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AN OPEN LETTER IN RESPONSE TO RECENT ATTEMPTS TO CURTAIL THE RIGHT OF SHAREHOLDERS TO PURSUE PRIVATE CAUSES OF ACTION UNDER THE SECURITIES LAWS

Our nation's financial markets are booming. The Dow Jones Industrial Average is at an all-time high, American companies are reaping record profits, and Wall Street's largest financial firms doled out more than twenty-five billion dollars in bonuses last year. As Senator Jim Webb noted in his response to the President's State of the Union address, "The stock market is at an all-time high, and so are corporate profits."

Despite this environment of record profits and growth, in recent months powerful corporate interest groups have launched a high-profile assault on shareholder rights. These groups contend that the right of shareholders to seek a legal recovery for fraud in a court of law—a basic right that has existed in this country for generations—is destroying the competitiveness of the United States' financial markets. The first attack came in November of last year with the release of the Interim Report of the Committee on Capital Markets Regulation, a Committee that was commissioned by Treasury Secretary Henry Paulson (the "Committee"). The Interim Report was prepared by representatives of investment banks, auditors and corporate issuers (without any input from institutional investors), and recommended imposing significant restrictions upon private securities litigation and severely reducing the standards of corporate accountability in the United States. The fundamentally flawed analysis and recommendations of the Committee were the subject of my letter dated December 8, 2006, which is available on the Firm's website, www.blbglaw.com.

While the motives and policy recommendations of the Committee have been widely criticized by investor advocates and neutral observers alike, a growing number of "Chicken Littles" are joining the Committee in arguing that shareholder litigation is causing the sky to fall on America's financial markets. A recent report conducted by McKinsey & Company (the "McKinsey Report") at the request of New York City Mayor Michael Bloomberg and Senator Charles Schumer has followed in the footsteps of the Committee by recommending significant limitations on the ability of shareholders to pursue private securities litigation. The McKinsey Report echoes the Committee by proposing a number of reforms that, taken together, would gut private securities litigation.

Perhaps even more disturbing, recent actions by the Securities and Exchange Commission ("SEC") suggest that the SEC is beginning to side with the corporate interest groups and against the investors whom it is supposed to protect. The SEC recently submitted an *amicus curiae* (friend of the court) brief to the Supreme Court in *Tellabs, Inc. v. Makor Issues & Rights Ltd.* In that brief, the SEC abandoned years of advocacy on behalf of investors by arguing in

favor of defendants and in support of an extremely stringent interpretation of the securities laws. The position advanced by the SEC in *Tellabs* represents a radical departure from positions that the SEC has previously taken in courts throughout the country and, if adopted by the Supreme Court, would make it extremely difficult for shareholders to pursue private securities litigation. In addition, the SEC's chief accountant—a former managing partner of Ernst & Young—recently told a conference of securities professionals that the SEC was considering ways to limit the legal liability of major accounting firms in securities litigation.

We believe that the situation is becoming grave. In defiance of common sense, empirical evidence and sound policy, anti-investor groups—aided by an all-too friendly administration—are beginning to highjack the public debate on these important issues. If these groups get their way, many of this country's most essential investor protections will disappear forever.

Over the past seventy-five years, shareholder lawsuits have returned many billions of dollars to defrauded investors and encouraged honest corporate disclosure by deterring fraudulent activity. During that time, the United States' financial markets have experienced unprecedented growth and success—success that is due in no small part to decades of dual enforcement of the nation's securities laws by both the SEC and through private shareholder lawsuits. The recent barrage of one-sided policy recommendations from powerful and self-serving anti-investor groups would overturn this long-standing regulatory regime. We believe that the time has come for institutional and other investors to add their voices to the public debate and to insist upon the preservation of their right to pursue private securities lawsuits.

In this letter, we discuss some of the many flaws with the McKinsey Report and also provide an overview of the SEC's recent actions against investor rights. We hope that this information will help you form your own views on these important issues that will have a significant impact on the future of securities litigation in this country.

The McKinsey Report[1]

The Proposed Limitations to Private Securities Actions

The McKinsey Report proposes a number of drastic reforms to private securities litigation that would result in an upheaval of the current regulatory and legal landscape. These include (i) closing the courthouse doors to securities lawsuits by forcing shareholders into mandatory arbitration proceedings, (ii) limiting the liability of foreign companies with U.S. listings to damages proportional to their degree of exposure to United States' markets, (iii) allowing interlocutory appeals of non-final orders, and (iv) placing a "cap" on the damages

[1] The McKinsey Report has a decidedly "pro-business" slant. It is based on interviews with "more than 50 financial services industry CEOs and business leaders," as well as a survey of "more than 30 other leading financial services CEOs" and "275 additional global financial services senior executives." McKinsey Report at 8.

recoverable against an auditor even if a jury finds that the auditor is liable for securities fraud.[2] These recommendations are misguided and unnecessary. If implemented, they would eviscerate the ability of defrauded shareholders to obtain a meaningful recovery in private litigation against parties who have committed fraud.

First, the McKinsey Report recommends that companies should be permitted to choose whether shareholder lawsuits can proceed in public courtrooms or must be forced into mandatory and confidential arbitration proceedings. This proposed reform is contrary to long-established notions of justice and access to the courts. By forcing shareholder lawsuits into arbitration, shareholders would no longer have the fundamental right to present their case to a jury. Nor would shareholders be able to use the broad discovery rules available to other civil litigants—the very rules that allow shareholders to obtain the "smoking gun" company documents, including email and other electronic documents, which are often the strongest evidence of fraud.

Further, our national court system has developed uniform procedures for the management of complex class actions and other shareholder litigation that ensures these important claims are addressed in a fair and balanced process that is not susceptible to abuse. For instance, all court proceedings in this country are open to the public and important shareholder lawsuits often receive extensive press coverage. In addition, final judgments by trial courts are subject to review by experienced and highly-capable federal appellate courts and, if necessary, by the United States Supreme Court. These protections provide important safeguards for investors pursuing claims against powerful corporate interests.

By contrast, arbitrations are typically conducted in private, overseen by arbitrators who have little or no experience with the relevant issues, and result in decisions that cannot be meaningfully reviewed, modified or overturned by any court. Even more troubling, because arbitrators are selected and paid by the parties, there is considerable evidence that arbitrators tend to be pro-defendant. This is because arbitrators, consciously or not, favor the "repeat customers"—*i.e.*, the corporations, investment banks and auditors that are mostly likely to select (and pay) arbitrators in the future.[3]

Second, the McKinsey Report contends that a cap is needed to limit the damages that shareholders can recover from foreign companies listing in the United States to an amount proportionate to the company's exposure to United States' markets. Imposing this type of cap would provide an unwarranted form of "diplomatic immunity" to foreign corporations that would permit those corporations to commit securities fraud in the United States while avoiding responsibility under United States law for the full measure of harm that the fraud causes investors. This approach would unwind decades of jurisprudence founded on the proposition that the United States cannot be used as a "base" for misconduct. As discussed below, the

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[2] McKinsey Report at 20-21.

[3] *See, e.g.,* Jean R. Sternlight "Panacea Or Corporate Tool?: Debunking The Supreme Court's Preference For Binding Arbitration," 74 Wash. U. L.Q. 637, 685 (Fall 1996).

McKinsey Report does not offer any compelling reason to allow foreign companies to escape liability for fraudulent practices that harm shareholders. We believe that foreign companies operating in this country should be held to the same standards to which all corporations must adhere: namely, if a corporation commits fraud, shareholders can pursue a claim for damages, without artificial limitations on the potential recovery.

Third, the McKinsey Report recommends allowing parties to immediately appeal interlocutory (non-final) orders of trial courts to the federal appellate courts. This recommendation is unnecessary and would be extremely harmful to shareholders' ability to pursue their claims in a timely fashion. As an initial matter, the McKinsey Report does not cite any evidence that trial courts are misapplying the law or being reversed with greater frequency than in the past. To the contrary, the percentage of securities class actions being dismissed has increased markedly since the enactment of the Private Securities Litigation Reform Act of 1995 (the "PSLRA").[4] Thus, the proposal is wholly unnecessary.

Moreover, the proposal would delay meritorious securities actions for months or even years while witnesses' memories fade, documents are lost or destroyed, and potential defendants go out of business. Indeed, it is commonly-accepted wisdom among experienced securities litigators that "delay favors the defendants." This prejudice to shareholders is particularly stark given that the PSLRA already imposes a strict discovery stay that prevents shareholder plaintiffs from obtaining any documents from the defendants until after motions to dismiss are decided—a process that often takes more than a year. Permitting appellate review of orders denying motions to dismiss (and any other non-final order) would virtually guarantee that this discovery stay would remain in place for substantially longer periods of time.

Finally, the McKinsey Report proposes placing an undefined "cap" on auditors' liability. There is no suggestion in the McKinsey Report, however, that the liability facing audit firms as a result of private securities litigation has markedly increased in recent years. Rather, securities lawsuits against audit firms have declined significantly since 2002—only one securities fraud class action was filed against an auditing firm in 2006, and only five were filed in 2005.[5] Moreover, the McKinsey Report's purported reason for the cap—to "reduce the likelihood of the ... US auditing industry losing another major player"—is wholly without basis. While the McKinsey Report claims that the auditing firm Arthur Andersen was liquidated because of the threat of securities-related litigation, this is patently incorrect.[6] Arthur Andersen collapsed because the U.S. Department of Justice indicted the firm for obstruction of justice in connection with the Enron debacle, not because of a securities fraud verdict.

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[4] "The Screening Effect of the Private Securities Litigation Reform Act," *by Stephen J. Choi, Karen K. Nelson & A.C. Pritchard,* May 2006.

[5] "Outside Audit: Booming Audit Firms Seek Shield from Suits," by David Reilly, *Wall Street Journal*, Nov. 1, 2006, p. C1; *Securities Class Action Case Filings: 2006 Mid-Year Assessment*," Cornerstone Research, 2006.

[6] McKinsey Report at 76.

There is no need for a liability cap to "protect" corporate auditors. A liability cap would simply insulate audit firms from legitimate shareholder claims and remove a strong incentive for such firms to conduct diligent audits with an emphasis on detecting fraudulent accounting practices by public companies. Caps would also increase rather than reduce litigation burdens on the courts. Without any further exposure at trial, audit firms would have little to no incentive to settle with shareholders for anything close to the liability cap even in the most meritorious cases.

Shareholder Litigation is Not Driving Foreign Companies Away From The United States' Financial Markets

The McKinsey Report attempts to justify the dangerously flawed policy reforms discussed above by citing to an alleged decline in the "competitiveness" of the United States' capital markets. In particular, the McKinsey Report contends that the growth of the stock markets and financial services industries in Europe and Asia is a competitive threat to New York's financial services sector. This purported justification for a broad curtailment of shareholder rights does not withstand scrutiny.

As an initial matter, the McKinsey Report fails to make out a convincing case that New York's preeminence as a financial market is seriously threatened. (This is perhaps not surprising given the record bonuses and profits recently experienced on Wall Street.) To support its argument, the McKinsey Report claims that, for the first ten months of 2006, United States' financial markets conducted only a third of the overall share of IPOs that they conducted in 2001.[7] Incredibly, the report—which was released on February 14, 2007—simply ignores data showing that, in November 2006, the SEC registered 32 IPOs worth a total of $8 billion—the highest monthly total in five years.[8] The report's disregard of this readily-available data suggests that the McKinsey Report and its CEO sponsors are straining to identify supposed threats to "competitiveness" in order to justify a blatantly anti-investor agenda.

Indeed, a recent study by Thomson Financial undercuts one of the main tenets of the McKinsey Report by demonstrating that foreign issuers are conducting IPOs in the United States in record numbers. Specifically, the study found that foreign IPOs accounted for 16% of the IPOs in this country last year, the highest proportion of foreign IPOs in the past twenty years. The study also found that IPOs of foreign companies conducted in the United States raised $10.6 billion, or 23%, of all IPO volume sold last year, which is the highest level since 1994.[9]

Another recent report, issued on February 14, 2007 by Goldman Sachs, concludes that certain IPOs are listing on foreign exchanges in Hong Kong, London and elsewhere largely

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[7] McKinsey Report at 43.

[8] "A Healthy, Well-Regulated Wall Street," Editorial, *New York Times*, Jan. 24, 2007.

[9] "Do Tough Rules Deter Foreign IPO Listings in U.S.", by Yvonne Ball, *The Wall Street Journal*, Feb. 20, 2007, p. C3.

because of the unavoidable—and largely beneficial—consequences of globalization. According to that report, many companies choose foreign exchanges because of "'[n]atural advantages, such as time zone, geographic adjacency and language."[10] For example, it is not surprising that the IPO for China Construction Bank, the largest IPO in the past five years, was conducted in Hong Kong. There certainly is no reason to conclude that this Chinese bank conducted its IPO on a Chinese exchange solely because it wished to avoid the hypothetical threat of shareholder litigation in the United States. As the Goldman Sachs study concludes, legal and regulatory factors such as a shareholders' right to pursue litigation when victimized by fraud are not the "critical drivers" behind the competitiveness of United States' financial markets.

One reason that many foreign companies choose to list on foreign exchanges is that they would not qualify for listing on the stock exchanges in the United States. Indeed, one of the largest initial offerings conducted outside the United States in 2005 was by PartyGaming—an online gambling concern whose business is prohibited under American law and whose officers face immediate arrest and prosecution if they enter the United States, let alone if they were to ring the opening bell on Wall Street. As should be clear, PartyGaming is not exactly the next Microsoft—its shares were initially priced at $2.12 on the London exchange but soon fell to approximately 0.70 cents, causing an aggregate loss to investors of more than $1 billion.[11] In addition, most foreign companies conducting offerings abroad are start-up companies being listed on London's "Alternate Investment Market" or "AIM"—a market created specifically for small companies that cannot meet the requirements to list on the major exchanges in New York.[12] As the McKinsey Report concedes, for many AIM-listed companies, the United States' capital markets are not an option due to certain minimum listing requirements.[13] In short, these companies are not avoiding the United States because of a purported fear of shareholder litigation, they are not permitted to list here.[14]

Shareholder Suits Are an Essential Component of a Well-Regulated Market

The McKinsey Report also claims that there is a need to eliminate so-called "frivolous" securities litigation. My December 8, 2006 letter discussed the important role that private litigation has played in encouraging transparency and accountability on Wall Street for nearly a century. My letter also discussed some of the many decisions of the United States Supreme

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[10] "Is Wall Street Doomed?", by Jim O'Neill and Sandra Lawson, *Global Economics Weekly*, Issue No. 07/06, February 14, 2007.

[11] "London's Freewheeling Exchange—It's Winning The Listings War Against New York, But Investors Can Get Burned," by David Henry, *BusinessWeek*, Nov. 27, 2006.

[12] For example, roughly half the companies listed on AIM fall under the $50 million market capitalization for listing on the NASDAQ, and nearly 75% fall under the $100 million required for listing on the NYSE.

[13] McKinsey Report at 11.

[14] Moreover, these IPOs constitute an extremely small percentage of the overall IPO market. While the average IPO conducted on AIM between January and June 2006 raised $60 million, the average IPO conducted in the United States during that time raised $205 million, or 340% more capital.

Court that have expressly recognized that private securities litigation deters fraud and helps ensure full disclosure of information to investors.

I will not repeat that discussion here, but I do note that the McKinsey Report fails to point to a single example of frivolous litigation since enactment of the PSLRA, let alone provide an example of a public company or audit firm being unduly harmed by meritless litigation. To the contrary, the McKinsey Report concedes—as any observer of securities litigation in the recent era of corporate mega-frauds must—that "many of these cases addressed the legitimate claims of investors and consumers in situations of notable corporate wrongdoing."[15]

Unable to provide any specific examples of "frivolous" litigation, the McKinsey Report repeatedly cites the billions of dollars defendants paid in 2005 and 2006 to settle securities litigation.[16] Even setting aside that these settlements returned substantial amounts to victimized shareholders (amounts far greater than the SEC has ever recovered), this argument is unconvincing. Focusing on large settlements in unquestionably meritorious cases—settlements that were obtained many years after the well-known mega-frauds of Enron, WorldCom, Global Crossing, Adelphia and others—provides no insight into current trends in shareholder litigation. Indeed, the empirical evidence shows that securities class action filings are at an all-time low, with 43 percent fewer class-actions filed in 2006 than the ten year historical average. Studies also show that the PSLRA has encouraged large institutional investors to seize control of private securities litigation and ensure that only the most meritorious cases, against the most culpable defendants, are filed and pursued.[17]

<u>Recent Actions by the SEC</u>

The questionable recommendations of anti-investor groups are troubling. What is even more disturbing, however, are recent actions of the SEC that suggest the agency itself intends to unilaterally limit the ability of shareholder victims to pursue private securities actions. This development is of particular concern to investors because the SEC is the primary government agency charged with protecting investors against securities fraud.

One illustration of the SEC's new-found hostility towards victimized investors is the *amicus curiae* (friend of the court) brief the SEC recently submitted to the Supreme Court in *Tellabs, Inc. v. Makor Issues & Rights Ltd.* in support of the defendants.[18] The issue before the

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[15] McKinsey Report at 16, 74.

[16] McKinsey Report at 16, 21, 74-76.

[17] Indeed, the filing of new securities class actions declined in 2005, and fell in 2006 to the lowest number since 1996. The attendant chance that a given company will face a securities class action has fallen from 1.4% in the period from 1993-1995 to just 1% today. Cornerstone 2007 Report.

[18] The case in the Supreme Court is captioned *Tellabs, Inc., et al. v. Makor Issues & Rights, Ltd., et al.*, and is on appeal from a decision of the Seventh Circuit Court of Appeals.

Supreme Court in *Tellabs* is the interpretation of a provision of the PSLRA that requires investors to plead facts "giving rise to a strong inference that the defendant acted with the required state of mind [referred to as scienter]." According to the plaintiffs' complaint in *Tellabs*, over the course of many months, the company's chief executive officer made repeated false statements about sales of the company's most important product. When the company corrected the CEO's false statements, the price of the company's publicly traded securities declined significantly, causing hundreds of millions of dollars in investor losses.[19] After a lower court dismissed the complaint for failure to adequately plead scienter, the United States Court of Appeals for the Seventh Circuit reinstated the complaint and allowed investors to proceed with their lawsuit.

The Supreme Court agreed to hear the case in order to determine whether the Seventh Circuit's interpretation of the PSLRA's pleading standards is correct. In its brief, the SEC argues for an extremely high pleading standard such that investor lawsuits would be dismissed at the pleading stage—before discovery—unless the investor can plead particularized facts showing a *high likelihood* that a defendant acted with scienter. The standard proposed by the SEC is significantly higher than the balanced standard adopted by the United States Court of Appeals for the Seventh Circuit, which held that a securities fraud suit should proceed if the complaint alleges particularized facts from which a reasonable person *could infer* that the defendant acted with scienter.[20] While this may seem like a technical legal point with few practical implications, it is, in fact, not. The majority of securities lawsuits that are dismissed at the pleading stage are dismissed for a failure to adequately plead scienter. Raising the standard for pleading scienter to the level that the SEC advocates would have devastating consequences on the ability of meritorious lawsuits to proceed to discovery and trial, and simply allow serious frauds to go unaddressed.

The SEC's position in *Tellabs* is disturbing for another important reason as well—it represents a significant departure from positions that the SEC has repeatedly taken in courts throughout the country on this same issue. For instance, in an *amicus curiae* brief the SEC submitted to the United States Court of Appeals for the Second Circuit in 1999, the SEC argued for a far more investor-friendly standard for pleading scienter and readily embraced its role as an advocate for investors. In so doing, the SEC repeatedly noted that the interpretation of the scienter standard "will have a significant impact on the [PSLRA's] effectiveness and on the *federal securities laws' protection of investors*" as they seek to recoup the trillions of dollars lost to fraud.[21] In its *Tellabs* brief, by contrast, the SEC barely acknowledges the role of the securities laws to protect investors, and instead emphasizes purported concerns about the "*costs on companies*" that private securities litigation entails.[22] This concern for the supposed "burden"

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[19] *See Makor Issues & Rights, Ltd. V. Tellabs, Inc,* 437 F.3d 588, 593 (7th Cir. 2006).

[20] *Id.*

[21] Statement of the Securities and Exchange Commission, *Amicus Curiae*, in Support of Appellants on the Issues Specified, at 2, March 1999. Submitted in *Novak v. Sally Frame Kasaks*, No. 98-9641 (2d Cir. 2000).

[22] Brief for the United States as *Amicus Curiae* Supporting Petitioners, at 1, February 9, 2007. Submitted in

placed on companies represents a radical departure from the SEC's previous position that a lower standard of scienter in private securities actions:

> would encourage corporate directors and officers to put their heads in the sand and would have enormously counterproductive effects on the integrity of corporate disclosure and the quality of corporate governance.[23]

The SEC's unwillingness to acknowledge to the Supreme Court what it previously represented to the Second Circuit Court of Appeals—that raising the pleading standards for scienter would have significant negative consequences on corporate governance—is troubling evidence that the SEC is no longer acting in the best interests of the investors it is supposed to serve.

The SEC's recent change in outlook is further evidenced by the fact that, on February 9, 2007, Conrad Hewitt, the SEC's chief accountant, told a conference of securities professionals that the SEC is considering using its rule-making power to impose a cap on auditor liability.[24] By imposing such a cap through agency rule-making, the SEC would overturn decades of legal precedent and Congressional policy choices. Moreover, the SEC would be making a unilateral regulatory decision that would prevent these issues from being openly debated in Congress and addressed in the context of a fully-informed legislative process. That the SEC is even considering such an action is cause for significant concern. As Lynn E. Turner, former chief accountant of the SEC, stated recently: "It is clear from these actions that this is a commission intent on reversing seven decades of rule making, by Democrats and Republicans, that have protected investors and opposed shielding auditors. *This administration and this agency are very pro-business and anti-investor.*"[25]

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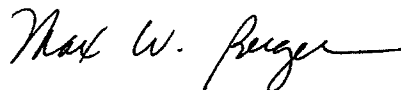
Given these recent developments, we urge each of you to review the McKinsey Report and to reflect on the recent actions of the SEC. We believe that it is extremely important for all investors to make their views known to their representatives, constituents, and the SEC. All investors have a stake in ensuring that our capital markets remain the fairest and most open in the world, and we submit that the time is now for each and every one of us to add our voices to the public debate.



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Tellabs, Inc., et al. v. Makor Issues & Rights, Ltd., et al, No. 06-484.

[23] Statement of the Securities and Exchange Commission, *Amicus Curiae*, in Support of Appellants on the Issues Specified, at 9-10, March 1999. Submitted in *Novak v. Sally Frame Kasaks*, No. 98-9641 (2d Cir. 2000).

[24] "SEC Seeks to Curtail Investor Suits," by Stephen Labaton, *New York Times,* February 13, 2007.

[25] *Id.*