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Re: Committee on Capital Markets Regulation Proposes to Scale Back Protections for United States Investors

Dear Friends and Colleagues:

A shareholder's power to pursue private litigation when victimized by fraud is an elemental aspect of corporate governance and shareholder rights in the United States. For over half a century, shareholder lawsuits have encouraged transparency and accountability on Wall Street, returned billions of dollars to the hands of defrauded investors, and helped sustain public faith in our capital markets—all without asking a penny from the taxpaying public. The Supreme Court of the United States has repeatedly described private anti-fraud lawsuits as "a most effective weapon in the enforcement of the securities laws and a necessary supplement to [Securities and Exchange] Commission action." *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985). Since the regulatory reforms enacted in the wake of the market crash of 1929 and the Great Depression that followed it, a shareholder's right to private enforcement of the federal anti-fraud rules has been a critical element of securities regulation in the United States.

That framework is now threatened. Powerful interests dogmatically opposed to private securities litigation (and to any regulation more generally) are poised to wield their influence in an effort to limit private securities litigation and reduce standards of corporate accountability in the United States. At the heart of this effort is the oft repeated though fundamentally flawed contention that American capital markets have grown "uncompetitive" in comparison to foreign counterparts as a result of excessive litigation and regulation. In order to defeat the supposed threat of competition from overseas, we are told that we must eviscerate investor protections in our own country in a cynical race to the unregulated bottom. We strongly disagree with the notion that more fraud or an increased tolerance for fraud would make United States capital markets more competitive in any way.

The so-called "Committee on Capital Markets Regulation" (the "Committee") is the most prominent public face of the effort to diminish investor protections and corporate accountability in our capital markets. Also known as the "Paulson Committee" for its close association with recently appointed Treasury Secretary Henry Paulson, the Committee was established in September 2006 for the stated purpose of conducting a "major study of how to improve the competitiveness of the U.S. public capital markets."

The Committee released its Interim Report (the "Report") on November 30, 2006, setting forth its recommendations for a considerable scaling back of investor protections in the United States. Among its targets are the Sarbanes-Oxley Act reforms enacted in response to the wave of corporate scandals in the earlier part of this decade—particularly those reforms designed to improve internal controls—and the ability of state Attorneys General to prosecute corporate malfeasance. The Committee's proposals aimed at shareholder litigation include liability caps for auditors, more lenient standards for outside directors, "clarification" of several elements of securities fraud to favor corporate defendants, and the possibility of requiring arbitration in securities litigation. Taken together, the Committee's recommendations have the potential to substantially restrict a shareholder's ability to take successful legal action when a fraud has occurred. These proposed restrictions are misguided and unnecessary and should be opposed on multiple grounds.

Private enforcement of the securities laws keeps corporate disclosure honest in the United States. American capital markets are widely recognized as the world's most open and transparent—a key strength of the American economy. As then-Senator Paul Sarbanes stated in his address to the floor of the Senate with the introduction of the Sarbanes Oxley Act in 2002, "[o]ur financial markets have long been regarded as the fairest, the most transparent, and the most efficient in the world. In fact, I think it is fair to say—and many of us have said it time and time again—that the American capital markets are one of the great economic assets of this country and a very important source of our economic strength."

Private lawsuits by shareholders make a substantial contribution to keeping our financial markets transparent by imposing real consequences for securities fraud and by ensuring accountability to shareholders, the true owners of public companies in the United States. The Supreme Court of the United States has repeatedly recognized the key role that effective private litigation by shareholders plays in deterring fraud in America's securities markets. *See, e.g., Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 345 (2005) ("The securities statutes seek to maintain public confidence in the marketplace. They do so by deterring fraud, in part, through the availability of private securities fraud actions."). Erecting further hurdles to impede shareholder lawsuits, as the Committee proposes, would simply be an invitation to more securities fraud.

Indeed, recent history suggests a direct relationship between limiting a shareholder's ability to sue and the prevalence of securities fraud. The last time Congress placed limits on private securities litigation was with the Private Securities Litigation Reform Act of 1995 (the "Reform Act"), which, in an effort to curb shareholder lawsuits regarded as abusive, placed difficult barriers before shareholder plaintiffs, including a discovery stay unique to securities litigation and a pleading standard that is widely

considered the most difficult standard applied to plaintiffs in any field of civil litigation in the United States. The result was an increase in dismissals of securities fraud lawsuits and, unsurprisingly, the parade of corporate horribles that rocked our capital markets in the late 1990s and the early part of this decade— WorldCom, Enron, HealthSouth, Tyco, Global Crossing, Adelphia, Refco, the mutual fund market-timing scandal, stock-option backdating, and the list goes on. Having only recently emerged from the rash of corporate scandals that verged on a crisis of confidence in our capital markets, it seems exceedingly naïve to suggest that ***further*** limits on private securities litigation are now in order.

It is likewise unrealistic to think that the SEC—a government agency subject to budgetary and political limitations—could take the place of effective private enforcement by shareholders. As *The Wall Street Journal* recently noted, for example, "[s]ome experts think the SEC's budget would need to increase three-or four-fold for it to be sufficiently funded"—and that without picking up the massive slack that would be left if the Committee's proposals were enacted. In fact, the inability of the SEC to conduct the full array of investigation and litigation necessary to maintain transparency in our capital markets has been one of the key rationales articulated by the Supreme Court in favor of private securities litigation. For example, in *J. I. Case Co. v. Borak*, the Supreme Court permitted private rights of action for fraudulent proxy statements explaining that:

> Private enforcement of the proxy rules provides a necessary supplement to Commission action. [T]he possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements. The Commission advises that it examines over 2,000 proxy statements annually and each of them must necessarily be expedited. Time does not permit an independent examination of the facts set out in the proxy material and this results in the Commission's acceptance of the representations contained therein at their face value, unless contrary to other material on file with it.

377 U.S. 426, 427 (1964). Similarly mindful of its own limitations, the SEC has consistently supported effective private enforcement by shareholders in some fifty years-worth of *amicus* briefs before the Supreme Court and other federal courts. For example, in the well-known case of *Novak v. Kasaks*, the SEC filed an *amicus* brief with the Court of Appeals for the Second Circuit supporting the plaintiff-appellants' argument that the district court had created too high a barrier for private plaintiffs pleading securities fraud. The Second Circuit agreed and reversed the district court, issuing a seminal decision interpreting the Reform Act. *Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000). Today, one need only observe the SEC's difficulty summoning sufficient resources to investigate the

many companies involved in the stock-option backdating scandal to recognize that the SEC could not reasonably be expected to carry the burden of all securities fraud litigation in the United States. Notably, although the Committee proposes numerous barriers to private enforcement of the securities laws, the Committee does not call for any concomitant increase in funding for the SEC. Further, given recent political appointments and pronouncements, one can be less than sanguine about the SEC as a vigorous advocate for shareholder rights.

The importance of private securities litigation is borne out not only by the possibility of such limitations at the SEC, but also by the very method that the Committee proposes to achieve its goal. Recognizing that Congress is highly unlikely to act to significantly curtail private securities litigation, the Committee proposes numerous reforms that the SEC could enact unilaterally, by means of rule and policy changes, to limit a shareholder's right to sue when harmed by fraud. Thus the Committee proposes that a government agency abruptly change its policy at the insistence of influential representatives of investment banks, auditors, and corporations, and then serve as the ***only*** entity with the ability to take effective legal action against these same firms. Such a scenario offers little comfort to investors and will do little to make our capital markets more competitive.

Shareholder lawsuits have returned billions of dollars in compensation to defrauded investors—nearly $50 billion since the 1995 Reform Act alone. Although the Committee repeatedly calls for securities regulation policy to be based on a cost/benefit analysis, the substantial sums returned to investors through private litigation are unlikely to be given sufficient weight in the thinking of the Committee's membership. History also demonstrates that the damage recoveries obtained for investors by the SEC pale in comparison with those obtained by private plaintiffs. In the *WorldCom* litigation, for example, the SEC obtained approximately $750 million for that company's aggrieved investors—a sum far lower than the more than $6 billion obtained through the *WorldCom* securities class action. Indeed, one of the Committee's proposals might actually have required that the $6 billion *WorldCom* recovery to investors be reduced by the $750 million obtained by the SEC.

The Committee also dismisses private securities litigation as a wasteful circular transfer of wealth from one group of innocent shareholders to another. This critique is misguided as well. An investor who purchases a stock that is artificially inflated due to fraud and holds that stock through a corrective disclosure and consequent market correction is unquestionably injured as a result of the fraud and ought to be made whole by the corporation and the others responsible in the same way as would any other victim of a tort by a corporation. In contrast, an investor who purchases shares after the corrective disclosure has occurred and a lawsuit has been filed purchases with full knowledge of the corporation's potential liability and therefore suffers no harm as a result

of the investment.

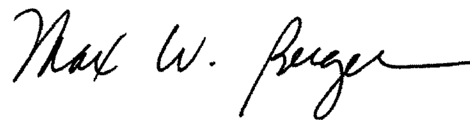
There is also no support for the Committee's underlying premise that United States capital markets have become uncompetitive in recent years as a result of excessive litigation and/or regulation. The Committee's principal evidence for this supposed competitive decline is the increase in IPOs listing on foreign exchanges—in London and Hong Kong in particular—since the Sarbanes-Oxley Act reforms. In fact, the United States' share of global IPOs peaked in 1996 and began declining thereafter—years before the recent wave of corporate fraud and the consequent enactment of Sarbanes-Oxley in 2002. The Committee's focus on IPO listings is also far too narrow and excludes numerous other measures of the health of United States capital markets. For example, the United States retains roughly half of the total stock market capitalization of the entire world and companies are regularly rewarded a premium for listing in United States markets, which continue to be regarded as the fairest and most transparent on earth.

Moreover, one cannot reasonably blame private securities litigation for the increased number of IPOs that took place in foreign exchanges in the past several years. Private securities litigation has been a fixture of the American legal landscape since a private right of action under Section 10(b) was first recognized shortly after the Second World War in the landmark case of *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). (Incidentally, the SEC submitted an *amicus* brief supporting the private right of action in that case.) Since that time, the United States has experienced a period of phenomenal economic prosperity and development and its capital markets have consistently been the envy of the world. To blame over sixty years of private securities litigation for global economic developments occurring only in the past several years is illogical and arbitrary. Perhaps unsurprisingly, the Committee discounts numerous far more likely explanations for the rise in IPOs overseas, such as the fact that underwriting fees charged by investment banks are often substantially higher in the United States than abroad.

Finally, let us consider the source. The Committee's membership consists almost exclusively of representatives of investment banks, auditors, and corporate issuers—the very entities and individuals most likely to benefit from the Committee's proposed limitations on shareholder litigation. For example, one of the Committee's main proposals is for caps on liability for auditors and the Committee's membership actually includes chief executive officers of both Deloitte and PricewaterhouseCoopers. In contrast, the Committee excluded any former regulators—including any former SEC officials—on the basis that, as the Committee's Co-Chair explained, "[t]hey may have a lack of objectivity." Plainly, a potential lack of objectivity was only a concern in connection with individuals unlikely to agree with the Committee's preconceived notions. The institutional investor community is likewise unrepresented. Further, as has been revealed in the *Washington Post*, funding for the Committee's work was provided in

large part by the C.V. Starr Foundation, described as a charity with "longstanding ties to Maurice R. Greenberg"—the former chairman of AIG, who himself stands accused of committing a massive securities fraud.

We urge each and every one of you to review the Committee's recommendations and to form your own conclusions concerning its proposals. Most importantly, we urge you to make your views known to your representatives, colleagues, and constituents. The Committee's Report is most likely only the first volley in what will be prove to be a longer public debate on the future of securities litigation and regulation in the United States. We believe that time is of the essence for all of us to make our views known as widely and publicly as we can.



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