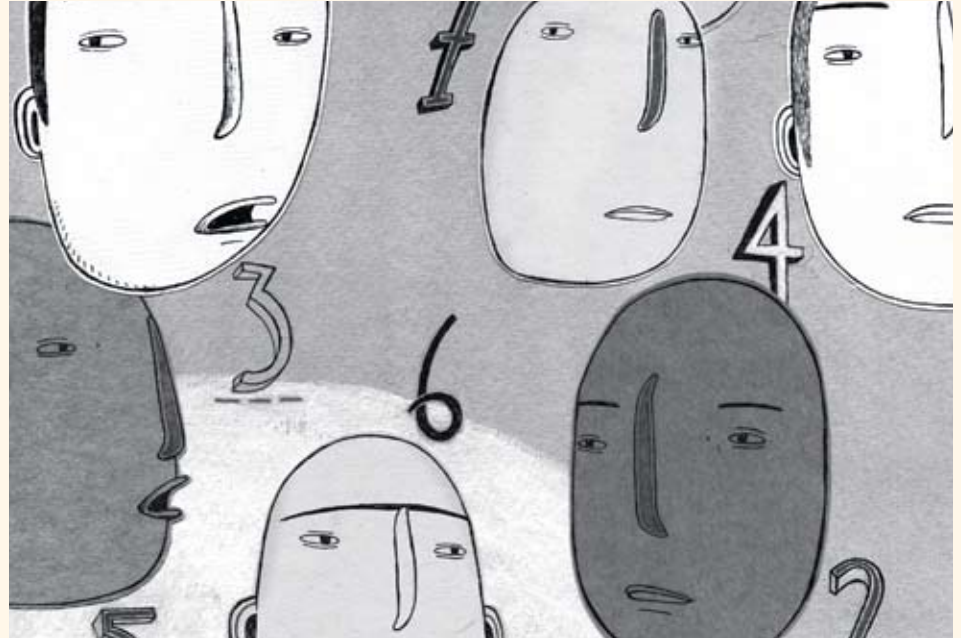


The Role of Private Securities Class Actions in Financial Market Reform

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Recent turmoil in the equities markets, including several high-profile securities frauds, has created unprecedented criticism of the way we regulate our financial markets. Shareholders and policy makers alike are searching for ways to ensure that we never again suffer a financial crisis like the one we saw in 2008.

Relying solely on government regulation to prevent such catastrophes is only a half measure, because it is likely that when the markets and the economy recover, the same anti-regulatory attitude that fueled the current crisis will lead to another round of deregulation. Therefore, while it is essential to expand the powers of the SEC and provide that agency with adequate



funding, reform proposals should also improve the effectiveness of securities class actions under the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.

Prior SEC Chairs and commissioners, including Arthur Levitt, Jr., Harvey Goldschmid, and Richard C. Breeden, have explicitly acknowledged the important—and complementary—role that private enforcement plays in the regulation of our markets. Likewise, Lynn Turner, the former chief accountant of the SEC, recently testified before Congress that “laws are not just enforced by the law enforcement agencies, but also through private rights of action of investors and consumers. This is critically important as law enforcement agencies have lacked the adequate resources to get the job done alone.”

Mary Schapiro, the new Chair of the SEC, has similarly highlighted the important role that must be played by private enforcement. In an interview with the *Financial Times* in April of 2009, Ms. Schapiro stated that the SEC plans “to explore fresh approaches to enforcement, including ways to ‘leverage’

third parties... We need to find some ways to increase staffing, but beyond that [to] leverage third parties without abdicating our responsibility...”.

Private litigation under the securities laws is responsive to Chairwoman Schapiro’s call. It is axiomatic that private enforcement of the securities laws has deterrent effects by increasing the costs related to fraud against investors, and vindicating the rights of shareholders through monetary compensation.

Moreover, academic research indicates that private enforcement results in benefits such as innovation (private lawyers are more likely to develop new methods of detecting and prosecuting fraudulent behavior), information sharing (lawyers in private litigation have the institutional know-how and coordinate their efforts with each other and the government, leading to more efficient adjudication), external accountability (private plaintiffs, with lawyers acting on contingency, hold corporations accountable by bringing stronger cases because of the investment involved in starting a case and by bringing cases where, for one

reason or another, public enforcers will not), internal accountability (private law firms are accountable to their clients, thereby producing results) and transparency (private enforcement takes place through the courts in an open process, allowing education about securities fraud which might not be gained otherwise, and thereby promoting deterrence and investor vigilance).

It is undisputed that private securities class actions have come to play a large role in the enforcement of the nation's securities laws. In 2008, private securities actions returned \$3.1 billion to investors, less attorneys fees and costs. Indeed, private litigation under the securities laws can sometimes be even more effective than governmental efforts at enforcement, as seen is the Enron scandal. In pursuing a case against Enron, the government prosecuted several senior officers of Enron but recovered next to nothing for investors.

Institutional investors representing a class of aggrieved shareholders, on the other hand, recovered almost \$7 billion for defrauded shareholders. The private litigants employed theories of "scheme liability" to obtain settlements from banks and other third parties who assisted Enron in the fraud. These "secondary actors" engaged in off balance sheet transactions which allowed Enron to appear profitable when, in fact, it was not.



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Unfortunately for shareholders (and those concerned with the integrity of markets), recent legal decisions have sharply restricted their ability to hold some "secondary actors" liable. The Supreme Court, in *Stoneridge Inv. Partners LLC v. Scientific-Atlanta, Inc.* 128 S.Ct. 761 (2008), made it more difficult to demonstrate scheme liability. As a result, suits against investment banks which facilitated Enron's fraud (one of the few sources of compensation to defrauded shareholders) have been stopped in their tracks.

Any reform aimed at enhancing investor protections must attempt to lift the restrictions on private securities litigation imposed by *Stoneridge*, as well as by other recent decisions limiting shareholders' access to the courts.

Shareholders and their advocates must work to:

Restore Aiding and Abetting Liability and Scheme Liability for Third-Party Actors Who Facilitate Fraud

As noted above, the Supreme Court in *Stoneridge* essentially made it impossible, as a matter of law, to seek damages from most entities that scheme to artificially inflate the price of shares, such as the banks in the notorious Enron fraud, unless the fraud is not too remote to the investor's determination to purchase the shares.

This decision needs to be legislatively reversed and Section 10(b) amended to allow a fraud-on-the-market presumption of reliance on statements made by third parties which make their way into the primary violator's public statements.

Prevent the Misreading of *Dura* from Creating Meritless "Loss Causation" Challenges

The Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005) has been misread by some courts to allow defendants to escape liability for the most obvious fraudulent behavior, and a reasonable interpretation of *Dura* may require additional legislation. Under *Dura*, a shareholder needs to demonstrate not only that the fraud inflated the price of the share, but also that the revelation of the

fraud was the cause of the price decline. Misreading *Dura* has allowed defendants who are aware of fraud before shareholders to avoid compensating shareholders by simultaneously releasing good (or bad) non-fraud related information the same day that a fraud is revealed, thus complicating the ability of plaintiffs to demonstrate the price impact of the revelation of the fraud. Because of the confusion surrounding *Dura*, some meritorious private shareholder actions have been dismissed. There should be a legislative fix that requires that defendants have the burden of breaking the chain of causation.

Additional measures to fully protect investor interests should be adopted through the courts or through legislation, including measures:

- **Protecting Confidential Witnesses**
Legislation needs to be enacted so whistleblowers don't fear retaliation, and so more details about their identity can be provided to courts.
- **Reinstating Reasonable Pleading Standards**
Courts have taken it upon themselves to unreasonably tighten pleading standards, so it is extremely difficult to plead some elements of a securities fraud claim.
- **Stopping Irrelevant Obstacles from Interfering in Class Certification**
Courts are reviewing the merits of a claim when determining whether class treatment is appropriate, an unnecessary examination that injects uncertainty into the litigation process.
- **Speeding Up the Litigation Process**
The PSLRA's automatic stay of almost all discovery has the effect of slowing down the eventual determination of securities fraud claims.

Private enforcement of the securities laws plays an important role in protecting investors. The reforms proposed here seek to allow meritorious claims to proceed and defrauded investors to receive their day in court. Reform that truly protects investors requires nothing less. [LS](#)