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## Buyer Beware: Private Securities Litigation Is Under Attack Again

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Special to the Legal

Not since the mid-1990s, when Congress enacted the Private Securities Litigation Reform Act of 1995 (PSLRA), raising the bar on investors seeking the aid of federal courts to redress harm caused by fraud, has there been such a strong anti-securities litigation effort as the effort taking hold in the United States today. Commentators describe today's movement as a natural result of the "swinging pendulum of public policy, investor confidence and corporate initiative" since the passage of the 2002 Sarbanes-Oxley Act (SOX).

There is little debate that the transparency and reliability of U.S. corporate governance systems, accounting and financial reporting standards, and related requirements for internal control structures, over time, lead to the kind of growth in value that is desired by long-term investors, who depend on clear and reliable financial reporting. But today's initiatives diminish the importance of the value for "investor protection" embodied in the Securities Act of 1933 and the Securities Exchange Act of 1934 (federal securities laws), and elevate the importance of the value for promoting "efficiency and capital formation in the financial markets" embodied in the National Securities Markets Improvement Act of 1996.

The views of the principal proponents of the "protect our markets" initiatives are represented in three voluminous reports published respectively by the Committee on Capital Markets Regulation, led by Harvard law professor Hal Scott and Treasury Secretary Henry Paulson; the Commission on the Regulation of U.S. Capital Markets in the 21st Century, established by the U.S. Chamber of Commerce (CoC report); and by New York City Mayor Michael Bloomberg and New York's U.S. Senator Charles Schumer (N.Y. report). These reports advocate the importance of protecting U.S. capital markets and the need to remedy perceived harm caused to U.S. capital market competitiveness by regulations like SOX and by private and governmental enforcement of the federal securities laws.

The CoC report states that the effort is to "seriously reconsider some of the systems and institutions built over the past 70 years to protect investors and foster capital formation." The Paulson report states that "since the end of World War II, firms raising capital did not so much choose to come to the United States, they came naturally. Today, the forces at work are increasingly different. Firms must choose to come to the United States to raise capital: they do not have to come. U.S.

financial markets need to attract business that has a choice, and therefore how our markets are regulated by rules and laws really does matter today."

The N.Y. report warns: "Unless we improve our corporate climate, we risk allowing New York to lose its pre-eminence in the global financial services sector. This would be devastating both for our city and nation." There is no mistaking the alarmist tone taken by these "protect our markets" constituents.

Seeking to protect issuers, auditing firms

and financial services companies — tellingly, prominent members of each populate the Paulson Committee and the CoC Commission — these reports make major recommendations. The CoC report recommends that Congress enact legislation to expressly incorporate SOX into the federal securities laws, thereby making the statute "fully subject to the [SEC] general powers to issue rules and exemptions" to limit the scope of SOX's Section 404 internal control certification requirement. That report propos-

es to protect public accounting firms by SEC regulations that prevent firms from being criminally indicted and impose caps on civil liability. It also seeks to reign in private securities litigation, recommending that the SEC to study "whether the PSLRA is achieving [its] objectives."

The Paulson report is more aggressive, advocating adoption by courts and regulators of the most stringent standards articulated for the materiality, scienter or state of mind, and

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reliance elements of securities claims.

The N.Y. report takes another step, recommending that the SEC promulgate regulations limiting liability of U.S.-market-listed foreign companies and providing SOX "opt-out" provision for certain public companies. The N.Y. report also recommends that the SEC "promote arbitration as a means of resolving securities-related disputes between public companies and investors," arguing that arbitration would "substantially reduce the costs that companies face" in the course of litigation and virtually eliminate the "burden" of discovery. While there may be pro-capital formation bases for these and other "protect our markets" recommendations, they nevertheless seek to limit the accountability of issuers, auditing firms and financial services companies for acts or omissions that can harm investors.

The recommendations have quickly moved toward policy. In agreement with Paulson report recommendations that the SEC argue for a stronger scienter element in a securities fraud suit, the SEC and the Department of Justice submitted a brief as

amicus curiae in the U.S. Supreme Court case *Tellabs v. Makor Issues & Rights*, arguing — in support of defendants — that plaintiffs must disprove at the pleading stage innocent explanations of the alleged fraud. A group of public pension fund investors submitted an opposing amicus curiae brief asking the court not to "rewrite" the PSLRA as requested. Argument on the appeal was heard last month and a decision by the Supreme Court is pending.

On another front, the "protect our markets" recommendation to resolve investor complaints through arbitration outside of federal court has moved closer to SEC policy. The *Wall Street Journal* recently reported that SEC Chairman Christopher Cox asked his staff to explore ways in which an issuer could require its shareholders to arbitrate grievances by enacting binding bylaw provisions. If permitted by the SEC, which has traditionally opposed similar measures, such bylaw provisions could limit shareholders' ability to recover damages or other remedies.

Investors' awareness of these initiatives is crucial because they threaten to limit investors' rights to obtain adequate redress for harms suffered directly from fraud. While cases like WorldCom slip into the past and the number of private securities actions

decline, corporate governance policymakers must consider the pragmatic reality that real people in real jobs with real temptations and real ethics are at the core of every decision involving accounting and financial reporting.

Mega-cases that highlight the power of "arrogance, greed, deceit and financial chicanery" may not be breaking news these days, but neither investors nor our capital markets can afford enabling those people tempted to defraud to subvert the legal system that has made the United States the model for financial markets worldwide.

President Bush stated when he signed SOX into law that "truthful books, honest people and well enforced laws [are the most effective tools] against fraud and corruption." The CoC report notes that for "more than 70 years, the United States has been home to the most fair, efficient, and sophisticated capital markets worldwide. This has brought unmatched prosperity to our nation and the world. ... By many measures, the U.S. capital markets remain the most liquid and trustworthy in the world. ... Investor protection ... is the hallmark of the U.S. capital markets."

When our laws, regulations and regulators that have long been tasked with protecting investors start protecting other interests, it is time for buyers to beware. •



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