

# **DAVIES REVIEW OF ISSUER LIABILITY**

## **INNACURATE STATEMENTS MADE TO THE MARKET: UNITED STATES**

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## QUESTIONS ON FOREIGN SYSTEMS

### INNACURATE STATEMENTS MADE TO THE MARKET

#### 1. Does the law in principle impose liability for market statements?

Yes. Actions for violations can result in injunctive relief, damages, or criminal liability. Civil liability imposed for damages in securities class actions is the difference between the price at which the investors purchased or sold the security and what the price would have been but for the misrepresentation.<sup>1</sup> Criminal liability may attach for wilful violation of the 1933 Act or the 1934 Act, punishable by fine or imprisonment. Claims under 10b-5 account for the “vast majority”<sup>2</sup> of securities litigation- yet there is ambiguity over some of its key elements:

#### Elements of 10b-5

##### *False or misleading material statement or omission*

Plaintiffs must show that the misrepresentation or omission was material, i.e., that a reasonable investor would likely consider the misstatement important. The Third and Ninth Circuits are split as to whether a statement that produced no effect on the market is “immaterial” as a matter of law. In the Third circuit, such a statement can be immaterial as matter of law, whereas in the Ninth Circuit statements can still be material even if market failed to react.<sup>3</sup>

##### *Scienter*

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<sup>1</sup> James D. Cox and Randall S. Thomas, Public and Private Enforcement of the Securities Laws: Have Things Changed Since Enron?, Vanderbilt University Law School Law and Economics Working Paper 05-02 (2004) [Hereinafter “Public and Private Enforcement”]

<sup>2</sup> For more detail on a comparison of bases for liability and why 10b-5 might be the dominant cause of action, see Question 2, *infra*.

<sup>3</sup> Interim Report of the Committee on Capital Markets Regulation [Hereinafter “Scott Report”] 80. November 30, 2006.

Plaintiffs must show that a defendant acted with more than negligence: with intent to deceive, manipulate, or defraud. Whereas the Second Circuit has established “motive and opportunity” as the basis for plaintiffs to establish strong inference of fraudulent intent, the Ninth Circuit has created the more nebulous “deliberate recklessness” standard.<sup>4</sup>

### *Causation*

Plaintiffs must show that misstatement of which they complain actually caused the loss/damage. The plaintiff must have actually relied, cannot say “would have sold.”

### *Reliance*

It is not necessary to show reliance for an omission. “Fraud on the market” theory introduces a rebuttable presumption of reliance on false/misleading statements, though Circuits are split as to how to prove an “efficient market” exists to create the presumption of reliance. For more detail on the “fraud on the market” theory, see Question 5, *infra*.

## **2. Does legislative policy encourage/discourage private litigation?**

In general, class action securities litigation has a negative public image. It is perceived as resulting in small sums for injured class members while generating enormous amounts in attorneys fees-- typically between 25 and 35 percent of recovery.<sup>5</sup> The notion that securities class actions effectively compensate injured parties is contradicted by data suggesting that the average securities class action settles for between two and three percent of investors’ losses.<sup>6</sup> Moreover, there has been concern expressed over the “circularity” of settlements, because costs are paid by diversified shareholders to diversified shareholders—those who traded get paid by those who did not. Securities class actions take on average 5 years to settle, such that settlements often benefit former shareholders at the expense of current ones.

Institutional investors, commonly defrauded beneficiaries, often fail to perfect their claims in settlements, perhaps because they do not see their participation as in such suits as good use of staff

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<sup>4</sup> *Id.* at 80. See Question 3, *infra* for post-PSLRA scienter standards.

<sup>5</sup> Cox and Thomas, Public and Private Enforcement, *supra* note 1.

<sup>6</sup> *Id.*; Scott Report, *supra* note 3 at 79.

time, or owing to conflicts of interest (corporate defendants or their money managers are often the customers of large institutional investors such as banks and mutual funds) and because “Standing shoulder to shoulder with the class action lawyers does not win one friends in the executive suites or at the club.”<sup>7</sup>

Given these challenges to making class action securities suits effective for their deterrent or compensatory mechanisms, broadly speaking, legislative policy has been designed with the intent to discourage frivolous litigation while retaining securities suits with merit. The Private Securities Litigation Act of 1995 (PSLRA) and the Securities Litigation Uniform Standards Act of 1998 (SLUSA) have been the two primary legislative acts shaping modern securities law enforcement.

#### The Private Securities Litigation Reform Act (PSLRA) of 1995

The PSLRA was enacted by Congress to reduce the incidence of frivolous litigation<sup>8</sup> and to ensure that suits went forward for the benefit of investors rather than lawyers. The initial lobbying force behind the PSLRA was the accounting industry, later joined by common class action defendants such as the defense bar and tech industry leaders. According to these reform advocates, plaintiffs were using a sudden drop in a company's stock price as evidence that the issuer and its agents had been misrepresenting the company's operations or performance in order to inflate its stock price.

Critics of these securities class actions alleged that plaintiffs' lawyers were filing such suits against "deep pocket" defendants -- whether or not these defendants actually committed fraud. Faced with the cost of discovery, defendants contended that the pressure to settle was enormous, forcing "innocent parties to settle frivolous securities class actions." Even if a company were willing to bear the expense of litigation, critics charged that companies inevitably settled rather than face a

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<sup>7</sup> See Question 6, *infra*, for more details on the role of institutional investors as lead plaintiffs; James D. Cox and Randall S. Thomas, *letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, Vanderbilt University Law School Law & Economics Working Paper 05-01 (2004). [Hereinafter “Empirical Evidence”].

<sup>8</sup> Based on the overall effect that the liability exposure was “chilling issuers from making statements about their businesses.” Adam C. Pritchard, *Should Congress Repeal Securities Class Action Reform?* University of Michigan John M. Olin Center for Law and Economics Working Paper 03-003 at 7 (2003).

potentially ruinous jury verdict.<sup>9</sup> Thus, the PSLRA intended to discourage the filing of meritless suits by instituting a number of procedural barriers for securities fraud claims.<sup>10</sup>

*Procedural barriers introduced by the PSLRA*

- Stay on discovery until after suit survives motion to dismiss.
- Imposition of a rebuttable presumption and imposition of sanctions for any aspect of a complaint that is in violation of any part of Rule 11 of the Federal Rules of Civil Procedure, further specifying that the sanctions will consist of payment of the prevailing party's attorneys' fees and costs incurred in the entire action.<sup>11</sup>
- Requirement that courts review attorney's fees for reasonableness.
- A "Lead Plaintiff" provision, requiring national publication of a notice advising class members that the action has been filed. The PSLRA then directs the court to appoint a "lead plaintiff" from among the class members, the presumption being that the most suitable plaintiff is the class member that has the largest financial interest in the relief sought. The lead plaintiff may then select counsel for the class.<sup>12</sup>
- Safe harbor for forward-looking statements that are not knowingly false and have been qualified by cautionary language.
- Eliminating securities fraud as the basis for civil racketeering claims under the Racketeer Influenced and Corrupt Organizations Act (RICO) of 1970, with its potential for treble damages.<sup>13</sup>

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<sup>9</sup> Office of the General Counsel, U.S. Securities and Exchange Commission, Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995, at 1 (1997) at <http://www.sec.gov/news/studies/lreform.txt> [hereinafter SEC Report].

<sup>10</sup> Pritchard and Sale, What Counts as Fraud? An Empirical Study of Motions to Dismiss Under the PSLRA. University of Iowa Legal Studies Research Paper No. 05-12 at 3 (2003).

<sup>11</sup> Pamela H. Bucy, Private Justice, 76 S. CAL. L. REV. 1, 28 (2002).

<sup>12</sup> "The lead plaintiff selects counsel for the class, subject to court approval. The lawyer who initially filed the action hopes to fill that role, but need not." Pritchard, *supra* note 8, at 6-7.

<sup>13</sup> *Id.* at 8.

- A heightened pleading standard applying to all private actions arising under the Securities Exchange Act of 1934 in which the plaintiff alleges that the defendant made material misstatements or omissions. The heightened standard calls for:
  - A specificity requirement with respect to allegations that a statement or omission is false or misleading. The complaint is required to specify which statements are misleading and the reasons why the statements are misleading.
  - Second, when a complaint is pleaded on information and belief, the plaintiff must state "with particularity all facts on which that belief is formed."
  - Third, plaintiffs are required to "state with particularity facts giving rise to a *strong inference* that the defendant acted with the required state of mind."<sup>14</sup> (emphasis added).

### Effects of the PSLRA

The Reform Act has resulted in an increased percentage of securities fraud class actions being dismissed.<sup>15</sup> Companies engaged in fraud where no hard evidence (accounting restatements or an SEC investigation) of fraud is publicly announced pre-filing of a suit are significantly less likely to face a private securities class action in the post PSLRA period. On the other hand, the presence of hard evidence makes it more likely that plaintiffs attorneys will recover a large amount of money.<sup>16</sup>

### Class Actions as Deterrents or Compensatory Mechanisms

Post PSRLA, although a higher percentage of class action securities lawsuits are being dismissed than before the Act, the ones that survive lead to higher settlements. At least one scholar has concluded that the combination of "higher settlements and a smaller percentage of such cases

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<sup>14</sup> Michael A. Perino, Did the Private Securities Litigation Reform Act Work? U. ILL. L. REV. 913, 926 (2003).

<sup>15</sup> Stock Price Reactions to Securities Fraud Class Actions Under the PSLRA. Ferris and Pritchard, University of Michigan Working Paper 01-009 at 2. <http://www.law.umich.edu/centersandprograms/olin/papers.htm>.

<sup>16</sup> Stephen J. Choi, Do Merits Matter Less After the PSLRA? University of Southern California Olin Law and Economics Research Paper Series 04-16 at 8 (2005).

getting to trial suggests that the class action lawsuits under the PSLRA are doing a more cost-effective job of deterring corporate fraud.<sup>17</sup>

On the other hand, from the perspective of compensation to harmed investors, authors of one study found that the ratio of settlement amounts to estimated provable losses in securities class actions - the most important indicator of whether investors have been compensated for their damages - has been lower since the passage of PSLRA and that settlement size has not increased since the passage of PSLRA.<sup>18</sup>

The same authors also found that, with the exception of the small set of cases where institutional investors have acted as lead plaintiffs, there are no significant differences between the pre-PSLRA and post-PSLRA cases with respect to almost every relevant characteristic: settlement amounts, length of class period, size of defendant firms, and estimated provable losses. "...[O]nly institutional investor lead plaintiffs appear to be associated with any difference in these metrics."<sup>19</sup>

### Securities Litigation Uniform Standards Act of 1998

By bringing putative class action under state law rather than under federal securities laws, plaintiffs were able to skirt the procedural hurdles and heightened pleading standards of the PSLRA. In response, the Securities Litigation Uniform Standards ACT (SLUSA) bars certain securities class actions from being brought in state court if they involve the securities of companies whose shares are traded on a national exchange or on NASDAQ's national market, making federal courts the exclusive venue for many securities fraud class actions.

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<sup>17</sup> See Pritchard, *supra* note 8.

<sup>18</sup> James D. Cox and Randall S. Thomas, *Litigation Reform Since the PSLRA: A Ten-Year Retrospective. Panel One: PSLRA: Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587, 1590 (2006) [hereinafter Cox and Thomas, *Does the Plaintiff Matter*].

<sup>19</sup> *Id.* at 1591.

- 3. Does the law distinguish between different types of statement, e.g., statements made in periodic reports (yearly or half-yearly or others), statements required to be made to the market, for example, about significant events affecting the company, voluntary statements made by companies to the market?**

### Disclosure Requirements Generally

Although the Securities Exchange Act of 1934 establishes a continuing periodic disclosure system for issuers whose securities are traded on a national securities exchange or in the organized over-the-counter market or are otherwise widely held in the United States, apart from that there is no general continuous disclosure requirement under the federal securities laws.

U.S. anti-fraud provisions create liability for material misstatements or omissions, though it is not entirely clear when a legal obligation to disclose arises, and decisions to disclose are decided on a case-by-case basis. Therefore, any disclosure, including interim and annual reports, requires careful examination of whether any material information is being misstated or omitted.<sup>20</sup>

#### *Episodic Reporting Requirements*

Disclosure is mandated episodically for such events as public offerings, proxy solicitations, and tender offers.<sup>21</sup> Section 12 of the 1934 Act requires companies above a certain size whose securities are traded in the United States to register with the SEC under the 1934 Act. A company whose securities are registered under Section 12 of the 1934 Act must file with the SEC an annual report, a quarterly report, and current reports within 15 to 5 days (depending on the type of event) of when material events occur.

#### *Disclosures required by the stock exchanges*

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<sup>20</sup> Bartos, Jim. UNITED STATES SECURITIES LAW: A PRACTICAL GUIDE 132 (2006).

<sup>21</sup> See Cox and Thomas, Public and Private Enforcement, *supra* note 1.

The NYSE, Amex and NASDAQ require companies with listed or quoted securities to make public promptly by a press release or by any other means information that would reasonably be expected to materially affect the price or market for the company's securities.<sup>22</sup>

### *Forward-looking statements*

In respect of statements predicting future performance, a company is required to disclose facts or trends that may have an impact on future results or events that are certain to occur in the future if such changes are material. Forward looking statements, on the other hand, involve anticipating a future trend that a company is not required to disclose.<sup>23</sup> The PSLRA introduced safe harbour provisions for forward-looking statements under the 1933 and 1934 Acts, whereby such statements are shielded from civil liability as long as a) such statements are identified as such and contain cautionary language tailored to identify factors that may cause actual results to differ or b) the complaining party cannot prove that the author of such statement had actual knowledge that the forward-looking statement was false or misleading.

The safe harbour is available for both oral and written statements by issuers and their directors, officers, and underwriters but the safe harbour excludes statements included in financial statements prepared in accordance with US GAAP and applies only to private actions.<sup>24</sup>

### Liability for Disclosure

#### *Section 11 of the 1933 Act*

Section 11 of the 1933 Act provides a private right of action for material misstatements or omissions in a registration statement and prospectus at the time the statement becomes effective. The plaintiff must have bought the security covered by the registration and is entitled to receive in damages the difference between the offering price and the price of the security on the date on which the action was brought or the price at which the security was sold. Section 11 claims are capped at the offering price.

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<sup>22</sup> Bartos, *supra* note 20 at 131. *See also* PSLRA safe harbor provisions under Question 3, *infra*.

<sup>23</sup> Bartos, *supra* note 20 at 210.

<sup>24</sup> *Id.* at 211.

Liability under Section 11 extends to the issuer, any person who signed the registration statement, the members of the issuer's board of directors, the underwriters and with respect to the portions of the statements they certified, the auditors or other experts. All parties other than the issuer have a due diligence defence to liability if they can prove that they had reason to believe and did in fact believe that the registration statement contained no material misstatement or omission.<sup>25</sup>

### *Section 12 of the 1933 Act*

Whereas Section 11 applies to the registration statement and prospectus at time of effectiveness, Section 12 applied to all information conveyed to the buyer at the time of sale.<sup>26</sup> Section 12a(1) provides a private right of action against a person who offers or sells a security in breach of Section 5 requirements for prior registration or for failure to distribute a final prospectus and Section 12a(2) provides a private right of action against any person who offers or sells a security by means of a prospectus or on the basis of oral communications containing material misstatements or omissions necessary to make the statements "in light of the circumstances under which they were made" not misleading.

Both Section 12(a)(1) and Section 12(a)(2) provide claims against any person who plays a material and active part in the sale and the action must be brought by the purchaser of the security, who is able to obtain rescission or equivalent damages.

### *Section 17 of the 1933 Act*

Section 17 of the 1933 Act prohibits any person from offering or selling any security by means of (i) a scheme or device to defraud, (ii) a material misstatement or omission, or (iii) a transaction or practice which would defraud or deceive the purchaser. Section 17 covers all offerings. US courts are divided as to whether it provides a private right of action though it remains a "powerful enforcement tool" for the SEC.

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<sup>25</sup> Under Section 11 there is a safe harbour for certain forward-looking statements. *Id.* at 218.

<sup>26</sup> *Id.* at 219.

*Section 18 of the 1934 Act*

Section 18 of the 1934 Act provides a private right of action against an issuer, and potentially an issuer's officers and directors, for a material misstatement or omission in any document filed with the SEC under the 1934 Act by any person who bought or sold securities in reliance on such statement at a price which was affected by the statement. In contrast to 10b-5, Section 18 does not require a showing of scienter and provides a defence if statements were made in good faith. However, Section 18 is not as commonly relied on as 10b-5 because of its heightened reliance and causation requirements; "reliance" under Section 18 cannot be predicated on a "fraud on the market" theory.

*Section 10 of the 1934 Act*

Section 10 of the 1934 Act is the broad anti-fraud provision which prohibits any person from using a manipulative or deceptive device in connection with the purchase or sale of any security, whether registered or unregistered. In addition to the SEC enforcement powers, Rule 10b-5 provides a clear private right of action and violations of 10b-5 are present in over 60% of all private class actions filings. Because 10b-5 imposes liability "in connection with" purchase and sale of securities, it can relate to any information released to the market which would affect trading. Thus, the putative defendant person need not be engaged in selling or buying and material misstatements by a corporate officer or press releases would be actionable under 10b-5.<sup>27</sup>

*Additional grounds for liability in the '33 and '34 Acts*

Section 15 of the 1933 Act provides that any person who controls a person who violated Sections 11 or 12 is also jointly and severally liable unless such control person had no knowledge of the violation or no reasonable grounds to conclude that the violation was occurring.

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<sup>27</sup> *Id.* at 217; See Eric L. Talley, *Litigation Reform Since the PSLRA: A Ten Year Retrospective: Panel Two: Cataclysmic Liability Rink Among Big Four Auditors* 106 COLUM. L. REV. 1641, n28 (2006).

Section 20 of the 1934 Act provides that persons controlling any person found liable under the 1934 Act shall also be liable, jointly and severally with the controlled person, unless the controlling person acted in good faith and did not directly or indirectly induce the acts constituting the violation.

### *Criminal liability*

Section 24 of the 1933 Act sets out criminal penalties, whereby any person who wilfully violates any provision of the 1933 Act is subject to a fine of up to \$100,000 or up to five years imprisonment, or both.<sup>28</sup> Section 32 of the 1934 Act provides that any person who “wilfully” violates the 1934 Act or “wilfully and knowingly” makes false or misleading statements with respect to a material fact in a filed document is subject to a fine of up to \$5M (\$20M for a non-natural person) or imprisonment up to 20 years or both.

### *Liability provisions in the Sarbanes-Oxley Act of 2002*

For private plaintiffs, the most salient provision of Sarbanes-Oxley was the extension of the statute of limitations for filing private securities action. Traditionally, private plaintiffs had a minimum of one year from discovering the act of fraud, or three years from its actual occurrence, to file a claim. Under Sarbanes-Oxley, limits were increased to two and five years, respectively.

Sarbanes-Oxley also applied criminal and civil liability with respect to the CEO and CFO certification of financial statements and other disclosures in reports under the 1934 Act, which, stands to effect claims by private plaintiffs though such liability exclude private rights of action.<sup>29</sup>

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<sup>28</sup> *Id.* at 216.

<sup>29</sup> *Id.* at 219; Eric L. Talley, *Litigation Reform Since the PSLRA: A Ten Year Retrospective: Panel Two: Cataclysmic Liability Rink Among Big Four Auditors* 106 COLUM. L. REV. 1641, 1655 (2006).

#### 4. What is the basis for such liability: negligence, intention, recklessness, strict?

##### Scienter requirement generally

In order to bring a claim under Rule 10b-5 a showing of negligent conduct will not suffice; the defendant must have acted with scienter or, broadly speaking “knowledge.” Although the precise definition remains unsettled, most federal courts will find that a reckless disregard of the truth under certain circumstances will constitute the requisite degree of scienter.<sup>30</sup>

##### *Pre-PSLRA pleading standard for scienter*

Pre-PSLRA, there had been a circuit split over the pleading standards for the Rule 10b-5 scienter requirement. The Ninth Circuit allowed plaintiffs to plead scienter generally but demanded particularity in all other elements of securities fraud, whereas the Second Circuit required plaintiffs to plead the state of mind with particularity, requiring pleading that defendants had the motive to commit fraud and the opportunity to do so with circumstantial evidence of either recklessness or conscious behaviour.

##### *Post-PSLRA pleading standard for scienter*

The PSLRA adopted Second Circuit’s “strong inference” provision, requiring that “...[T]he complaint shall...state with particularity facts giving rise to a *strong inference* that the defendant acted with the required state of mind” (emphasis added.) Even with the requirement that plaintiffs plead scienter with particularity, the “strong inference” language has led to another, subsequent, Circuit split as to how much detail is in fact necessary to give rise to a “strong inference.”

##### *Second and Third Circuit pleading standard for scienter*

The Second and third Circuits have held that the PSLRA codified the Second Circuit’s pre-PSLRA approach, under which a plaintiff can adequately plead scienter by alleging facts showing

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<sup>30</sup> *Id.* at 217.

motive for committing securities fraud and the opportunity for doing so (“motive and opportunity”).) Plaintiffs in the Second Circuit can plead a “strong inference” of fraudulent intent by including sufficient allegations that the defendants received concrete, personal benefits from the alleged fraud; participated in deliberately illegal behaviour; knew or had access to facts “suggesting that the statements were inaccurate; or “failed to check information they had a duty to monitor.

#### *Ninth Circuit pleading standard for scienter*

The Ninth Circuit rejected the “motive and opportunity” test and developed what is perceived as a more stringent scienter standard. A post-PSLRA plaintiff in the Ninth Circuit will be required to "plead, in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct."<sup>31</sup> The Ninth Circuit also requires much greater disclosure of the attorney's pre-filing investigative efforts than other circuits require.

The remaining circuits have taken an intermediate approach, holding that, under certain circumstances, pleading motive and opportunity might be enough to meet the “strong inference” standard.<sup>32</sup>

#### *Pleading standards for forward-looking statements*

The PSRLA also created a separate liability standard for forward looking statements, under which courts will not hold defendants liable for financial projections and other forward-looking statements if those statements were accompanied by cautionary language specifically-tailored to render the forward-looking statements to be immaterial and non-actionable even if false. To circumvent the safe harbour for forward-looking statements, plaintiffs must prove that defendants made the statements with actual knowledge of their falsity.

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<sup>31</sup> *In re Silicon Graphics Inc. Sec Litig.*, 183 F.3d 970, 974 (9<sup>th</sup> Circuit 1999)

<sup>32</sup> Jennifer O’Hare, Preemption Under the Securities Litigation Uniform Standards Act: If It Looks Like a Securities Fraud Claim and Acts Like a Securities Fraud Claim, Is It a Securities Fraud Claim? 56 ALA. L. REV. 325, n.64.

**5. What is the range of claimants? (For example, only those who buy shares or also those who sell or hold shares)**

In order to bring a claim under Rule 10b-5 a plaintiff must either be a purchaser or seller of the securities and the conduct complained of must relate to material misinformation upon which the plaintiff relied. However, the Supreme Court has taken a broad view of the reliance element in adoption of the “fraud on the market” theory. Under this theory, public information is presumed to affect the market and the plaintiff is presumed to have relied on it, even if the plaintiff never saw the statements in question. This presumption can be rebutted by proving that the plaintiff's decision to buy or sell was not influenced by the misstatements or that the misstatements did not in fact affect the market price of the stock. In a fraud on the market case, in satisfying the loss causation element of the 10b-5 claim, the plaintiff must show the price inflation was caused specifically by the material misstatement and not by other factors.<sup>33</sup>

**6. What is the range of defendants (company only, directors, advisers)**

The range of defendants can include directors, advisers, and firms:

- a. Director liability: officers and directors are named as defendants in the majority of shareholder class actions. In 2005, CEOs were named in 96 percent of all cases, CFOs in 82 percent, and chairmen of the board were named defendants 72 percent of the time.<sup>34</sup> Although rare, outside directors also can be included as defendants in securities class actions.<sup>35</sup>
- b. Adviser liability: although one of the PSLRA's objectives was to end “joint and several liability” for auditors so that no auditor could be held liable for other defendants in private securities class actions, the PSLRA may have failed to insulate the audit profession because, as some authors argue, “in the era of multibillion dollar

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<sup>33</sup> Bartos, *supra* note 20 at 217.

<sup>34</sup> See PricewaterhouseCoopers LLP, 2005 Securities Litigation Study 11 (2005).

<sup>35</sup> See Scott report, *supra* note 3, Chapter 3.

claims, even a small share of proportional liability” (still possible under the PSLRA) exposes even large audit firms to financial failure.<sup>36</sup>

- c. Firm liability: Extant guidelines from the Department of Justice as to when entities should be indicted provides nine factors federal prosecutors should consider in deciding whether to bring charges against a firm. However, these factors have proven controversial, the fourth in particular, which directs prosecutors to consider whether the corporation appears to be protecting culpable employees, as evidenced through advancing of attorney’s fees and whether the firm waives the attorney-client privilege generated during the course of a company’s internal investigations. This fourth factor, seen as pressuring firms to not pay legal fees of its employees, was held to be an unconstitutional violation of the right to counsel in the June 2006 Southern District of New York case, *U.S. v Stein*.<sup>37</sup>

**7. Does such litigation actually occur? If so, in what sorts of circumstances, brought by what sorts of claimants and against whom?**

Yes. On an unconsolidated basis, securities class actions accounted for roughly 48 percent of all class actions pending in federal court in 2004 and 2005. On top of administrative penalties, private class actions in 2004 resulted in \$3.5 billion in liability, and foreign companies commonly cite the U.S. enforcement system as the most important reason why they are reluctant to list in the U.S. market.<sup>38</sup> Lead plaintiffs in post-PSLRA cases include institutional lead plaintiffs and non-institutional lead plaintiffs encompassing single individuals, an aggregation of individuals, and non-institutional entities.

Involvement of Institutional Investors

At the heart of the PSLRA’s lead plaintiff provision was a belief among legislators that the securities class action needed an "owner" of the suit's outcome. This belief was founded on an

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<sup>36</sup> *Id.* at 88.

<sup>37</sup> *Id.* at 85

<sup>38</sup> Scott Report, *supra* note 3 at 71.

interest in reducing the decision-making role and a hope that investors with the largest losses who would be appointed as lead plaintiffs would be in a better position to manage the cases and negotiate the fees demanded by plaintiffs class counsel.<sup>39</sup> Although there are indications that they are getting involved more frequently in recent years, pension funds and other financial institutions have been slow to take roles as lead plaintiffs in securities class action litigation.

There may be several explanations for institutional investors' reluctance to take the lead plaintiff role. In addition to facing political pressure, in taking the lead plaintiff role, institutions assume a host of costs such as putting their commercial relationships at risk,<sup>40</sup> the amount of time that they would need to spend to manage the case, the threat of disclosure of proprietary nonpublic information during discovery, and the threat of suit by other disgruntled plaintiffs. Finally, and though this strategy is not without its own costs, institutional investors with large potential claims have sometimes might find it more advantageous to opt out of the class and act for themselves rather than on behalf of all other investors.<sup>41</sup>

Those that institutional investors that have chosen to take lead plaintiff roles have also been very selective in their interventions. Research demonstrates that an institutional investor is more likely to become a lead plaintiff for cases against large capitalization firms, with bigger estimated losses, and when the SEC has filed a parallel action.<sup>42</sup>

Press reports that institutions are aggressively lobbied by plaintiffs' law firms to appear as lead plaintiffs and, once selected as lead, those institutions nominate as the class counsel a law firm that is a patron of its political officers.<sup>43</sup>

Having found that institutional lead plaintiffs positively increase settlements by the small but statistically significant 0.04% for every 1% increase in provable losses, the fact remains that institutional lead plaintiffs appear in few cases. Moreover, given the difficulty of controlling for all

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<sup>39</sup> In the case of *In re Cendant Corp. Litigation*, institutional investor involvement was able to counsel fees were lowered to one-half to one-third of the historical average of 32% of the recovery through institutional investor involvement. *See Cox and Thomas, Does the Plaintiff Matter*, *supra* note 18 at 1589.

<sup>40</sup> Banks, mutual funds, and insurance companies, three of the five largest classes of financial institutions, are vendors of financial services whose customers include large corporations. *Cox and Thomas, Empirical Evidence*, *supra* note 7 at 12.

<sup>41</sup> *Cox and Thomas, Does the Plaintiff Matter*, *supra* note 18 at 1608-9.

<sup>42</sup> *Id.* at 1630.

<sup>43</sup> *Id.* at 1618.

aspects of case quality, study authors also acknowledge the possibility that the higher settlements in these cases simply may reflect that institutions take the stronger cases.<sup>44</sup>

**8. Is any form of collective private litigation facilitated by the legal system (for example, class actions and features of the civil procedure system not particular to securities enforcement)**

The number of private suits for violations likely reflect collateral legal rules such as the availability of contingent fees, the “American Rule” respecting parties’ responsibility for attorneys fees, and the class action mechanism.

Contingent fees

Typically, a securities class action suit begins once a shareholder has filed suit in federal court claiming that the corporation in which she holds stock, its individual directors, and its accountants have violated federal securities law. Most likely, that shareholder has retained an attorney to prepare this claim. The shareholder and attorney probably have signed a retainer agreement in which the attorney agrees to forego compensation until the end of the litigation, or takes a small fee in exchange for a promise by the shareholder that the attorney will receive a certain portion of the shareholder's award. This retainer contract is called a contingency fee agreement.<sup>45</sup>

In contrast to other contingent fee attorneys, class action attorneys typically do not contract *ex ante* for compensation. Rather, they prosecute the lawsuit with the expectation that they will recover their fees and costs at the conclusion of the litigation if they achieve a successful outcome.<sup>46</sup>

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<sup>44</sup> *Id.* at 1636.

<sup>45</sup> Nanette L. Stasko, Comment, Competitive Bidding in the Courthouse: In re Oracle Securities Litigation, 59 BROOK. L. REV. 1667, 1672-73 (1994).

<sup>46</sup> The contingent fee arrangement produces incentives to settle rather than expend additional resources in attempting to litigate the case. *See* Lisa L. Casey, Reforming Securities Class Actions from the Bench: Judging Fiduciaries and Fiduciary Judging 2003 B.Y.U.L. REV. 1239 (2003).

### Attorney's fees

Because class actions are assessed as a contingent fee based on the value of the award, there is no cost to claimants if their action fails. Although the PSLRA imposes the threat sanctions under Rule 11, including but not limited attorneys fees, claimants in US class actions are not generally liable for defendant's legal costs under the "American Rule."

### Procedures for initiating a class action

In seeking certification of a class, representative plaintiffs must demonstrate that the prerequisites for maintaining the lawsuit as a class have been satisfied pursuant to Federal Rule of Civil Procedure 23. Under Rule 23, the representative plaintiffs must demonstrate that the class is so numerous that joinder of individual members is impracticable, that there are issues of law or fact common to the class, that the claims of the class representative are typical of the claims of the class, that the class representatives will fairly and adequately protect the interests of the class, and that other special requirements for maintaining a class action are met.<sup>47</sup>

Once the court has approved the class, all potential claimants are presumed to be members of the class and are entitled to any remedy awarded, unless they expressly opt out. Under PSLRA's lead plaintiff provision, notice is published to class members, seeking one or more to become the representative under supervision of the court. Any shareholder that is a member of the class can respond by filing a motion to be appointed lead plaintiff. The court, within ninety days of the notice's publication, is required to select a lead plaintiff.<sup>48</sup>

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<sup>47</sup> Jim Bartos, *supra* note 20 at 264.

<sup>48</sup> Congress intended to reverse the pre-PSLRA practice of counsel choosing the plaintiff rather than the plaintiff choosing counsel. Cox and Thomas, *supra* note 18 at 1595.

**9. Costs of litigation- Do US rules facilitate mounting a threat of litigation substantial enough to coerce settlements?**

*“Reaching an agreement in principle to settle this securities litigation...[marks an important step] toward putting these matters behind us. By working to resolve these issues now, we’re aiming to avoid the costs, risks and distractions of protracted litigation.”*

- Time Warner Chairman and Chief Executive Dick Parsons. Time Warner Press Release, August 3, 2005.

Before the PSLRA and its provisions staying discovery, it was easier to make the claim that the US rules for filing class action suits combined with contingent attorney’s fees reduced the effort by plaintiffs attorneys to a simple "race to the courthouse" with class actions filed soon after significant stock price declines, apparently with very little pre-filing investigation. In addition, plaintiffs attorneys faced little downside risk from dismissals because courts rarely impose sanctions under Rule 11 of the Federal Rules of Civil Procedure.

Indeed, the stay on discovery imposed by the PSLRA has resulted in more effort by plaintiffs attorneys, though the high cash flow requirements of investigating fraud and pursuing litigation concentrated the abilities of certain large firms to undertake securities class actions.

From defendants’ perspective, the US system was susceptible to the claim that defendants facing even non-meritorious claims were into coerced into settlements by the prospect of protracted jury trial and litigation costs including discovery. In the words of former SEC Commissioner Joseph Grundfest in early 1995, “The value to plaintiffs of these suits has nothing to do with the suits’ merits; instead, it depends on plaintiffs’ ability to use the right to file a complaint to compel discovery which in turn imposes litigation costs on defendants.”<sup>49</sup>

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<sup>49</sup> Joseph Grundfest, Why Disimply?, 108 HARV. L. REV. 727, 740 (1995).

Even post PSLRA, however, the average public company faces a 10 percent probability of at least one shareholder class action suit over a 5-year period.<sup>50</sup> Perhaps this is because in addition to reducing costs for the defendants, the stay on discovery while a motion to dismiss is pending under the Act may also have decreased the fixed costs to the plaintiff's law firm.<sup>51</sup> (Prior to 1995, plaintiffs had free reign –though not without cost-- to use the discovery process to troll for evidence to support its claims.) It may also be that more cases have been filed, as plaintiffs attorneys post-PSLRA are seeking a sort of economic strategy of “portfolio diversification.”<sup>52</sup>

Although there has been a marked increase in dismissals post-PSLRA,<sup>53</sup> plaintiffs attorneys still face little risk of sanctions, despite the PSLRA's express requirements for courts to include in the record specific findings regarding each party's and each attorney's compliance with Rule 11.<sup>54</sup> Corporations still face similar incentives to settle claims that make it past the motion to dismiss screen. It remains cheaper to pay the costs of settlement than a protracted trial with discovery; corporations also fear the reputational losses of a trial and the uncertainty of a jury verdict. Cognitive psychologists have studied and tried to explain defendants' risk aversion and propensity to settle even in cases in which plaintiffs may have a low probability of success at trial.<sup>55</sup>

#### How to survive motion to dismiss given that PSLRA stays discovery

Plaintiffs lawyers have attempted to satisfy the “strong inference” requirement set forth in the PSLRA by providing an intuitive basis from which scienter may be inferred. A typical allegation will state that the firm and its managers ignored generally accepted accounting principles (GAAP), provided numbers not supported by those principles and, thereby, intentionally misled the investing public.<sup>56</sup> Moreover, “the strength of these allegations is likely to vary with the evidence that accounting principles have been violated,”<sup>57</sup> for example if the firm's auditors or the SEC have required it to restate its revenues.

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<sup>50</sup> Scott Report, *supra* note 3.

<sup>51</sup> Perino, *supra* note 14 at 937.

<sup>52</sup> *Id.*

<sup>53</sup> Pre-PSLRA studies found dismissal rates between 24% and 40%. A later study by Professors Grundfest and Pritchard of 167 decisions on motions to dismiss found that 65.9% were granted in some form. *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> Pritchard and Sale, *supra* note 10 at 12.

<sup>57</sup> *Id.*

**10. What is the balance of enforcement as between private litigation and public enforcement via, for example, a securities market regulator or public prosecuting authorities?**

There are two predominant perspectives of the role of private suits in the enforcement of the securities laws: one perspective enlists plaintiffs as “private attorneys general,” and the other perspective paints the same plaintiffs as nothing more than “vexatious litigants.”<sup>58</sup>

While which of the two roles private suits play remains the subject of debate, the SEC’s role is more clear: to protect investors and their interest. While in some cases the SEC is able to return ill-gotten gains disgorged by defendants to defrauded investors (under Section 308, the “Fair Funds for Investors” section of Sarbanes-Oxley) the Commission is not authorized to act on behalf of individual investors.<sup>59</sup> The SEC has “repeatedly acknowledged ... that private litigation enables a level of compliance that would be impossible to achieve if enforcement were limited to the government.”<sup>60</sup>

In terms of the cases it decides to initiate, the SEC generally prioritizes the cases in terms of (1) the message delivered to the industry and public about the reach of SEC's enforcement efforts, (2) the amount of investor harm done, (3) the deterrent value of the action, and (4) SEC's visibility in certain areas such as insider trading and financial fraud.<sup>61</sup> Consistent with the SEC-stated heuristic of minimizing ongoing losses to investors, the strongest explanatory variable underlying the SEC's choice of its targets is the level of financial distress of the issuer.<sup>62</sup>

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<sup>58</sup> James D. Cox and Randall S. Thomas, SEC Enforcement Heuristics: An Empirical Inquiry, 53 Duke L.J. 737, 741 (2003) [hereinafter SEC Enforcement].

<sup>59</sup> SEC Division of Enforcement website, <http://www.sec.gov/divisions/enforce/about.htm>. Last visited December 30, 2006.

<sup>60</sup> William Rubenstein, On What A “Private Attorney General” Is - And Why It Matters, 57 VAND. L. REV. 2129, 2151 (2004).

<sup>61</sup> Cox and Thomas, SEC Enforcement, *supra* note 58 at 751.

<sup>62</sup> *Id.* at 778.

The most common types of SEC suits that give rise to securities class actions are those involving misrepresentations committed in the public offering of securities, misleading financial reports of issuers, and insider trading cases.<sup>63</sup>

Authors of an a study examining the overlap in private class action suits and SEC enforcement found that only about 15 percent of settled private cases in our sample have a parallel SEC action. Authors also found that when both a SEC and private action proceed for the same misconduct, private recoveries are statistically larger and settled more quickly than when there is no parallel SEC enforcement action.<sup>64</sup>

Although there was a shift in SEC enforcement post Enron (from a focus on targeting firms in financial distress to firms where shareholders have suffered greater provable losses with a bias toward selecting smaller firms) the data in both periods indicate that provable losses, total assets, class period and presence of an SEC enforcement action are all positively and significantly related to the dollar amount of the settlement obtained in a private action.

### Enforcement links

One development linking SEC enforcement activities to recoveries by private investors occurred in July 2002, when Congress enacted the Sarbanes-Oxley Act.<sup>61</sup> Section 308(a) of the Act authorizes the SEC, in its discretion, to apply for the benefit of victims of a securities law violation the civil penalties (i.e., fines) collected in enforcement cases toward any disgorgement funds obtained from the respondent.<sup>62</sup> This so-called "Fair Fund" provision thus expands the sum of money that can become available to victims of a securities law violation. Indirectly, it provides additional incentive for the SEC to impose civil penalties in its administrative proceedings against certain market professionals, and to seek civil penalties in its court enforcement actions. Although the fair funds provisions does have limitations, disgorgements the SEC obtains for victims can be significant.<sup>65</sup> However, As the SEC found in its own study, it is unlikely that profit disgorgements generated by the Fair Funds provision can be expected to displace private recoveries: "financial

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<sup>63</sup> *Id.* at 749

<sup>64</sup> *Id.* at 777.

<sup>65</sup> Cox and Thomas, SEC Enforcement, *supra* note 57 at 756.

fraud violations . . . may cause huge investor losses that dwarf, by several orders of magnitude, any profit that violators may have made."<sup>66</sup>

On the whole, though the small amounts recovered by individual plaintiffs undermine the compensatory justification of the class action suit, if provable losses are a determinant of the size of actual recoveries, it provides at least some credibility to the deterrent effect of class actions if, as one study indicates, “merits do matter.”<sup>67</sup>

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<sup>66</sup> *Id.*

<sup>67</sup> See Cox and Thomas, Public and Private Enforcement Since Enron, *supra* note 1.

## INNACURATE STATEMENTS MADE TO THE MARKET: FOLLOW UP QUESTIONS

### Follow-Up Questions and Responses

Prepared by Alisa R. Valderrama

January 5, 2007

1. Is it enough to show fraud that the statement was made knowing it was inaccurate? Or is there some further requirement ie the intention to 'deceive manipulate or defraud'? In the UK there would be fraud if a knowingly false statement were made with the intention that it be relied upon, whether or not the maker intended to cheat the recipient of the statement.

Rule 10b-5 is violated only when a fraud occurs "in connection with" a purchase or sale of securities. Many early decisions involved a transaction directly between a plaintiff and defendant, but courts no longer require that there be privity between plaintiffs and defendants. As a result, the "in connection with" requirement became a subject for judicial interpretation.

Courts generally find that a fraud or misrepresentation occurs "in connection with" securities trading "whenever [such] assertions are made ... in a manner reasonably calculated to influence the investing public ...." or when the fraud touches on "the value of the stock at issue or the value of the consideration in return for it."<sup>68</sup>

It would be enough that defendants made a statement knowing it was inaccurate, since the requisite scienter needed for a violation includes a deceptive intent.

"Scienter" is defined in the context of the Securities Exchange Act of 1934 § 10(b), 15 U.S.C.S. § 78(b) as a mental state embracing intent to deceive, manipulate, or defraud. Courts reason that § 10(b) makes unlawful the use of any manipulative or deceptive device or contrivance in contravention of Securities and Exchange Commission rules. As a result, the court has held that the words "manipulative and deceptive" used in conjunction with "device or contrivance" strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct.

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<sup>68</sup> 1-5 Federal Securities Exchange Act of 1934 § 5.04 .

As the Second Circuit has stated:

“When the fraud alleged is that the plaintiff bought or sold a security in reliance on misrepresentations as to its value, made by a defendant whose position made it reasonable for the plaintiff to rely on the representation and imposed some duty on the defendant to be honest or to disclose information, then whatever problems there may be with the case, a connection between the fraud and the transaction should not be one of them.”<sup>69</sup>

2. Recklessness. In the UK that means making a statement in fact false, not caring whether it is true or not. Does the US concept go beyond that?

Finding of “recklessness” is ultimately a factual determination which will necessarily vary from case to case. The standard articulated in *Sundstrand*, is a good statement of recklessness: In *Sundstrand*, the Seventh Circuit there held that recklessness was “highly unreasonable conduct which is an extreme departure from the standards of ordinary care. While the danger need not be known, it must at least be so obvious that any reasonable man would have known of it.”<sup>70</sup>

Generally consistent with the standard articulated above, more examples from the Ninth and Second Circuits:<sup>71</sup>

*Ninth Circuit examples of “recklessness”*

The Ninth Circuit in *SEC v. Rubera*, defined recklessness as “a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it. Reckless conduct must be something more egregious than even “white heart/empty head” good faith and represents an extreme departure from the standards of ordinary care such that the defendant must have been

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<sup>69</sup> *In re Ames Dept. Stores Inc. Stock Litig.*, 991 F.2d 953, 967 (2d Cir. 1993).

<sup>70</sup> 553 F.2d at 1045

<sup>71</sup> Although there is no official Circuit split on this issue, see page 10 for evidence that a slightly different recklessness standard gets applied in the two circuits.

aware of it. Recklessness satisfies the scienter requirement only to the extent that it reflects some degree of intentional or conscious misconduct.<sup>72</sup>

More succinctly, the court in *SEC v. Glt Dain Rauscher, Inc.* stated: Reckless conduct is conduct that consists of a highly unreasonable act, or omission, that is an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.<sup>73</sup>

The Ninth Circuit in *Silicon Graphics* said “Recklessness only satisfies scienter under [10b-5] to the extent that it reflects some degree of intentional or conscious misconduct. Recklessness in the § 10(b) context is a form of intentional conduct.”<sup>74</sup>

#### *Second Circuit “recklessness”*

In *Rothman v. Gregor*, the Court found “The fact that management's optimism about a prosperous future turned out to be unwarranted is not circumstantial evidence of conscious fraudulent behavior or recklessness: People in charge of an enterprise are not required to take a gloomy, fearful or defeatist view of the future; subject to what current data indicates, they can be expected to be confident about their stewardship and the prospects of the business that they manage”<sup>75</sup>

The Second Circuit in *Novak v Kasaks* set the standard for recklessness as conduct that is "highly unreasonable" and that represents an extreme departure from the standards of ordinary care to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it. The *Novak* court also said “Similarly, an egregious refusal to see the obvious, or to investigate the doubtful, may in some cases give rise to an inference of recklessness.”<sup>76</sup>

4. Safe harbour for forward-looking statements. A requirement for this is that 'the complaining party cannot prove that the author of such statements has actual knowledge that the forward-looking statement was false or misleading.' How is this different from what has to be shown in

<sup>72</sup> SEC v. Rubera, 350 F.3d 1084 (9<sup>th</sup> Cir. 2003).

<sup>73</sup> SEC v. Glt Dain Rauscher, Inc., 254 F.3d 852 (9<sup>th</sup> Cir 2001)

<sup>74</sup> In Re Silicon Graphics Sec. Litig., 183 F.3d 970 (9<sup>th</sup> Cir. 1999).

<sup>75</sup> Rothman v. Gregor, 220 F.3d 81 (2<sup>nd</sup> Cir. 2000)

<sup>76</sup> Novak v Kasaks, 216 F.3d at 310 (2<sup>nd</sup> Cir. 2000).

respect of non-forward looking statements? Is it simply that recklessness cannot be a cause of action?

Recklessness cannot be a cause of action under Section 18. The higher standard of “actual knowledge” is required in order to prevail on a Section 18 cause of action. However, because of the disjunctive nature of subsection (c)(1) a defendant can obtain the protection of the safe harbor section by meeting any of the three independent tests:

1) A disclosure is identified as forward-looking and is accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement" (the "bespeaks caution" prong);

OR

2) When a forward-looking statement is deemed to be "immaterial" (the "immateriality" prong);

OR

3) In any instance where a forward-looking statement is material but it is either not specifically identified as forward-looking and/or it is not accompanied by the required cautionary statements, and the plaintiff is unable to prove actual knowledge of falsity on the part of the issuer making the statement (the "actual knowledge" prong).<sup>77</sup>

*Text of PSLRA's Safe Harbor provision (15 U.S.C. 78u-5(c)):*

[I]n any private action arising under this [title \[15 USCS §§ 78a et seq.\]](#) that is based on an untrue statement of a material fact or omission of a material fact necessary to make the statement not misleading, a person referred to in subsection (a) shall not be liable with respect to any forward-looking statement, whether written or oral, if and to the extent that—

(A) the forward-looking statement is--

(i) identified as a forward-looking statement, and is accompanied by

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<sup>77</sup> Ann Morales Olazabal, Safe Harbor for Forward-Looking Statements Under the Private Securities Litigation Reform Act of 1995: What's Safe and What's Not? 105 Dick. L. Rev. 1 (2000)

meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement; or

(ii) immaterial; or

(B) the plaintiff fails to prove that the forward-looking statement--

(i) if made by a natural person, was made with actual knowledge by that person that the statement was false or misleading; or

(ii) if made by a business entity; was--

(I) made by or with the approval of an executive officer of that entity; and

(II) made or approved by such officer with actual knowledge by that officer that the statement was false or misleading

*General 10b-5 liability as compared to liability for forward looking statement as discussed in Silicon Graphics*

“...Under the Reform Act's "safe harbor" provisions, plaintiffs must prove that "forward-looking" statements were made with "actual knowledge" that they were false or misleading. [15 U.S.C. §§ 78u-5\(c\)\(1\)\(B\), 77z-2\(c\)\(1\)\(B\)](#). A recklessness standard for pleading that would apply to *all* statements, such as that proposed in the Specter Amendment, would have been inconsistent with the safe harbor's requirement of "actual knowledge" [of falsity for forward-looking statements.]”

In the case of a statement made by a corporate officer or other representative, the plaintiff must prove "actual knowledge" by the speaker. In the case of such a statement issued by the issuer as an entity, the plaintiff would have to prove that the statement was approved by an executive officer of the entity and that that approval was given with "actual knowledge" that the statement was false or misleading.<sup>78</sup>

*Application of safe harbor protection in In Re Advanta Corp. Securities Litigation*

In *Advanta*, the company, a leading issuer of credit cards, sustained a \$ 20 million first quarter loss in 1997, allegedly caused by the adoption of new policies that resulted in many more high risk

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<sup>78</sup> In re Silicon Graphics, 183 F.3d 970 (9<sup>th</sup> Cir. 1999).

customers and consequently excessive charged-off accounts. Plaintiffs, former shareholders of Advanta, charged that the company failed to disclose these risky practices even after it became clear that large losses were their inevitable result.

*Advanta* plaintiffs focused on a statement made by company Vice President for Investor Relations, Janet Point, to the Dow Jones News Service about the company's plans to convert existing accounts at "teaser" interest rates to the usual higher rates, and the effect on revenues of this conversion. Since Point's statement was neither identified as a forward-looking statement nor accompanied by any cautionary language, it could not find safe harbor under the "bespeaks caution" prong of the PSLRA. Neither was there any argument that her statement was immaterial so as to be exempt under prong two. Consequently, the defendants argued the "actual knowledge" prong of the Act safeguarded the statement.<sup>79</sup>

*Application of the "actual knowledge" defense in Advanta:*

In applying the PSLRA, the Third Circuit scrutinized plaintiff's allegations regarding alleged "actual knowledge." Plaintiff's logic was as follows: in an article published six months after Point's statement, Advanta's CEO admitted that Advanta did not increase its rates to as high as Point had said the company would, and that since Point was a company representative, she must have known the company would not re-price at the level she had projected. No specific facts were pled to support the necessary inference that Point or anyone at Advanta knew when Point spoke to Dow Jones that the company would not re-price its credit card accounts as high as originally planned. Under these circumstances, the court found that Point's statement was protected by the Act's safe harbor.

5. Section 18 of 1934 Act. It does not require scienter, which seems favourable to plaintiffs, but also there is a defence if statements made in good faith. What does good faith mean? That the maker believed the statement to be true? If so, is this not a scienter standard?

What you seem to be asking is whether a statement "made in bad faith" would necessarily meet the same liability standard for "scienter." It seems that the answer is "no."

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<sup>79</sup> In Re Advanta Corp. Securities Litigation , 180 F.3d 525 (3d Cir. 1999).

The closest answer I could find directly on point comes from a law review article which states:

“The purpose of Section 18 is to encourage reliance on documents filed with the Commission. The statute allows for a "due diligence" defense if an auditor acted in "good faith and had no knowledge that [a] statement was false or misleading." The Court has said that such a defense raises the requisite mental state for the section to something "more than negligence." The Court's statement suggests that an auditor would have to be grossly negligent in her audit in order to be liable. Such a standard knocks on the door of a scienter requirement and, thus, makes it very difficult for any auditor to be found liable for violating.”<sup>80</sup>

*Text of [15 U.S.C. 78r\(a\)](#) (2003) otherwise known as Section 18(a):*

”Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 78o of this title, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.”

#### *Application of Section 18*

Because scienter is not element of claim under § 18 of Securities Exchange Act of 1934, where plaintiffs alleged, for all defendants, that there were (1) false or misleading statements; (2) that were material; (3) contained in Securities and Exchange Commission filings; and (4) that plaintiffs relied upon them, all of defendants' motions to dismiss were denied. <sup>81</sup>

To state a prima facie case under § 18 of the Securities Exchange Act of 1934, plaintiffs must allege: (1) a false and misleading statement made by the defendant; (2) that is material; (3)

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<sup>80</sup> Note, Congressional Oversight: Interpreting the Phrase “Financial Statements” within Section 10A of the Securities Exchange Act of 1934, 31 Hofstra L. Rev 849 (2003).

<sup>81</sup> Pacholder High Yield Fund, Inc. v Cucuz (In re Hayes Lemmerz Int'l, Inc. Equity Secs. Litig.) 271 F Supp 2d 1007, (2003, ED Mich).

contained in an Securities Exchange Commission filing; (4) upon which plaintiffs relied in their purchase of a security.

“Good faith” is an affirmative defense under Section 18, whereby defendants’ burden is to prove that they had no knowledge that the statement was false or misleading.

6. Is there any more material on the 9th v 2nd circuit's clash on the particularity of pleadings post PSLRA?

The general consensus seems to be that PSLRA enactment left the judicial system with some doubt as to what standard should be adopted in order to infer scienter during pleadings for a securities fraud claim, the Second Circuit two-prong test or the Ninth Circuit deliberate recklessness standard.<sup>82</sup>

*Second Circuit Post-PSLRA approach*

The Second Circuit has concluded that the enactment of the PSLRA essentially codified the pre-PSLRA approach adopted in that circuit.<sup>83</sup> In *Novak*, plaintiffs brought suit against the defendant manufacturer and their officers for "knowingly and intentionally" overstating the financial condition of the corporation. The plaintiffs claimed the defendant accomplished this through irregular accounting methods of inventory that were not in compliance with corporate policy. As a result of this overstatement, the value of the stock was artificially inflated and decreased dramatically when the defendants finally recognized the inappropriate practice, which resulted in a substantial impact to the company's earnings for the period.

The *Novak* court held that the defendants, although clearly aware that the inventory was in fact worthless and obsolete, consciously decided against making the appropriate financial adjustments due to the fear that it would greatly impact the company's financial standing. Further, by choosing not to make the appropriate adjustments, the financial statement disclosures were inaccurate and deceiving because the company was not following their stated policies. As a result, the court held that, based on the Second Circuit's conscious or reckless misbehavior test, the plaintiffs clearly met

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<sup>82</sup> The following analysis is compiled from Kevin Shmelzer, *The Door Slammed Shut Needs to Be ReOpened: Examining the Pleading Requirements Under the Private Securities Litigation Reform Act*, 78 *Temp. L. Rev.* 405 (2005).

<sup>83</sup> See, e.g., *Novak v Kasaks*, 216 F.3d at 310 (2<sup>nd</sup> Cir. 2000) (holding that PSLRA "effectively raised the nationwide pleading standard to that previously existing in this circuit and no higher.")

the pleading requirements as required by the PSLRA because the facts gave rise to a strong inference of scienter. The court stated, "When managers deliberately make materially false statements ... with the intent to deceive the investment community ...," their state of mind borders on "actual intent" at most and at the least it "approximates actual intent," either of which is sufficient for scienter.

The Second Circuit approach to the PSLRA, requiring "motive and opportunity to commit fraud" or "strong circumstantial evidence of conscious misbehavior or recklessness to satisfy the scienter pleading requirement," has gained acceptance in the First Circuit and the Third Circuit.

#### *Third Circuit Standard follows Second Circuit*

In the *Advanta Corp. Securities Litigation*, plaintiffs sued the defendant, an issuer of credit cards, and its officers for releasing statements which were "materially false and misleading" concerning the strength and stability of the credit worthiness of the company's customers.<sup>84</sup>

The Third Circuit dismissed the complaint, holding that the allegations made by the plaintiffs were insufficient because they were merely general assertions that the defendants acted knowingly, and that an inference potentially could be drawn that the defendants were aware that the statements were false based on their positions within the company. Rather, to bring an actionable claim and satisfy the strong inference of scienter, the Third Circuit held that the plaintiffs must plead particular facts showing that either the defendants' false statements were an "extreme departure" from ordinary care and recklessness should be inferred or that the defendants acted in a way that allowed them to capitalize on the inflated stock price.

#### *Ninth Circuit post-PSLRA approach*

The Ninth Circuit's position, on the other hand, greatly raises its pre-PSLRA standard of general averments satisfying the pleading requirements for scienter to a standard which is even more stringent than that of the Second Circuit.

The Ninth Circuit has held that facts which "constitute strong circumstantial evidence of deliberately reckless or conscious misconduct" are required to be pleaded in order to meet the

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<sup>84</sup> *In re Advanta Corp. Securities Litigation* 180 F.3d 525 (3d Cir. 1999),

heightened pleading requirements of the PSLRA, and as such, motive and opportunity would not suffice.

The court in *Silicon Graphics* (SGI) discussed how "Congress intended to elevate the pleading requirement above the Second Circuit standard which required plaintiffs merely to provide facts showing simple recklessness or a motive to commit fraud and opportunity to do so."<sup>85</sup>

In SGI, the plaintiff brought suit against the defendant computer manufacturer and its officers for issuing false and misleading statements in order to artificially inflate the stock price. The plaintiff contended that the defendants conspired to purposely portray the financial condition of the company in a positive light when they were well aware that the financial condition was beginning to deteriorate. This was accomplished, the plaintiff alleged, to maintain an inflated stock price which, in turn, would allow the defendants to sell the stock they owned for a substantial profit. In order to substantiate her claim, the plaintiff alluded to public statements made by the defendants which contradicted internal reports that disclosed the foundering condition of the company. Further, the plaintiff outlined how the defendants had both motive and opportunity, given that several defendants sold stock after the false statements were made, but before the actual financial condition was released.

Despite the motive and opportunity, based on the defendants selling their stock, as well as the inference that there was recklessness based on the false statements which contradicted the internal reports, the court held that the plaintiff's pleading was insufficient to establish a strong inference of scienter. The court concluded "In short ... [the] complaint is insufficiently specific to raise a strong inference of deliberate recklessness." In order to meet the "deliberate recklessness" standard for scienter, the court stated that the plaintiff would need to provide more specific facts of the alleged internal reports rather than simple assertions that there were internal reports that contradicted the defendants' public statements.

The SGI court further held that "mere motive and opportunity to commit fraud," that is based on generic, boilerplate language, without additional specific facts, will not suffice to meet the deliberate recklessness standard. In light of this strong scienter standard, the question that ultimately arises is how exactly can a plaintiff bring an actionable claim which will not be dismissed due to insufficient pleading? Clearly, the plaintiff in SGI needed to provide the actual

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<sup>85</sup> *In re Silicon Graphics Inc. Securities Litigation* ("SGI") 183 F.3d 970 (9th Cir. 1999).

internal reports which contradict the false statement, although how the reports could actually be obtained without discovery is perplexing.

The Ninth Circuit standard of deliberate recklessness has also gained acceptance in other jurisdictions. Specifically the Ninth Circuit standard is used in the Sixth, Eighth, and Eleventh Circuits.

In the Sixth Circuit *Comshare* case, plaintiff shareholders brought a securities fraud suit against a computer software developer and licensor, its officers, and its directors for misleading investors by not following the company's own revenue recognition policies. The plaintiffs alleged that the defendants were reckless in improperly recognizing revenue and did so in an attempt to artificially maintain the price of the company's stock in order to generate more compensation for themselves, as their salaries were tied to the performance of the stock. The court held that an allegation encompassing mere facts that a defendant had the motive and opportunity does not meet a strong inference standard required in order to bring an actionable claim.

As a result, the fact that the defendants had both motive and opportunity to inflate revenues so as to receive greater compensation was irrelevant because motive and opportunity by themselves do not suffice as strong inferences of scienter. Further, the plaintiffs provided no support or evidence, but merely general assertions, that the defendants purposefully inflated revenue. Thus, without specific facts of this misconduct, recklessness cannot be inferred for scienter under the Sixth Circuit's interpretation of the PSLRA.<sup>86</sup>

Simple motive and opportunity will not suffice in a jurisdiction which has adopted the Ninth Circuit approach, and it also appears as though the recklessness standard is elevated as compared to the Second Circuit approach.

#### 7. What does Rule 11 of the Federal Rules of Civil Procedure say?

Text of Rule 11. (b) Representations to Court; (c) Sanctions

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<sup>86</sup> *In re Comshare, Inc. Securities Litigation* 183 F.3d 542 (6th Cir. 1999).

(b) Representations to Court. By presenting to the court (whether by signing, filing, submitting, or later advocating) a pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances,--

(1) it is not being presented for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation;

(2) the claims, defenses, and other legal contentions therein are warranted by existing law or by a nonfrivolous argument for the extension, modification, or reversal of existing law or the establishment of new law;

(3) the allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery; and

(4) the denials of factual contentions are warranted on the evidence or, if specifically so identified, are reasonably based on a lack of information or belief.

(c) Sanctions. If, after notice and a reasonable opportunity to respond, the court determines that subdivision (b) has been violated, the court may, subject to the conditions stated below, impose an appropriate sanction upon the attorneys, law firms, or parties that have violated subdivision (b) or are responsible for the violation.

*Additional notes on Federal Rule of Civil Procedure 11 and PSLRA*

Rule 11 governs the imposition of sanctions for abusive pleading practices in litigation. The PSLRA departs from the common application of Rule 11 by placing an increased emphasis on the use of sanctions as a means to deter frivolous pleadings. The Act forces the court to review the pleadings for Rule 11 violations, to impose sanctions where violations are found, and creates a presumption that attorneys' fees and costs are proper when one party fails to comply with Rule

11(b). The PSLRA's requirement that the court make specific findings as to potential Rule 11 violations is not present in the course of ordinary litigation.<sup>87</sup>

*Standard for Liability under Rule 11*

For both parties and their attorneys the standard is that of “reasonable inquiry” under the circumstances.<sup>88</sup>

8. Is it agreed that there is no civil liability for breaches of the stock exchange rules?

Stock exchanges are self-regulatory organizations (SROs), and they enforce their rules and the federal securities laws using the sanctions available to them - denial of membership and its privileges. Private rights of action, while an important component of regulating compliance with federal securities law, are not expressly authorized by the Exchange Act with respect to SRO rules. Thus, investors cannot generally seek to enforce exchange rules against member firms in court, or to sue an SRO for failing to follow its own rules or to enforce rules against its members. Mandatory arbitration clauses in customer agreements permitted by SRO rules effectively preclude litigation of many customer disputes in court.<sup>89</sup>

*SEC involvement in enforcement of exchange rules*

The SEC has oversight authority over SROs such as requirements that different exchanges provide due process in its disciplinary proceedings against its members, and provide notice of adverse actions to the Commission. The Commission also has the ability to impose intermediate sanctions on exchanges for failure to carry out their enforcement responsibilities.<sup>90</sup>

9. Is the civil liability there referred to one to the company alone, not available to shareholders?

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<sup>87</sup> Comment, Private Securities Litigation Reform Failure: How Scierter Has Prevented The Private Securities Litigation Reform Act of 1995 from Achieving Its Goals, 42 San Diego L. Rev. 779 (2005).

<sup>88</sup> *Bus. Guides, Inc. v. Chromatic Communications Enters.*, 498 U.S. 533, 541 (1991).

<sup>89</sup> Onnig H. Dombalagian, Demythologizing the Stock Exchange: Reconciling Self-Regulation and the National Market System, 39 U. Rich. L. Rev. 1069 at 1122 (2005).

<sup>90</sup> *Id.*

Let me know if I still misunderstand your question, but I will try to clarify as best I can: Referring to the bottom of page 8: What was meant by saying that Section 302 “stands to effect” private litigation was that even though neither section 302 nor its implementing regulations make any reference to the creation of a private cause of action, Section 302 will nonetheless have an impact on shareholder claims. (In addition, the SEC has implemented rules pursuant to the certification provision of section 302, which specifically mandated that false certifications would expose the CEO and/or CFO to private causes of action under 10b-5.)

### *Section 302 interaction with securities class actions*

There are two primary ways in which the SOX certification provisions could be used to further the securities fraud suits of private plaintiffs. First, the certifications could be used as evidence from which defendant's knowledge of the misrepresentations or reckless disregard of them could be inferred. Pursuant to the first theory, plaintiffs would use certification requirements as circumstantial evidence of the particular defendant's knowledge of the misrepresentations or reckless disregard of their truth or falsity. In essence, this argument would use a certification containing a misrepresentation as to the company's financial condition against the certifying officer or director to infer that that officer or director had knowledge of the misrepresentation.

Second, the certification itself could be used as direct evidence of defendant's knowledge or reckless disregard. Pursuant to the second theory, plaintiffs would allege that the certification itself is direct evidence of the particular defendant's knowledge of the misrepresentation or reckless disregard of them. Consequently, the certification would provide the "particular facts" that the PSLRA requires of plaintiffs' pleadings so that, in theory, plaintiffs could overcome a motion to dismiss and thereby, proceed to discovery.<sup>91</sup>

### 10. Financial distress: Does this mean SEC goes in particular after insolvent companies?

My assertion that the SEC goes after companies in financial distress comes from a study undertaken by Cox and Thomas in a study they conducted where provable losses, length of class period, and a measure of financial distress were all used as independent variables to examine

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<sup>91</sup> Kourtney T. Cowart, The Sarbanes-Oxley Act: How A Current Model in the Law of Unintended Consequences May Affect Securities Litigation, 42 Duq. L. Rev. 293, 312 (2004)

empirically what leads the SEC to file an enforcement action in a case alleging fraud of the type that could lead to a private action.<sup>92</sup>

Their study found that financial distress was the only variable that is significant under ordinary measures of statistical significance. The significance of the financial distress measure is consistent with the claim that the SEC is very concerned about fraud at companies that are experiencing financial distress, probably because of the high likelihood that investors will be harmed, and the high visibility of such harm.

The authors used a firm's "Altman's Z-score" as the measure- which though it is used in its traditional role as an outright indicator or predictor of firm bankruptcy, need not be an indicator of insolvency, and can also be used as a summary measure of distress.<sup>93</sup>

As more general information on how the SEC gauges its enforcement priorities:

The SEC will initiate enforcement actions based on its belief about which situations pose the greatest harm to investor. The SEC will prioritize according to the message the action sends to the industry and public, the relative harm to investors, the deterrent effects of the action, and the visibility the SEC enjoys in combating such abuses.<sup>94</sup>

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<sup>92</sup> James D. Cox and Randall S. Thomas, SEC Enforcement Heuristics: An Empirical Inquiry, 53 Duke L.J. 737, 741 (2003)

<sup>93</sup> John Yozzo, 24 American Bankruptcy Institute Journal 28 (2002).

<sup>94</sup> Cox and Thomas, *supra* note 20.