (D-NY). H.R. 3818 is the most comprehensive proposed reworking of federal securities statutes, and is compared below with the Corporate and Auditing Accountability, Responsibility,

and Transparency Act of 2002, H.R. 3763, proposed by Representative Oxley. This report will also point out where proposals in these two bills overlap with proposals in other pending bills. The LaFalce bill is used in this paper because it is the most comprehensive – all the other bills that have been proposed dealing directly with the PSLRA contain provisions that also appear in the LaFalce measure.

Many of the proposed bills suffer a fundamental weakness: in their rush respond to Enron these bills propose changes to the federal securities laws that would, if enacted, do little to help investors. Many of these changes, however, would do a great deal to increase the cost of public offerings and further enrich private plaintiffs' lawyers at investors' expense.

Although more investor protection is required, the private plaintiffs' bar does not offer the best solution. Because the SEC is better positioned to pursue defrauders and, when necessary, distribute recoveries to defrauded investors, legislative enactments, if any, should expand SEC enforcement powers, not the power of plaintiffs' lawyers.

Section 2(c) of H.R. 3763, for example, entrusts the SEC to improve the quality of audits. H.R. 3763 does not expand further the grounds for yet more private lawsuits against auditors (lawsuits against auditors are already numerous and lucrative as shown in Part AIV above). Nor does H.R. 3763 legislate a solution to the issue of auditor independence. H.R. 3763 instead empowers the SEC to promulgate regulations that will ensure auditor independence.

The litmus test for post-Enron proposals that purport to increase investor protections should be whether the proposals offer more transparency to public filings or just offer more opportunities for the private plaintiffs' bar to file lawsuits and receive attorneys fees. Proposals that offer the former should be fairly considered; but those that offer only the latter should be rejected. Absent a demonstrable benefit for investors that is absent in today's litigation environment, it would be a mistake to further empower the private plaintiffs' bar, which a majority of Congress found in 1995 had abused the power already bestowed upon them.

I. The Discovery Stay

In December of 1995, Congress passed the Reform Act to discourage the filing of meritless and abusive securities-fraud lawsuits. A key provision of the Reform Act was the discovery-stay provision, which was added because Congress found that the private plaintiffs' bar would file lawsuits for the express purpose of forcing defendants to settle rather than face the horrendously expensive prospect of

civil discovery.[2] Congress did not have this same concern, however, about the SEC, and no one suggested that the SEC engages in such tactics. Thus, the Reform Act's discovery-stay provision applies only to private actions and presents no bar to the SEC.[3] The SEC may, even under the Reform Act's discovery-stay provision, take all the discovery it can get.

Section 12(e) of The Comprehensive Investor Protection Act of 2002, H.R. 3818, however, would repeal the discovery-stay provision imposed by Section 21D(b)(3) of the Exchange Act and Section 27(b) of the Securities Act of 1933.[4] That repeal is presented as one that would affect only auditors. It would require, upon the filing of a securities-fraud complaint which names auditors as defendants, the auditors to begin producing their audit work papers before any of the other defendants would have to produce documents. It is deceptively simple in its appeal and its approach.

In the wake of Enron, this discovery roll-back against auditors sounds appealing. In reality, however, this discovery roll-back affects every potential defendant in securities-fraud cases. The potency of Section 12(e) derives from the fact that audit work papers contain a wealth of information that could be used by plaintiff's lawyers against all defendants, not just auditors. This information includes not only financial data but also documents such as correspondence about key business and financial issues; board minutes; internal projections and estimates; and contracts. In short, an auditor's work papers reveal the inner-most workings of a company, and thus making audit work papers subject to immediate discovery effectively undoes one of the Reform Act's key provisions vis a vis every defendant and grants access to whatever company documents were collected during the course of an audit. While only the auditors would face the immediate cost of complying with this discovery, other defendants would once again face the kind of "fishing-

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[2] See, e.g., Steckman v. Hart Brewing, Inc., Civil No. 96-1077-K, 1996 WL 881659, at *5 (S.D. Cal. Dec. 24, 1996) ("One of the salient features of the 1995 Reform Act is the . . . automatic discovery stay that was specifically enacted to protect against the abusive practice of filing law suits like this one 'with only faint hope that the discovery process might lead eventually to some plausible cause of action.'") (quoting Joint Explanatory Statement of the Committee of Conference, H.R. Rep. 104-369, Cong. 1st Sess. 31 (Nov. 28, 1995)).

[3] In re Stratosphere Corp. Sec. Litig., 1 F. Supp. 2d 1096, 1104 (D. Nev. 1998) ("The Private Securities Reform Act of 1995 ("PSLRA") amended the Exchange Act and the Securities Act, and applies to private plaintiff class actions").

[4] H.R. 3617, proposed by Mr. Markey, and H.R. 3829, proposed by Mr. Stupack would do the same.

expedition" lawsuits that Congress wanted to stamp out with the Reform Act in 1995.[5]

Section 12(e), should it pass, will likely become an end-run around the stay on discovery in Section 21D(b)(3) of the Exchange Act and Section 27(b) of the Securities Act of 1933. Section 12(e) would thus encourage plaintiff's lawyers to file lawsuits simply to get discovery and force a settlement. Section 12(e) would also ensure that auditors are named as defendants in most securities-fraud suits in order to get this discovery, whether or not the auditors share blame for the alleged securities fraud.

Thus, contrary to appearances, the proposed limited roll-back of the Reform Act's discovery stay, is really not limited at all. The scope of audit work papers (no one proposes scaling back the scope of audits), ensures that this provision effectively provides for discovery against all defendants.

As the statistics in Part AII above demonstrate, about 70% of the suits filed after the PSLRA survive the discovery-stay and the defendants' motions to dismiss. There is no suggestion (nor could there be) that restatement-of-earnings cases will not also go forward should the discovery-stay remain intact, particularly when complaints alleging accounting irregularities and restatements typically result in larger settlements than cases without these allegations (see Part AIV above). In fact, post-PSLRA case histories tell us that such suits are likely to survive the motion to dismiss and proceed to settlement negotiations. Several large accounting restatements–some of them even larger than the restatement in Enron–have resulted in remarkable settlements since the PSLRA passed: Cendant, Waste Management I & II, Sunbeam, and Rite-Aid are but a few. Cendant, for example, settled for over $3 billion, and the accountants there paid over $300 million to settle the case.[6] All of these cases, including Cendant, were filed post-PSLRA; all of these cases, including Cendant, survived the discovery-stay provision; and all of these cases, including Cendant, survived the defendants' motions to dismiss, went into discovery, and were resolved with large recoveries for investors (and enormous fees for plaintiffs' lawyers).

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5 See Greebel v. FTP Software, Inc., 194 F.3d 185, 191 (1st Cir. 1999) ("The enactment of the PSLRA in 1995 *marked a bipartisan effort to curb abuse in private securities lawsuits, particularly the filing of strike suits*.") (Emphasis added).

6 See In re Cendant Securities Litigation, 109 F. Supp. 2d 235, 239 (D.N.J. 1999) ("The Cendant settlement provides for a payment to the class of $2,851,500,000 in cash[.] . . . The [Ernst & Young] settlement provides for a cash payment of $335,000,000.").

Section 12(e) is also superfluous in view of a provision in the existing PSLRA discovery-stay that, in appropriate circumstances, allows courts to lift the discovery stay against private plaintiffs. The PSLRA provides that discovery may proceed before a motion to dismiss is resolved when the party seeking to take discovery shows "that particularized discovery is necessary to preserved evidence or to prevent undue prejudice to that party."[7] Many courts have lifted or partially lifted the discovery stay when plaintiffs make the required showing, making the discovery-stay provision a far cry from the bane of investors that some would make it out to be.[8]

H.R. 3763, by contrast, leaves the discovery-stay (and the provision to lift that stay when necessary) intact. Rather than propose measures like H.R. 3818's roll back of the discovery stay, H.R. 3763 places much of the responsibility for changes into the hands of the SEC, which the late Justice William O. Douglas (a former SEC chairman himself) wisely referred to as a well oiled shotgun that the government keeps behind the door.[9] This approach of expanding SEC powers, not those of the private plaintiffs' bar, is in our view far preferable with respect to discovery as well as other areas of securities litigation.

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[7] 15 U.S.C. § 78u-4(b)(3)(B).

[8] See In re Pacific Gateway Exchange, Inc., No. C 00-1211 PJH (JL), 2001 WL 1334747, at *2 (N.D. Cal. Oct. 17, 2001) (granting plaintiffs' motion for a partial lifting of Reform Act's discovery stay); Anderson v. First Security Corp., 157 F. Supp. 2d 1230, 1242-43 (D. Utah 2001) (granting defendants' motion to dismiss ***and*** granting plaintiffs' motion for limited discovery); In re Comdisco Sec. Litig., 166 F. Supp. 2d 1260, 1263 (N.D. Ill. 2001) ("Class Counsel's motion is granted. Individual Defendants' counsel are ordered to deliver photocopies of all Insurance Policies to Class Counsel forthwith.."); In re Flir Sys., Inc. Sec. Litig., No. Civ. 00-360-HA, 2000 WL 33201904 (D. Or. Dec. 13, 2000) (permitted the plaintiffs to depose a former employee of the defendant, Steven Palmquist, in an attempt to bolster their § 10(b) claim); In re Websecure, Inc., Sec. Litig., 1997 WL 773717 (D. Mass. Nov. 26, 1997) (granting expedited discovery where plaintiffs sought particularized discovery about spending of IPO proceeds, company's business plan, and company's business prospects when company was in bankruptcy).

[9] See, e.g., Sparta Surgical Corp. v. National Association of Securities Dealers, 159 F.3d 1209, 1214 n.1 (9th Cir. 1998).

II. Joint & Several Liability

Section 12(a) of H.R. 3818 proposes to broaden significantly the circumstances in which a defendant is joint and severally liable when a final judgment is entered against that defendant, regardless of the degree of fault each defendant bears or how much of the plaintiffs' loss each defendant might be responsible for. This provision would dramatically alter the PSLRA joint-and-several-liability provision, under which a defendant against whom a final judgment is entered in a private action is jointly and severally liable only if that defendant "knowingly" violated the federal securities laws.[10] (The Exchange Act defines "knowingly" here as having actual knowledge that a representation is false or misleading and that investors are reasonably likely to rely on such misrepresentations.)[11] Outside director, lawyers, and non-speaking company officials could become more vulnerable to frivolous suits under the proposed reforms—increasing plaintiffs' leverage against other potential deep pockets.

Section 12(a) of H.R. 3818 leaves this provision intact, but it also adds three more provisions to the Exchange Act's joint-and-several-liability provision: (1) any auditor that audited financial statements that are the subject of the class action and failed to detect and report a violation of the federal securities laws becomes jointly and severally liable for the whole amount of the plaintiffs' damages; (2) if an auditor also performed non-auditing work during the fiscal year in which the violations occurred, the auditor again becomes jointly and severally liable; and (3) if the issuer is insolvent (as is the case in Enron and Global Crossings), any defendant against whom a final judgment is entered becomes jointly and severally liable.

The first of these provisions is troubling because it makes auditors jointly and severally liable for damages unrelated to the grounds that led to a final judgment being entered against them. Securities-fraud actions often involve issues such as earnings projections and oral statements by the company to the financial press –issues that auditors have little to do with even if there are also accounting fraud issues in the case. The first provision of Section 12(a) of H.R. 3818 makes auditors potentially liable for these matters that are wholly unrelated to their work as auditors. If, for example, the issuer misleads the market about product development (the classic case being FDA approval of a new drug) and the issuer also engages in revenue-recognition fraud, an auditor that does not detect and report the revenue-recognition fraud will be liable for affirmative misstatements or omissions about the matters wholly unrelated to its audit. This is an inherently bad idea because it will make audits extremely expensive for publicly traded companies big and small.

The second provision concerning auditors is even more problematic. Even if the auditor detected and reported the revenue-recognition fraud, the auditor would still be jointly and severally liable if the auditor also performed "non-audit functions" for the company. At a minimum, H.R. 3818 should be reworked to clearly and exhaustively define what it means by "non-audit functions." In light of recent events, for example, H.R. 3818's drafters might mean

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[10] 15 U.S.C. § 78u-4(f)(2)(A).

[11] 15 U.S.C. § 78u-4(f)(10)(A).

consulting work. This ambiguity should be corrected if the provision goes forward at all. A far better approach would be to leave it to the SEC to determine through its rule-making function, as it already has, which non-audit functions may be performed for audit clients by independent auditors.

The third provision – imposing joint and several liability when issuers are insolvent– promises to convert all non-issuer defendants, including officers and outside directors, into de facto insurers for the issuer. Even now, the issuer's directors and officers can be sued whether or not the issuer is insolvent or in bankruptcy, but now, under the PSLRA proportionate liability provisions, these defendants (along with their D&O carriers) will only be liable for the harm they caused. Among other adverse effects, the joint-and-several-liability provision of H.R. 3818 promises to make D&O insurance prohibitively expensive and to discourage people from serving as outside directors.

III. Liability for Aiding and Abetting and for Breach of Fiduciary Duty

Section 14 of H.R. 3818 would amend the Securities Act, the Exchange Act, the Investment Company Act, and the Investment Advisers Act to add a private cause of action against aiders and abetters for either knowing or reckless conduct.[12] This amendment could lead to a flood of private litigation against alleged aiders and abettors. Section 14 would also make liable those whose "omission or failure constituted a breach of a duty owed by such person." Both of these provisions are dangerously vague and overturn well established Supreme Court precedent.

First, knowing or reckless conduct is a standard for scienter that all federal appellate courts have endorsed for primary violator liability under section 10(b) of the Exchange Act.[13] Courts have sought to define exactly what degree of recklessness on the part of a primary violator is required, and not all circuits agree on an exact definition. H.R. 3818 unfortunately does not address what kind of recklessness will suffice for aiding and abetting liability. It is unclear, for example, whether H.R. 3818 would permit aiding and abetting liability on a showing that the alleged aider and abetter acted recklessly even when plaintiffs show no indicia that the aider and abetter acted with any intent.

For example, in addressing the scienter standard, district courts in the Second Circuit refuse to permit § 10(b) liability without some indicia of intent..[14] Reading any other standard into Section 14 of H.R. 3818 could lower the threshold for aiding and abetting liability below

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[12] H.R. 3617, proposed by Mr. Markey and S. 1933, proposed by Senator Shelby contain similar provisions.

[13] See,e.g., City of Philadelphia v. Fleming Cos., Inc., 264 F.3d 1245, 1259 (10th Cir. 2001) ("With regard to the continued viability of recklessness as a substantive pleading standard for scienter under the PSLRA, five circuit courts agree that plaintiffs can adequately plead scienter by setting forth facts raising a "strong inference" of intentional or reckless misconduct. . . . We agree.") (Collecting caselaw).

[14] See Hart v. Internet Wire, Inc., 145 F. Supp. 2d 360, 366 (S.D.N.Y. 2001) ("A 10(b) plaintiff who relies on a recklessness theory is not relieved of the burden to plead and prove fraudulent intent[.]"); In re Fishbach Corp. Sec. Litig., No. 89 CIV. 5826 (KMW),1992 WL 8715 at *4-5 (S.D.N.Y. Jan. 15, 1992) (explaining the intent component of recklessness for § 10(b) liability).

that for primary liability in the Second Circuit. The way the statute now reads might well permits such a result.

Moreover, it is unclear whether the drafters of H.R. 3818 mean to allow plaintiffs to plead aiding and abetting via allegations of motive and opportunity. This is an important point because, unlike recklessness, motive and opportunity is not scienter, but merely a way to plead scienter. The drafters' failure to spell out just how plaintiffs may plead scienter for purposes of aiding and abetting liability leaves for the courts to resolve this contentious question and, in some circuits, would lower the threshold for pleading scienter on aiding and abetting liability below that set for pleading scienter on a primary violation.

Second, Section 14 of H.R. 3818 makes liable those who breach a duty that they owe. The proposed statute does not say what duty, to whom the duty might be owed, and it does not limit who can sue for breach of this undefined duty. For example, do the proponents of H.R. 3818 mean to convert legal malpractice or some fiduciary breach into aiding and abetting liability? Do they also intend to undo decades of jurisprudence that has refused to federalize corporate fiduciary duties?[15]

A summary of the bill expressly says that it intends to undo the result of Central Bank of Denver–a Supreme Court decision that rejected aiding and abetting liability[16]-- but that summary does not say what seems apparent from the text of Section14: that H.R. 3818 also intends to undo Santa Fe Industries v. Green–a Supreme Court decision that refused to federalize fiduciary duties.[17] H.R. 3818 thus could federalize state corporate and tort law and give a cause of action under the federal securities laws to vast new classes of potential plaintiffs

Third, there is the question of reliance. Do the drafters of H.R. 3818 mean to impose aiding and abetting liability for a statement by an accountant, lawyer, or investment banker even when the plaintiff shows no reliance on that statement? If they do, they "disregard the careful limits on 10b-5 recovery,"[18] including long standing Supreme Court precedent requiring that plaintiffs who allege material misrepresentation to show reliance.[19]

The proposed text's silence on these points invites a new wave of securities litigation over the types of conduct that fall within the scope of Section 14 of H.R. 3818. These ambiguities, we believe, should be corrected in the language of the proposed text, or, better yet,

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[15] See Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 476, 97 S. Ct. 1292, 1302 (1977).

[16] available at <<www.house.gov/banking_democrats/pr_020228a.htm>>

[17] See United States v. O'Hagan, 521 U.S. 642, 643, 117 S. Ct. 2199, 2202 (1997) (Santa Fe Industries was "a decision underscoring that § 10(b) is not an all-purpose breach of fiduciary duty ban, but trains on conduct that is manipulative or decep-tive").

[18] Central Bank of Denver v. First Central Bank of Denver , 511 U.S. 164, 180, 114 U.S. 1439, 1450 (1994).

[19] See Affiliate Ute, __U.S. __ (year) (holding that plaintiffs must show reliance in cases that allege affirmative misrepresentations, but reliance can be presumed in cases alleging material omissions). See also Basic, Inc. v. Levinson, __U.S. __ (year) (allowing the fraud-on-the-market theory to substitute for plaintiffs' reliance showing in limited circumstances).

Section 14 should simply be dropped. Any new securities legislation should not, as was done with the Reform Act, relegate to legislative history important clarifications about what the drafters mean. Doing so only invites years of expensive litigation and contradictory results amongst the various federal circuits that, ultimately, the Supreme Court must resolve. The uncertainty that such vagaries inject into the law would do little to enhance investor protection.

Finally, Section 14 suffers yet another problem, once again related to the scienter standard: it sets a lower threshold for private plaintiffs seeking to impose aiding and abetting liability than does Section 20(e) of the Exchange Act. Section 20(e), added by the Reform Act in keeping with Congressional intent to give the SEC broader enforcement powers than plaintiffs' lawyers, allows the SEC to pursue aiders and abetters who *knowingly* aid or abett a violation of the Exchange Act.[20] Private plaintiffs cannot now sue any aiders and abetters, but, should Section 14 become law, it will set a lower evidentiary and pleading standard for private plaintiffs suing aiders and abetters than Section 20(e) now sets for the SEC. Like the discovery-stay roll back that H.R. 3818 proposes, Section 14 promises only to significantly increase the number of defendants named in private lawsuits.

IV. The Rule 11 Problem Remains Unresolved By The Pending Bills

One of the few provisions of the PSLRA that would remain intact if H.R. 3818 were to become law is the mandatory Rule 11 findings provision. Section 21D(c)(1) of the Securities Exchange Act and Section 27(c)(1) of Securities Act direct that district courts "shall include in the record specific findings regarding the compliance by each party and by each attorney representing any party with each requirement of Rule 11(b) of the Federal Rules of Civil Procedure[.]"[21] This provision is not an option for the federal district courts, and failure to make such findings is an abuse of discretion.[22] The mandatory nature of this provision notwitstanding, federal district courts have made the required findings in only a handful of cases reported since the Reform Act passed.[23] Sanctions have been awarded in even fewer cases. The PSLRA thus failed to undo decades of institutional reluctance by the federal judiciary to impose sanctions. Even though the flood of suits continues (see Part AI above), at least one investor protection Congress established in 1995 (protection against frivolous pleadings) remains largely unapplied. From this perspective, the post-PSLRA litigation environment is bad for shareholders; they must pay the cost of frivolous pleadings in place of the lawyers who file them and whom Congress intended to foot the bill.

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20 15 U.S.C. § 78t(e).

21 15 U.S.C. § 78u-4(c)(1) (Exchange Act provision); 15 U.S.C. § 77z-1(c)(1) (Securities Act provision)

See Elhert v. Singer, 245 F.3d 1313, 1320 (11th Cir. 2001) ("Defendants argue that the district court erred in failing to make Rule 11 findings expressly required by the PSLRA. We agree. . . . Because the district court did not make the necessary Rule 11 findings, we remand for this purpose.").

See, e.g., Gonzalez v. Jose Santiago, Inc., 141 F. Supp. 2d 202, 207 (D.P.R. 2001); Demarco v. Depotech Corp., 131 F. Supp. 2d 1185, 1188-89 (S.D. Cal. 2001); Polar Int'l Brokerage Corp. v. Reeve, 196 F.R.D. 13, 20 (S.D.N.Y. 2000); Inter-County Resources v. Medical Resources, Inc., 49 F. Supp. 2d 682, 686 (S.D.N.Y. 1999); Harding Univ. v. Consulting Servs. Group, L.P., 48 F. Supp. 2d 765, 773 (N.D. Ill. 1999); Richter v. Achs, 174 F.R.D. 316, 319 (S.D.N.Y. 1997).

V. New Proposals For Disclosure Requirements

Section 8 of H.R. 3818 proposes to require the SEC to issue new disclosure rules for issuers, and many of these rules could create yet more grounds for civil liability. These new rules would require, among other things, issuers to update "information previously disclosed." In so doing, Section 8 promises to further cloud when and under what circumstances an issuer must update previously-disclosed information.

Courts currently view the duty to update as a limited one that is triggered only "when statements that, although reasonable at the time made, become misleading when viewed in the context of subsequent events."[24] Under the PSLRA, there is also currently no duty to update forward-looking statements.[25]

Section 8 of H.R. 3818 removes the tripwire that now triggers an issuer's duty to update: when previous disclosures become misleading. That qualifier appears nowhere in the text of the proposed statute, although we trust that the SEC would include such a qualifier in any new rule issued pursuant to Section 8. Section 8 also promises to further shift the definition of what is and what is not material away from quantitative standards and towards qualitative standards. While this sounds appealing, such a shift has been implemented and abandoned before (because it did not work).[26]

If issuers are unsure of what is material and what is not, they are likely to bury investors with reams of detail that reduces transparency of disclosures simply because there will be so much of it to sift through. That has never been viewed as sound policy.[27]

Furthermore, for years the SEC has sought to encourage issuers to make forward-looking statements.[28] In 1995, the PSLRA strengthened those safe harbors. Now, however, Section 8 of

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24 See Oran v. Stafford, 226 F.3d 275, 286 (3d Cir. 2000).

25 See 15 U.S.C. § 78u-5(d) ("Nothing in this section shall impose upon any person a duty to update a forward-looking statement.").

26 See John M. Fedders, Qualitative Materiality: The Birth, Struggles, and Demise of An Unworkable Standard, 48 Catholic Univ. L. Rev. 41, 86 (Fall 1998) ("The qualitative materiality standard has come and gone. It died at the bar of common sense. It was a standard that had no standards. . . . Its intended beneficiaries–investors–ignored corporate qualitative disclosures. Moreover, the standard was found unfit by the courts[.]").

27 See In re Convergent Technologies Sec. Litig., 948 F.2d 507, 516 (9th Cir. 1991) ("A company need not detail every corporate event, current or prospective.... The securities laws do not require management 'to bury the shareholders in an avalanche of trivial information--a result that is hardly conducive to informed decisionmaking' ") (quoting TSC Industries, 426 U.S. at 448-49, 96 S. Ct. at 2132).

28 See Guides for Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5992, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81, 756 (Nov. 7, 1978); Safe Harbor Rules for Projections, Securities Act Release No. 6084, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117 (July 5, 1979).

H.R. 3818 could expand the duty to update to include a duty to update forward-looking statements . It does so because it does not expressly exclude from its scope forward-looking statements. In so doing, Section 8 may end up denying investors the kind of forward-looking information from companies that, for years, the SEC has believed enhances investors' ability to make informed investment decisions.

VI. Risk Rating System

Section 9(b) of H.R. 3818 is yet one more example of how H.R. 3818 contains many overreactions to Enron and disregards fundamental tenets of the federal securities laws. Section 9(b) proposes to direct the SEC to "establish a risk rating system" and rate issuers based on the risk issuers present to investors. This conversion of the SEC into a nationalized version of Moodys or Standard and Poors would be an unprecedented shift in the SEC's mission and in the overall approach of the federal securities laws.

Since their inception both the federal securities laws and the SEC have eschewed any role in evaluating, or even commentary on, the risks or merits of any security. Every registration statement, for example, contains a disclaimer that the SEC has not passed on the merits of the securities offered by that registration statement. Simply put, the federal securities laws are disclosure based not (as are a few state securities laws) merit based. Investors know this and do not rely on the SEC to screen their investments for them. Section 9(b) of H.R. 3818, however, would undo almost seventy years of federal precedent and turn the SEC into an organization that evaluates risk in addition to requiring issuers to disclose risk.

This vastly expanded function for the SEC is unnecessary, as the market already evaluates the risk and credit rating of issuers. While the market does so on an almost daily basis, Section 9(c) of H.R. 3818 would require a re-evaluation by the SEC of risk no more frequently than every three years. In today's speed-of-light global markets, three years–even three weeks–is an eternity, and investors who rely on SEC risk ratings would do so at their peril. Such a rating system could even distort market valuations of issuers, and in a worst-case scenario make the SEC (if it mistakenly assigned a low or moderate risk rating to a company such as Enron) responsible for investor losses of a similar magnitude to those now blamed on the malfeasance of large auditing firms.

Section 9 of H.R. 3818 is a well-intentioned but ill-advised shift in what has been a workable disclosure-based approach for our securities laws since 1933. It should be omitted from any new securities legislation.

VII. Conclusions

For years, federal courts have seriously considered the SEC's views on securities laws because the SEC is the agency charged with their enforcement.[29] The SEC should enforce the securities laws, and the private plaintiffs' bar should not be empowered further.

[29] See, e.g., Navellier v. Sletten, 262 F.3d 923, 945 (9th Cir. 2001) ("We see no reason here not to defer to the sensible and informed judgment of the SEC, the agency charged with administering the statute.").

Expanding the role of the SEC rather than private litigants will yield at least two benefits. First, it will diminish the impact that lobbies by both defendants and the plaintiffs' bar have on the shape of legislation. Second, expanding the SEC's role in securities enforcement will not burden defrauded investors with attorneys' fees that sometimes consume more than one-third of a recovery. Instead, lower costs of enforcement will be spread out among all issuers (through SEC filing fees) and among taxpayers (to the extent the SEC budget is supplemented out of general funds).

Enron and other recent high profile failures cannot be the excuse for returning to past risks of litigation abuse. Yet that is what proposed roll-backs of several Reform Act provisions could well achieve. Using Enron to justify such roll-backs is ill-advised where no one has yet repudiated SEC Chairman Harvey Pitt's testimony before Congress that there is no relationship between the PSLRA and the demise of Enron.[30]

[30] See 34 BNA Securities Regulation & Law Report No.13 at 520 (Apr. 1, 2002) ("SEC Chairman Harvey Pitt has testified before Congress that there was **no relationship between the 1995 Act and the demise of Enron.**") (bold in original).

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