Investor Litigation in the U.S. - The System is Working

by

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INTRODUCTION

In recent months, numerous critics have been on the warpath against investor class actions, seeking to discredit this long-established legal mechanism. Some of these criticisms are political, from persons with an ideological or financial interest in limiting investor redress for corporate wrongdoing. Some are well-intentioned, having been goaded forward by a veritable "pr campaign" of half-truths and sound bites. But, whatever their source, what these proponents share is a lack of facts and analysis in support of their position.

The U.S. capital markets have led the world for the last seventy years. Returns on investment are higher here and the cost of capital is lower. There is a significant listing premium for firms listing in the U.S. All of these achievements are attributable, at least in part, to our system of transparency and disclosure. This system in turn relies, in large part, upon the deterrence provided by investor access to the courts. Moreover, a major stated rationale for litigation reform -- the alleged loss of U.S. competitiveness in the IPO market -- holds no water and cannot be linked to the system of class-action litigation that has worked since the 1940s.

In short, the present securities litigation system works. Indeed, the system operates to protect the integrity of the American capital markets, which inures to the benefit of firms and stockholders alike. Furthermore, securities litigation reform is neither necessary nor desirable at a time when corporate wrongdoing continues to be front-page news on an almost daily basis. Nor does reform make economic sense -- particularly since the protections afforded investors by U.S. markets provide firms with a lower cost of capital and increased valuations. And, after all, that is the goal of investors.

The Studies

Citing an alleged decline in the competitiveness of the U.S. capital markets, the Committee on Capital Markets Regulation ("CCMR"), a group comprised primarily of business leaders, issued a report in late November 2006 urging that changes be made in the way that private securities class action suits are prosecuted.[1] The CCMR suggested arbitration of securities class cases and limitations on the liability of outside directors, along with damage caps for accounting firms. The CCMR's report suggests that the United States suffers from the "over-enforcement" of the country's securities laws – opining that American competitiveness can be enhanced by reducing class action litigation instituted by shareholders.

The CCMR was funded in large part by Maurice Greenberg, the disgraced ex-CEO of American International Group, who is himself a defendant in a number of securities and breach of fiduciary duty suits, as well as the subject of various governmental investigations. In addition, the membership of the CCMR had a decidedly "pro-business" slant. The committee was comprised of, among others, numerous corporate executives (including the CEO's of Office Depot,

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and two major auditing firms – PricewaterhouseCoopers and Deloitte), and a representative of investment banking interests (Lehman Brothers). Interestingly, however, the CCMR opted not to include any former federal securities regulators as members out of a concern for their "objectivity."[2] Putting aside the dubious source of the CCMR's report, its conclusions were backed by Henry M. Paulson, Jr., U.S. Secretary of the Treasury, who has stated publicly that the American legal system is "an Achilles' heel for our economy."[3] Indeed, Secretary Paulson believes that "legal reform is crucial" to American competitiveness.[4]

On January 22, 2007, McKinsey & Company ("McKinsey") published a study stating that without governmental intervention, "today's trends in the U.S. financial markets could have a significant negative impact on the economy."[5] The McKinsey study, which had been commissioned by Senator Charles Schumer (D-N.Y.) and New York City Mayor Michael Bloomberg, found, *inter alia*, that (a) "[t]he choice of venue for IPOs" illustrates that "the world's corporations no longer turn primarily to stock exchanges in the United States . . . to raise capital internationally;"[6] and (b) the American "legal environment" was responsible for "growing international concerns about participating in U.S. financial markets."[7] The McKinsey study was based upon interviews with "more than 50 financial services industry CEOs and business leaders," as well as survey responses received from over 300 other CEO's and senior corporate executives.[8]

As part of its plea for litigation reform, the McKinsey study calls for a "cap" on auditor liability, as well as limiting the liability of "foreign companies with U.S. listings to securities-related damages proportional to their degree of exposure to the U.S. markets."[9] The McKinsey report incorrectly stated that one major U.S. accounting firm – Arthur Andersen – already had been driven out of business by litigation.[10] In fact, Andersen's demise was the result of its criminal conviction, and was totally unconnected to civil litigation.

Other critics recently have argued that the Securities and Exchange Commission ("SEC" or the "Commission") should even do away with the private right of action itself. They have argued that investors can rely upon SEC enforcement actions to recoup their losses.

A Major Purported Justification for Litigation Reform – an Alleged Decline in U.S. Competitiveness – is Flawed.

Reform advocates assert that change is necessary because the fear of abusive lawsuits has reduced the competitiveness of the U.S. capital markets. However, there is no credible evidence that the present litigation system has adversely affected American competitiveness. Indeed, as succinctly set forth in a May 2005 study conducted by the Economic Policy Institute ("EPI"):

> [t]here is no historical correlation between the inflated estimates of the costs of the tort system and corporate profits, product quality, productivity, or research and development (R&D) spending. Evidence suggests that the tort system, without the proposed restrictions, has actually been beneficial to the economy in all these areas.[11]

The EPI report further concluded that "it is hard to find any evidence that allegedly excessive tort costs have harmed the U.S. economy."[12]

In support of their contention that so-called "abusive" litigation has harmed American competitiveness, critics point to the rising number of initial public offerings that are being placed on foreign exchanges, particularly the London Stock Exchange ("LSE"), as opposed to Wall Street. In this regard, critics repeatedly cite to the same "facts" – of the 25 largest IPOs (by dollar volume) that took place during 2005, 92% (or 23 of 25) listed on an exchange outside of the U.S. (a figure that purportedly includes, *inter alia*, the largest single IPO during the last five years).[13] Critics further assert that while 90% of all funds raised by non-U.S. firms through an IPO in 2000 occurred on the U.S. capital markets, that figure stood at only 10% in 2005.[14]

However, these critics wholly ignore statistics indicating that, at present, IPO activity on the U.S. securities' exchanges is robust. Dealogic has stated that U.S. IPOs totaled 172 during the first eleven months of 2006, raising over $40 billion in capital.[15] In November 2006 alone, $8 billion worth of new IPO capital was raised, the single best month in more than 5 years. Dealogic also reported that when comparing 2006 IPOs of greater than $100 million, new issues on the New York Stock Exchange were up over 20%, as compared to only 11% for their counterparts on the LSE.[16] Additionally, there were 94 registered IPOs on the American exchanges during the last quarter of 2006 – the highest quarterly level since 2000.[17] *Barron's* has reported that U.S. IPO volume during 2006 represented a 22% increase over 2005, and an almost 170% increase compared to 2003.[18]

Statistics regarding the growing number of IPOs being placed in London, yet another "trend" cited by critics, are deceptive in that they incorporate new offerings on the "Alternative Investment Market" (or "AIM"). Indeed, in 2005 alone, over 500 new listings were placed on AIM.[19] Yet, as of the end of 2005, 70% of the firms on AIM had "a market capitalization under $50 million"[20] (and thus would be too small for a U.S. listing). But, AIM is geared toward speculative companies that often lack a track record of any earnings at all.[21] Moreover, while the average U.S.-based IPO between January and June 2006 raised $205 million, the average IPO on AIM during that same period raised less than $60 million.[22] Furthermore, many AIM-placed IPOs could not qualify for a U.S. listing, because they could not meet U.S. listing standards.

While some studies have concluded that, at present, the LSE raises more IPO money than do the American exchanges, it is important to focus not only on the number and size of new IPOs, but on their quality. Indeed, when one examines the issue closely, the quality of recent London-based IPOs does not support the contention that radical changes in U.S. law and investor protections are warranted.

In point of fact, many recent London-based IPOs involve particularly weak companies, a fact which led James Chanos of Kynikos Associates to decry that "[t]his is the worst dreck I've ever seen."[23] For example, PartyGaming, an online gaming company and one of London's biggest IPOs of the past several years, has lost much of its value recently as U.S. regulators tightened restrictions on the transfer of money to gambling sites offshore. In a June 2005 IPO consisting of 781.6 million then existing "ordinary shares," the firm raised $1.7 billion.[24] While PartyGaming's shares were priced initially at 116 pence (or $2.12) -- by October 11, 2006, the firm's share price stood at only 37 3/4 pence (or $0.70), representing an aggregate loss to investors on those "ordinary shares" of $1.11 billion. All of the funds that were raised in the company's initial offering went exclusively to PartyGaming's founders, rather than to the firm itself.[25]

There are numerous other examples of this same phenomenon. In February 2005, AFK Sistema ("Sistema"), a Russian company, raised $1.56 billion in an IPO placed in London. While the offering was hugely successful, the company's prospectus posed serious questions as to whether the firm presented a safe investment opportunity. Sistema is controlled by its Executive Chairman, billionaire Vladimir Yevtushenkov, which, in the company's own words, permits him "exert significant influence over certain actions requiring shareholder approval."[26] Indeed, the firm conceded that only two members of Sistema's board were independent and that "[t]he interests of [the firm's Executive Chairman] could conflict with the interests of our shareholders... and he may make decisions that materially adversely affect your investment..."[27] As if that were not enough to raise a red flag, Sistema also noted that it had previously engaged in numerous self-interested transactions (and that it "may" continue such a course of conduct in the future). In the firm's own words, such deals might "potentially result[] in the conclusion of transactions on less favorable terms than could be obtained in arm's-length transactions."[28]

Yet another Russian company, Rosneft, also experienced great success when it went public in London in mid-2006 (this was the largest IPO in history involving an oil company). Notwithstanding that fact, some have questioned aspects of the firm's asset acquisition history (calling it "little more than legalised money-laundering").[29] Moreover, the company's prospectus illuminated numerous risks associated with the offering including, but not limited to, self-interested transactions and accounting procedures and processes that "may not be as sophisticated and robust as those of companies organized in jurisdictions with a long history of compliance with U.S. GAAP" (indeed, the company stated that its accounting firm had "identified" the existence of specific internal control weaknesses that were "material").[30] These problems are not minor or trivial – but rather appear to reflect a company with a somewhat troubled past (and a questionable long-term future).

Furthermore, a recent report issued by BDO Stoy Hayward ("BDO") suggests that London was "paying a steep price" for "a slew of new stock listings" during 2006 as "financial fraud in the United Kingdom rose 40 percent."[31] Several of the reasons cited for this increasing fraud should cause concern on the part of all investors: (a) "[t]he UK is regarded as a soft touch in terms of the limited prospects of being successfully prosecuted or of being sentenced to a long term"[32] and (b) "[t]he government does not take fraud seriously enough. . . . In short, the fraudsters all too often get away with their criminal activity."[33] Significantly, BDO expects 2007 to bring a rise in frauds against "venture capitalists and corporate lenders," premised upon "deliberately over-optimistic" business plans and "falsely valued" property.[34]

All of this leads to the conclusion that the increase in London-based IPOs is being fueled by firms that do not qualify as a safe place for the public to invest their hard-earned savings. Clearly, the American capital markets (and those that invest in them) would not be served by a surge in IPOs by firms that present undue risk.

While the largest IPO during the first half of 2006 (involving Bank of China Ltd.), was placed on the Hong Kong Exchange (which itself has seen increased IPO activity in recent years), China also has been criticized for lax enforcement of accounting and other financial standards. As succinctly noted in one recent press report:

> Global markets, and Asian ones in particular, are hell-bent in attracting new companies, particularly Chinese ones, into IPOs largely without the scrutiny of regulatory agencies. ***At some point, the lack of scrutiny of corporate governance that U.S. securities law now demands is going to rebound with a vengeance.***
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> A Hong Kong-based partner with one of the big three international accounting firms recently said privately that as far as he knows, not one single due diligence of Chinese companies has ever been completely successful. ***In other words, virtually every multinational setting up for business to take equity in a Chinese company has discovered that what they are taking on is not what they thought they would find. Chinese corporate governance by and large is woeful.***[35]

Indeed, the article further notes that "[m]ost observers regard both the Hong Kong Stock Exchange and the government's enforcement arm, the Financial Services Commission, to be relatively ineffective."[36] In view of the foregoing facts, it hardly is surprising that the piece concludes that other financial markets (such as Hong Kong and London) "may end up wishing" that they had U.S. type protections that promoted transparency and accuracy in financial reporting.[37]

In addition, reform proponents wholly ignore that any drop in U.S. IPO activity can be explained by factors unrelated to the current securities litigation system which has been in place for over sixty years, including both (a) high American underwriting fees; and (b) an inclination for placing IPOs in the offering company's country of origin. For example, a June 2006 study concluded that underwriting fees on U.S.

based IPO transactions commonly run from 6.5% to 7%, while such fees are, on average, 3-4% for deals placed on the European exchanges.[38] Furthermore, a recently-issued white paper authored by Ernst & Young found that during both 2005 and the first half of 2006, the overwhelming majority of firms undertaking initial public offerings (90%) did so in their "home country" (for example, during the first six months of last year, 690 of the 767 firms that conducted an IPO did so in their country of origin).[39] Indeed, in 2005, nine of the ten largest IPOs were placed domestically.[40] Of the ten largest IPOs that took place during the first half of 2006, only two occurred outside of the listing firm's country of origin.[41] The largest IPO for all of 2006, involving Industrial & Commercial Bank of China, raised $19 billion -- with the shares listed "locally" (on both the Hong Kong and Shanghai exchanges). According to the authors, this experience was "not new" since "[e]ven at the height of the U.S.-based tech boom in 2000, 94% of IPOs listed domestically."[42]

The Ernst & Young report also determined that in 2006, the American markets had, in fact, been "highly successful in attracting what could be termed 'in play' IPOs"[43] – finding specifically that of the seventeen IPO transactions during the first half of 2006 that presented a "competitive opportunity" for the American exchanges, 65% of them (11 of 17) were placed in the United States. This figure (which included four "in play" IPOs that raised over $380 million each) was an improvement over the U.S. "success rate" with regard to "in play" IPOs during 2005 (which was 58%). Indeed, the "in play" success rate for the first six months of 2006 compares favorably to the 73.1% rate that transpired during 2000 (two years prior to the enactment of Sarbanes Oxley).[44]

The fact that this country's "in play" success rate is as high as it is is extremely impressive given that firms contemplating an IPO now have the benefit of more listing alternatives than ever before. At present, there are 46 exchanges outside of the North America with a total market capitalization in excess of $25 trillion.[45] During 2005, "no fewer than twenty-nine different countries hosted more than $1 billion worth of IPOs."[46] Notwithstanding these facts, however, during the first half of 2006, the American capital markets captured "in play" IPO deals from countries such as China (China GrenTech Corp. Ltd., which raised $112.5 million), Russia (CTC Media Inc., which raised $380.52 million), and Argentina (Ternium SA, which raised $542.86 million).[47]

Critics also have stated that since some U.S.-based firms place IPO's abroad, American competitiveness must be on the wane. That, of course, is a gross overstatement – given that during the first six months of last year, 102 of the 110 initial public offerings involving an American based firm were placed on a U.S-capital market.[48] Six of the remaining eight were placed on AIM and involved companies which did not have the historical revenue stream to support a U.S. listing (according to Ernst & Young, on average, those six IPOs raised just $53.8 million each).[49]

Apart from the foregoing, reform advocates also disregard the fact that the Commission's interpretation of Rule 144[50] has made the private equity markets an attractive alternative to an IPO. In a series of no-action letters,[51] the SEC has indicated that under certain circumstances, issuers lawfully may follow a private "restricted stock" offering with a "registered" exchange offer. These offers are exempt from the liabilities imposed by the Securities Act of 1933[lii] that governs IPOs. Thus, issuers, in what have become known as "AB exchange offers," may access capital without any liability risk under the Securities Act. This also has markedly reduced the number of IPOs. Indeed, as even the CCMR report concedes: "[i]n 2005, foreign companies raised $83 billion in 186 equity issues in the Rule 144A market compared to $5.3 billion in 34 public offerings."[53] Thus, "90 percent of the volume of international equity issues in the United States were done in the private market."[54]

Firms Enjoy a Listing Premium and a Lower Cost of Capital Under the Current System.

It is well established that companies that list in the United States enjoy a lower cost of capital. Indeed, a recent study published by Luzi Hall of the University of Pennsylvania and Christian Leuz of the University of Chicago found "strong evidence that cross-listings on U.S exchanges [were] associated with a significant decrease in firms' cost of equity capital."[55] Lower capital costs averaged 12.48%,[56] with the "reduction in the cost of capital for exchange listings . . . larger for firms from countries with weak institutional structures, i.e., less extensive disclosure regulation and weak investor protection."[57] In addition, firms that list on a U.S. exchange also enjoy a listing premium of 16% on average.[58] This premium is even larger (37%) for firms that list on a major U.S. exchange.[59] These increased valuations and lower capital costs are the direct result of a U.S. regulatory landscape that promotes transparency and investor protection. Regulators and legislators who tamper with fundamental investor protections do so at peril of jeopardizing these premiums.

A leading study on the relationship between a U.S. listing and increased valuations was published in January 2003 by, *inter alia*, Professor Andrew Karolyi of the Ohio State University and Professor Craig Doidge of the University of Toronto.[60] The study, entitled "Why are foreign firms listed in the U.S. worth more?," concluded that investor protection mechanisms in place in this country (including increased disclosure) were responsible for higher valuations enjoyed by firms that cross-listed. Stated otherwise, the foregoing study clearly established that investors are willing to pay a premium if a particular firm agrees to adhere to U.S. laws and regulations designed to promote transparency and fair and honest markets. Subsequent work performed by Professor Karolyi, *et al*. found that the increased valuations of foreign firms also held for the period from 2003 to 2005. Commenting on these findings, a New York Stock Exchange Vice President noted that: "[t]he study shows that a U.S. listing is worth it, despite the incremental cost of compliance with Sarbanes-Oxley ***…Global investors feel a new-found confidence when companies are willing to accept U.S. laws and regulations, and they value those companies more."*** [61]

Given that there is a significant benefit to foreign firms that choose to list on an American exchange, it is not difficult to see why Charles D. Niemeier, member of the U.S. Public Company Accounting Oversight Board, recently concluded that:

> [c]laims that the cost of securities regulation in the United States . . . has damaged the competitiveness of U.S. companies and markets are to my mind overstated. ***Indeed, the U.S. financial reporting and disclosure system has strengthened U.S. markets' resilience for the long-term and contributes significantly to the competitive edge the companies enjoy due to favorable long-term funding.***[62]

Not surprisingly, these studies (establishing that a foreign firm's valuation increases due to the increased transparency offered by the American capital markets) are ignored (or manipulated) by critics. The McKinsey study makes no reference to the work performed by Professor Karolyi, ***et al***. While the CCMR report concedes the existence of a premium, the report asserts that the premium has fallen 19% since 2002 (the enactment date of Sarbanes Oxley).[63] Thus, the authors posit that there is a direct correlation between increased regulatory burdens in this country and a declining listing premium.[64]

However, that argument is fundamentally flawed on several fronts. First, there has been no 19% decline in the listing premium since 2002. Rather, the CCMR appears to have arrived at the 19% figure merely by comparing the "listing premium[s] between the 2003-2005 period and the 1997-2001 [period]."[65] ***In point of fact, the work performed by Professor Karolyi, et al. establishes that the valuation premium actually has grown larger since that time.***[66] While the listing premium did fall to its lowest point since

1997 during calendar year 2002 (in response to the wave of corporate scandals occurring in that year), the rising premium since that time confirms that the Sarbanes Oxley reforms, which sought, *inter alia*, to promote transparency, have both repaired (and enhanced) worldwide confidence in the American capital markets. Second, while the listing premium has risen since 2002, the cost of complying with Sarbanes Oxley related regulations appears to have decreased during that period. By way of example, a recent survey conducted by Financial Executives International concluded that:

> total average cost for [SOX] Section 404 compliance was $3.8 million during fiscal year 2005, ***down 16.3 percent from 2004***. The data shows that many of these reductions can be attributed to lower staff and consultant time and reduced auditor fees, including the following 2005 vs. 2004 comparisons:
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> • Internal staff time decreased 11.8 percent
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> • External costs, including software and consultant fees, but excluding primary auditor fees, fell 22.7 percent
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> • Auditor attestation fees dropped 13 percent.[67]

Apart from the foregoing, empirical evidence also suggests that the lower cost of capital enjoyed by firms listing in the U.S. is "several orders of magnitude greater" than the cost of compliance with American regulation.[68]

Interestingly, Professor Karolyi also doubts the validity of the link drawn by the CCMR Report, stating that global events are responsible for any declining premium that may have been found by the committee. Indeed, Professor Karolyi notes that stock markets around the globe all have been affected by the adoption of stronger listing standards on an international scale, along with the coordination of those standards across borders.[69] Accordingly, to the extent that the listing premium is declining (which it is not), such a phenomenon actually is being fueled by the fact that other countries have begun to adopt "investor protection" procedures and processes based on the long-established U.S. model.[70] As explained by Ethiopis Tafara, the Director of the Office of International Affairs at the Commission, the primary reforms implemented by Sarbanes Oxley "have not competitively disadvantaged U.S. markets, simply by virtue of the fact that they have been widely adopted elsewhere."[71]

Private Suits are an Invaluable Tool in the Overall Regime of Enforcing this Country's Securities Laws.

One suggested reform that recently has received a great deal of public attention is that the SEC should, by rule, preclude private actions against corporations under Section 10(b) of the Securities Exchange Act of 1934 ("Section 10(b)"),[72] leaving such suits to be brought only by the Commission. Such a radical suggestion is extremely troublesome.

The purported legal basis for such a extreme change to the current securities litigation system is Section 36 of the Exchange Act ("Section 36") which provides, in relevant part, that the Commission can "conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this chapter or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors."[73] It is difficult (if not impossible) to see how such a reform to Section 10(b) litigation would be "consistent with the protection of investors," since it would eviscerate an invaluable weapon that shareholders have used for at least sixty years to seek redress on account of financial misconduct affecting the markets.

Moreover, it would strain credibility to its limits to assert that SEC rulemaking under Section 36 can override express Congressional action (such as the Private Securities Litigation Reform Act ("PSLRA")),[74] which sought, and had the desired effect of, curtailing dramatically frivolous suits, while at the same time encouraging institutional investors to take the lead in ensuring that cases were meritorious and well-prosecuted), as well as the myriad of legal precedents from the federal courts that have interpreted the Exchange Act and Section 10(b). A fair construction of Section 36 is that the Commission can exempt an individual firm from specific Exchange Act requirements based upon compelling facts or circumstances (and so long as the exemption serves the public interest). That provision cannot (and should not) be read as authorizing the wholesale elimination of a well-recognized legal remedy which helps ensure that the three primary aims of securities litigation are fulfilled: (a) obtaining compensation for aggrieved investors; (b) ensuring that wrongdoers are punished; and (c) preventing future transgressions.

Apart from the foregoing, proponents of this change overlook the fact that private lawsuits against wrongdoer firms are invaluable in ensuring that this country's securities laws are vigorously enforced. Indeed, both the Commission and the Supreme Court long have recognized that fact. Harvey J. Goldschmid, a former SEC member and currently a Professor of Law at Columbia University, has opined that that "[p]rivate enforcement is a necessary supplement to the work that the SEC does."[75] Former SEC Chairman Arthur Leavitt has stated that "private suits are the primary method for compensating defrauded investors."[76] The Supreme Court has "repeatedly . . . emphasized" that private actions under the Exchange Act "provide a most effective weapon in the enforcement of the securities laws and are a necessary supplement to Commission action."[77] Indeed, since 1946, the federal courts have recognized that private enforcement of Section 10(b) is vital both to effectuate the underlying purpose of the securities laws (ensuring honest and open markets) and to deter future transgressions that might threaten market integrity.[78]

There is no question that at present, private enforcement of the federal securities laws is both a necessary and indispensable part of the overall regulatory scheme. Hampered by budgetary constraints, the number of enforcement actions commenced by the Commission in recent years continues to fall – indeed, that agency brought 9% fewer cases during the fiscal year ending September 30, 2006 than it did during the prior fiscal year.[79] At the same time, corporate malfeasance appears to be on the rise. A March 2006 report by the proxy advisory firm, Glass, Lewis & Co. ("Glass Lewis") concluded that "[c]ompanies with U.S.-listed securities filed 1,295 financial restatements in 2005, nearly double the previous year's mark."[80] This figure represented one restatement for every 12 publicly-traded companies and compels the conclusion that investors can ill afford a system that impairs their right to pursue those firms that affirmatively (and knowingly) misrepresent facts in their financial statements. The sheer volume of these restatements compels the conclusion that even post-Sarbanes Oxley, firms continue to be plagued by material weaknesses in their control systems. Equally as troubling was the report's finding that firms often seek to hide restatements from their own shareholders, a phenomenon referred to as "one of Wall Street's biggest open secrets." In so-called "stealth restatements," firms announce restatements "without amending their prior filings" – an occurrence that "often leaves investors unaware" that prior financial filings are incorrect (and should not be relied upon).

In addition to an increasing number of restatements, the past year has seen over 100 companies become embroiled in the options-backdating scandal.[81] Analysts already are questioning whether the SEC has adequate resources to investigate and prosecute backdating cases. Lynn E. Turner, Director of Research at Glass Lewis, and a former Chief Accountant at the SEC, has noted "[g]iven the budget cutbacks in the number of people in the SEC's enforcement arm, and the ongoing corporate scandals, all investors should be worried."[82] Only by banding together through the class action vehicle can investors obtain the strength in numbers that can give them any hope of recovery on account of such malfeasance.

Also telling is the fact that where corporate malfeasance has been the subject of both a private securities fraud class action and a parallel SEC investigation, the private action typically has resulted in a greater recovery for investors. Indeed, in several significant cases, the Commission's efforts failed to achieve any financial compensation for aggrieved stockholders. For example, in the pending Global Crossing class action litigation, four partial settlements to date have recovered $444 million for injured shareholders. In stark contrast, the efforts of the SEC resulted in no recovery for the firm's investors. Similarly, the Oxford Health Plans, Inc. securities litigation settled for $300 million, including a payment of $75 million by the firm's outside auditor. Here again, the SEC's enforcement efforts recovered no money for the company's stockholders. In Cendant, private investors recovered $3.2 billion, while the SEC got nothing.

Even in those cases where proceeds have been recovered in both the class action and by the Commission, the private action has seen investors recover far greater sums. In the case of Symbol Technologies, a class action settlement garnered $102 million, while the settlement fund in a parallel SEC action was just $37 million. A class action settlement involving Bristol-Myers Squibb resulted in a $300 million fund for investors – while the SEC settlement fund was only half that figure. In WorldCom, the SEC obtained $750 million, while the private suit obtained over $6 billion. The list goes on an on.

Moreover, as Professor Goldschmid stated, dual enforcement of the nation's securities laws by both the Commission and private plaintiffs serves as "a potential safety valve against the potential capture of the agency by industry."[83] Ironically, in response to an inquiry made by Senator Charles Grassley (R-Iowa), the Government Accountability Office currently is reviewing "the operations of the Securities and Exchange Commission's enforcement division and compliance department."[84] In a letter, Senator Grassley indicated that he had "become increasingly concerned regarding the operations of the SEC, and whether the SEC is faithfully adhering to its mission to protect investors."[85]

The So-Called "Circularity Argument" Does Not Justify Radical Securities Litigation Reform.

Critics of the present securities litigation system also have raised the canard that shareholder litigation is just shareholders suing themselves, since they are the actual owners of the defendant companies. However, every lawsuit is about the reallocation of resources based upon where fault lies. In this context, shareholder suits reallocate funds to injured shareholder purchasers from current shareholders. The injured shareholders paid substantially more for a share of the corporation due to the fraud than did the current holders. Thus, a suit merely seeks to readjust this disparity somewhat. While it is true the two groups may have some overlap, that also will be largely true any time one large corporation brings suit against another (since institutional investors largely own all of corporate America). In July 2005, for example, significant resources were reallocated among a group of overlapping shareholders when Microsoft agreed to pay IBM $775 million (and also provide a credit of $75 million) in order to resolve certain private antitrust claims purportedly held by IBM[86] (this arrangement dwarfed the average settlement in securities class actions in 2005 – which was $25 million, according to NERA Economic Consulting ("NERA")). No one would seriously suggest that Microsoft's payment should have been reduced because Microsoft and IBM have many, if not most, shareholders in common.

In addition, for several reasons, the notion that a class action recovery merely involves a shift of funds among the same shareholders is an over-generalization. First, there are countless cases in which the overlap between "injured" and "current" shareholders actually is quite small (that is, the group of investors who held positions in a securities fraud defendant at the end of the class period differ substantially from the group of investors holding shares at the time of a settlement). At Oxford Health Plans (settlement of $300 million), stockholders who owned shares in the firm at the end of the class period, but not at settlement, held a combined 64.53 million shares at the class period's conclusion. In Dynergy (settlement of $473 million), shareholders holding 127.23 million shares in the firm at the end the end of the class period (but not at settlement) owned only 5.49 million shares a year later. These numbers are even more stark when one looks at Symbol Technologies, Inc., which settled an outstanding securities fraud complaint for $163 million. There, shareholders who owned stock at the end of the class period (but who disposed of their shares prior to settlement) held a combined 79.93 million shares at the conclusion of the class period. That number declined to only 7.11 million shares one year later. At DPL, Inc. (value of settlement $140 million), 14.3 million shares were held at the end of the class period by shareholders who no longer owned a piece of the company at the time that the matter was settled.

Furthermore, this "circularity" argument (shareholders suing themselves) ignores the increasing use of so-called "index investing" by large institutional shareholders. Under this approach, a stockholder's stake in a particular company automatically is sold as the share price declines. Upon a huge stock drop precipitated by fraud, institutional investors utilizing such an investment strategy quickly are transformed to the status of "former shareholders." For example, in the case of Oxford Health, one large shareholder owned 8,453,717 shares worth $633 million on September 30, 1997, prior to the October 27, 1997 disclosures that sent the company's stock plummeting 62%. As a result of the October 27th revelations, this shareholder's shares lost $395 million in value. By December 31, 1997, they owned zero shares. This investor, and the many others similarly situated, surely had a strong economic interest in recovering as much as possible of the $395 million loss in value that it suffered on October 27, 1997. And since it no longer owned any of the firm's stock, any such recovery could not possibly be accurately portrayed as a transfer of money from the right hand to the left. Nor is this an isolated example, since it is merely indicative of the effect of indexing. And, of course, directed investment strategies also can have the very same result.

Institutional Investors Achieve Meaningful Corporate Governance Reform Through Litigation.

Critics also overlook the deterrent effects of our system of investor rights. Indeed, many of the advances in shareholder rights and corporate governance over the past twenty-five years have been a direct result of litigation.

In the seminal case of *Smith v. Van Gorkom*,[87] the Delaware Supreme Court reversed a decision issued by the Court of Chancery granting judgment for the defendant directors – holding that the board violated its duty of care when it hastily agreed to a sale of the corporation after only two hours of consideration, in reliance upon nothing more than a twenty minute verbal presentation by the company's Chairman. The *Van Gorkom* case started a veritable revolution in board procedures and investor protection. The decision compelled companies to retain independent third-party experts to assist in evaluating significant transactions, including those affecting corporate control.[88] *Van Gorkom* also resulted in a host of procedural protections that we now take for granted such as: fairness opinions, special committees of independent directors and independent legal advisors.

Notwithstanding that the Delaware Supreme Court in *In re Walt Disney Co. Deriv. Litig.*[89] affirmed a lower court's decision that the payment to Michael Ovitz of $140 million in no-fault severance benefits after only 14 months as Disney's President was not a waste of corporate assets, the case focused awareness on the practices and processes governing executive compensation. In view of *Disney*, corporate directors are now dealing with compensation decisions very differently. Compensation committees are retaining third-party consultants who have no prior ties to the firm to ensure that they are receiving "independent and unbiased advice;"[90]

and no longer are blindly relying upon "benchmark" studies to establish executive remuneration. Such studies, which look to purported industry norms and pay packages at peer companies, have had the effect of artificially inflating executive compensation.[91] Furthermore, corporate boards are ensuring, in ever-increasing numbers, that compensation committees have access to all material information before they arrive at executive pay decisions.

In the *WorldCom* case,[92] the court found that the firm's underwriters failed to perform adequate due diligence when they sold $25 billion in WorldCom bonds to investors over a period of several years. In the wake of that case, underwriters of public offerings have been prompted to exercise a greater degree of care when investigating and verifying the representations of management during the due diligence process. Underwriters no longer rely blindly on audited financial statements (or so-called "auditor comfort" letters in the case of unaudited statements) when assessing management's representations regarding a firm's financial condition. Instead, underwriters are conducting their own independent investigation of the hard facts underlying such representations (and are retaining independent accounting experts to assist them with that undertaking). Moreover, the superficial review that constituted due diligence before *WorldCom* apparently has now given way to a real critical assessment.

Former New York State Attorney General Eliot Spitzer's highly publicized actions against Wall Street investment banks pertaining to analyst "conflict of interest" led to significant reforms, including the creation of "walls" between research analysts and investment banking personnel. Now, investors receive the benefit of truly "independent" research. In addition, as a direct result of Mr. Spitzer's suit against Marsh & McLennan, several major insurers agreed to cease providing brokers with so-called "contingent commissions." Akin to a "kickback," such commissions had resulted in brokers steering customers (often against their best interests) to specific insurance carriers.

Recently, there has developed a substantial body of research showing that companies with good corporate governance practices tend to outperform companies with poor practices.[93] In recognition of that fact, since the enactment of the PSLRA, institutional investors (particularly public pension funds) have used shareholder litigation in ways that have dramatically enhanced their ability to advance meaningful corporate governance reform. Indeed, such investors often refuse to settle with corporate defendants without such reform being put in place. For example, the Broadcom Corp. securities litigation suit was settled with an agreement to select a "lead independent" director and to allow the shareholders the right to nominate a director. Similarly, as part of a settlement of shareholder litigation involving Ashland Inc., plaintiffs secured a series of corporate reforms from the company, including the right to submit candidates for nomination to the firm's board of directors. Investors achieved an extensive set of corporate governance reforms in connection with the settlement of securities litigation involving Hanover Compressor – including the regular rotation of the company's outside auditor, as well as a commitment that shareholders holding more than 1% of the firm's stock could nominate candidates for two new independent director positions.

Arbitration Of Securities Fraud Disputes Would Be Fundamentally Unfair To Shareholders.

Among the reforms advocated by the McKinsey study is that investor securities fraud suits should be heard in arbitration (as opposed to federal court). In the view of McKinsey, arbitration would reduce the cost to public firms, while, at the same time, purportedly providing investors with "more timely and cost-effective remedies."[94] While no one would dispute that public firms would substantially reduce their costs if Section 10(b) disputes were subject to arbitration, shareholders' rights would be gutted under such a system.

It is well-known that arbitration does not provide parties with any formal discovery rights. While this fact may not pose a problem in a garden-variety commercial dispute between two parties of equal bargaining position (each of whom will have employees or agents with knowledge of the underlying facts in dispute and access to relevant documents), it certainly is of vital importance in a Section 10(b) case where the documents evidencing the fraud (and those persons responsible for the malfeasance) are under the exclusive control of the wrongdoer corporation. Apart from the issue of discovery, arbitrators typically lack formal legal training, a major problem already identified with National Association of Securities Dealers ("NASD") arbitrators,[95] and, as such, may not fully understand and/or follow the applicable law. Since the decisions of arbitrators typically are "final" (there only are limited appellate rights associated with arbitration awards), this lack of training ultimately may result in meritorious securities suits being foreclosed. Furthermore, since arbitrators do not answer to higher courts (as do federal district court judges), but only to the "market for arbitrators" (which is driven solely by their ability to obtain repeat business), arbitrators tend to favor their more frequent corporate clients (or firms that could become "repeat customers").[96] In view of the foregoing, it cannot plausibly be maintained that the investing public at large would benefit from a system where arbitration was the preferred method of resolving Section 10(b) claims.

The Empirical Evidence Shows that Securities Class Action Litigation Reform is Not Necessary.

In 1995, in response to alleged misuse of the class action process in federal securities litigation, Congress enacted the PSLRA.[97] By the late 1980s and early 1990s, politicians and business leaders began to criticize class action suits brought pursuant to Section 10(b), asserting that there had been an explosion of meritless claims.[98] Detractors claimed that such suits were being used by investors to insure against investment losses, and that any drop in the price of stock – whether fraud-related or not – resulted in litigation.[99] Moreover, critics also stated that "[t]he cost of discovery often force[d] defendants to settle abusive securities class actions. . . . [P]laintiffs sometimes file[d] frivolous lawsuits in order to conduct discovery in the hopes of finding a sustainable claim not alleged in the complaint."[100]

The PSLRA was designed to curb these perceived abuses. In the words of one court, "[l]egislators were apparently motivated in large part by a perceived need to deter strike suits wherein opportunistic private plaintiffs file securities fraud claims of dubious merit in order to extract large settlement recoveries."[101] The statute imposed a number of restrictions on securities fraud class actions, specifically, and securities actions, generally. For example, the PSLRA imposed an automatic stay of discovery once a defendant in a securities class action moves to dismiss under Federal Rule of Civil Procedure ("FRCP") 12(b)(6);[102] created a safe harbor for "forward-looking" statements;[103] and heightened the pleading standard for scienter beyond the requirements of FRCP Rule 9(b).[104]

The effects of the PSLRA on securities litigation have been ***dramatic***. A recent study by NERA found that the rate of dismissal of securities fraud cases has "nearly doubled" since 1995.[105] More specifically, in litigation commenced between 1991 and 1995, just over 19% of cases were dismissed. That figure grew to 38.2% in cases filed between 2000 and 2004. In short, the PSLRA has resulted in the screening out of so-called strike suits. This conclusion is buttressed by research conducted by James D. Cox, a securities and corporate law professor at Duke Law School, who found no explosion of abusive litigation post-PSLRA. Professor Cox "studied 600 class action lawsuits over the last decade" and concluded that it was hard to locate "abusive or malicious" filings in view of the PSLRA (and court decisions implementing the statute) which have made the pursuit of such claims "more difficult."[106]

Apart from the foregoing, new securities fraud class action filings ***actually are declining***. In this regard, Cornerstone Research recently reported that that "[c]lass action securities fraud filings plunged to a record low in 2006" – the 110 filings during 2006 were "the smallest number of filings in a calendar year" since the passage of the PSLRA (and further represented (a) a 38 percent decline from the number of filings made during 2005 (178); and (b) a 43 percent decline from the "ten-year historical average of 193").[107]

Concerned about the alleged availability of insurance (as well as what they see as the potential for further reduction in the number of players in the accounting industry), several reform advocates have expressed dismay at suits brought against outside auditing firms and have advocated that a "cap" be placed on the potential liability of auditors. However, in advocating for such reform, McKinsey relies upon facts that simply are untrue. In particular, the McKinsey study posits that Arthur Andersen was one of several companies that were "forced into liquidation . . . because of the threat of securities-related litigation."[108] Such a contention ignores history – the demise of Arthur Andersen was caused by its criminal conviction in 2002. Moreover, McKinsey cites no other examples of companies purportedly liquidated because of securities litigation. The reason is that they do not exist.

While the McKinsey study posits that litigation reform would prevent further consolidation in the accounting profession, the evidence shows that most new securities fraud filings do not even name auditors as defendants. More specifically, during 2005, only 3% of newly filed securities fraud actions included an accounting firm as a defendant. That figure dropped to 2% for actions commenced during the first half of 2006.[109]

Apart from the foregoing, enacting a limit on auditor liability potentially robs investors of their right to seek compensation from actors who have played a starring role in a number of the most prominent corporate governance fiascoes of recent years. Moreover, the rise in restatements reported by Glass Lewis strongly suggests that independent auditors continue to fall far short of the mark when it comes to (a) ensuring that financial statements comply with generally accepted accounting principles and (b) assessing whether their corporate clients have adequate control procedures in place to make certain that information required to be disclosed is done so accurately.

If reform actually is needed in this area, it should involve a trade off making it easier to recover from independent auditors who have ignored their important role as "corporate watchdog." In 1994, the Supreme Court held that Section 10(b) would not support a cause of action for aiding and abetting and also indicated in dictum that no aiding and abetting liability exists under any of the liability provisions of either the Securities Act of 1933 or the Exchange Act.[110] In practical terms, this decision has made it more difficult to bring securities fraud claims against the "agents" of a corporation (such as an outside auditor), even when such agents provided substantial assistance to those corporate officials who perpetrated the misconduct that caused investors' losses. In acknowledgement of that fact, John C. Coffee, Jr., Professor of Law at Columbia University, has proposed a "trade off" – recognition of aiding and abetting liability under the federal securities laws in exchange for a "cap" on auditor liability in the neighborhood of $300 million.[111] Whether this is truly necessary or desirable, is something that needs discussion. But, at least it is a reasonable starting point.

The McKinsey study asserts that litigation reform is now needed "to eliminate those suits filed to pressure companies into settlement rather than to redress legitimate wrongs, as these suits dampen the business environment without providing a commensurate social benefit."[112] However, overlooked by McKinsey (and others) is that the empirical evidence hardly suggests that any such suits still exist post-PSLRA. Quite to the contrary, the current system is working as it should – screening out frivolous filings, while, at the same time, encouraging sophisticated institutional investors to take the lead in prosecuting meritorious actions where corporate malfeasance has resulted in significant damages to the investing public at large.

Increasing Settlement Amounts Do Not Justify Securities Litigation Reform.

In support of its contention that litigation reform is of vital importance to the future of the American economy, the McKinsey study points to an increasing apprehension on the part of U.S. corporations that has been fueled, in part, by growing securities fraud settlements. More specifically, the study notes the "total bill for securities settlements in 2005 was $3.5 billion" (excluding WorldCom related settlements) – a 15% increase over 2004 and an almost 70% increase over 2003.[113] However, this argument is misleading – increasing settlements are simply the result of higher losses on the part of investors that occurred during the first part of this decade. Indeed, the higher settlements of the past 2-3 years are primarily due to the vast number of cases that arose as a result of "the collapse of the stock market bubble in 2000-2002."[114] In this regard, NERA reported that "median investor losses for cases with class periods ending in 2000-2002 [were] $397 million – more than 80% higher than the maximum for any prior end-of-class period year."[115] Moreover, after reviewing the data on settlements through the end of 2006, NERA concluded that "while average settlements have been rising, ***there is no statistical evidence that this is the result of a more difficult litigation environment for defendants***."[116]

In addition, critics ignore that the losses suffered by the investing public on account of corporate misconduct have far outpaced rising settlement amounts. While average settlement values in securities class actions grew to $25 million in 2005,[117] those settlements provided investors with a median settlement payment of only 2.8 cents for each dollar that they lost.[118]

Furthermore, one should not overlook the fact that many of the settlements over the past few years featured, as a critical component, a payment by a third party actor (*e.g.*; auditor, underwriter, *etc.*) whose own malfeasance proximately caused the losses suffered by the investing public. Thus, the system already is working in the way that critics believe it should – apportioning fault among parties in accordance with their relative degrees of responsibility.

Pro-Business Interests Are Attempting to Scale Back Investor Rights on a Variety of Different Fronts.

At the end of the day, the current debate is not just about the continued viability of the shareholder class action. Shareholder lawsuits are just one part of the entire package of investor rights through which investors demand accountability from the companies in which they invest. In recent years, pro-business interests have sought, on several different fronts, to oppose shareholder activism that fosters such accountability. Thus, the fight over investor lawsuits actually is a fight over corporate accountability. Conrad Black was not alone in attacking the investors who demanded that he respect their ownership rights as "governance terrorists."[119] Business Roundtable President, John Castellani, has expressed his view that the entire movement criticizing executive compensation levels is in reality "not about corporate governance."[120] In a recent op-ed piece appearing in the *Wall Street Journal*, Henry Manne, Dean Emeritus of the George Mason University School of Law, asserted that "many of the advocates of shareholder democracy actually have a hidden agenda, most usually either a greater degree of government control over private enterprises, or more power to unions via their control of pension funds."[121]

Thus, it is not just investor lawsuits that these vested interests find objectionable. They are viscerally opposed to proxy access -- the notion that shareholders should have access to a company's proxy to nominate directors. They have opposed majority voting for directors, as well as the NYSE's proposed reform of its voting rules to prohibit the practice of broker non-votes being counted for management. In other words, they consistently favor limits on investor rights and oversight of boards and management.

This broader, anti-investor agenda makes clear that the true goal of many reform advocates actually goes far beyond merely seeking "changes" to the manner in which investor class actions are prosecuted. In point of fact, these critics want to roll-back the gains that investors have made in recent years. They want a system that minimizes accountability to shareholders and reduces investor oversight of corporate boards. Advancing such a system would come with a huge price, however – since reducing accountability and transparency would threaten the integrity of the American capital markets. Since those markets draw their muscle and influence from a package of investor protections that is unparalleled in the world, to do as these critics would like will actually reduce, not enhance, American competitiveness.

CONCLUSION

The current system of investor rights has resulted in lower costs of capital and higher valuations. Moreover, these lower capital costs and increased valuations are inextricably tied to the enhanced quality and transparency of financial reporting in this country. Of course, this transparency and accuracy in financial reporting traces its roots to the enactment of the federal securities laws in the 1930s; and to the recognition by the courts beginning in the 1940s that investors could themselves take action under Section 10(b) to redress (and also deter) misconduct that adversely affected the maintenance of fair and honest markets.

Prior to the enactment of the PSLRA, there was little client control of shareholder litigation, resulting in frivolous filings, shoddy legal work and unchecked legal fees. The statute sought to (a) deter abusive filings and (b) promote institutional investor involvement in securities litigation as a means of ensuring that cases were litigated properly and in the best interests of class members (as opposed to attorneys). Over the past decade, that is exactly what has occurred. Abusive litigation has been sharply curtailed and the contributions of institutional investors to securities litigation have led to, among other things, significant governance reforms and lower fee requests.[122]

Simply put, a case cannot be made for radical litigation reform. Notwithstanding the McKinsey study's "urgent call" for action at the federal level,[123] in point of fact, firms and investors alike benefit from the current system – albeit in different ways. To alter the status quo now – in the wake of, *inter alia*, the options-backdating scandal and increasing numbers of restatements that threaten the integrity of reported financial results – sends the message that accountability to shareholders is a goal not worth pursuing. The new Congress (as well as the Commission) should resist the invitation to take any action that runs counter to that goal, as well as to the fundamental precepts that the securities laws were intended to promote fair dealing and ethical standards of honesty.

[1] The CCMR report is available at http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf. (and is hereinafter cited as the "CCMR Report").

[2] Floyd Norris, "Panel of Executives and Academics to Consider Regulation and Competitiveness," *The New York Times*, Sept. 13, 2006 (available at 2006 WLNR 15859180).

[3] Michael Orey, "How Business Trounced the Trial Lawyers -- By focusing on litigation reform at the state level, business has won key battles. Suddenly, it's a tough time to be a plaintiffs' attorney," *BusinessWeek*, Jan. 8, 2007 (available at 2007 WLNR 158184).

[4] Remarks by Treasury Secretary Henry M. Paulson on the Competitiveness of U.S. Capital Markets, Economic Club of New York, New York, N.Y., Nov. 20, 2006 (available at http://www.treas.gov/press/releases/ hp174.htm).

[5] *See* "Sustaining New York's and the US' Global Financial Services Leadership," McKinsey & Co., Jan. 2007 at p. 19. ("McKinsey"). A copy of the McKinsey study is available for download at http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf.

[6] McKinsey, *supra*, at Note 5, at p. 12.

[7] *Id.* at p. 16.

[8] *Id.* at p. 8.

[9] *Id.* at pp. 20-21.

[10] *Id.* at p. 76.

[11] Lawrence Chimerine and Ross Eisenbrey, "The Frivolous Case for Tort Law Change, Opponents of the legal system exaggerate its costs, ignore its benefits," *Economic Policy Institute - Briefing Paper #157*, May 17, 2005 (available at http://www.epinet.org/content.cfm/bp157).

[12] *Id.*

[13] *See, e.g.*, Dan Jamieson, "Blaming SOX for slump in IPOs seen as bum rap -- Law's advocates claim U.S. market has been hurt by globalization," *Investment News*, Nov. 27, 2006 ("Last year, 23 of the 25 largest IPOs did not list in the United States, according to one widely cited statistic from the Financial Services Forum, a Washington-based lobbying group for large U.S. financial services firms") (available at 2006 WLNR 20782842).

[14] *See, e.g.*, Testimony of Donald L. Evans, Chief Executive Officer Financial Services Forum before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Apr. 26, 2006 ("In 2000, nine out of every 10 dollars raised by foreign companies through new stock offerings were raised in the United States. In 2005, the reverse was true - nine out of every 10 dollars raised by foreign companies through new company listings occurred outside the Unites States, principally in Europe.") (available at 2006 WLNR 7019044).

[15] "Market surge helps lift IPOs to 5-year high," *Associated Press*, Dec. 5, 2006 (available at 2006 WLNR 20973616).

[16] David Henry, "London's Freewheeling Exchange – It's winning the listings war against New York, but investors can get burned," *BusinessWeek*, Nov. 27, 2006 (available at 2006 WLNR 20258148) ("Henry").

[17] Anuj Gangahar, "COMPANIES INTERNATIONAL: U.S. deals reach six-year record," *Financial Times UK*, Dec. 29, 2006 (available at 2006 WLNR 22686018).

[18] Jack Willoughby, "IPOs Catch Fire," *Barron's*, Jan. 29, 2007 (available on Lexis).

[19] *See, e.g.*, Grace Wong, "The war for start-ups going public," *cnnmoney.com*, June 14, 2006 (available at http://money.cnn.com/2006/06/14/smbusiness/vc_aim/).

[20] "Listing in London," Panmure Gordon & Co., March 2006 (available at http://events.ey.co.il/objects/Tim%20Linacre.pdf).

[21] David Ian Miller, "Yes, You Still Can Go Public," *Inc.com*, July 2005 (noting that "AIM is geared specifically toward growing businesses without long track records or money to burn on a costly IPO") (available at http://www.inc.com/magazine/20050701/ finance.html).

[22] Ernst & Young, "Global Capital Market Trends," Jan. 2007 at p. 3 (copy on file with the authors) ("E&Y").

[23] Henry, *supra*, at Note 16.

[24] Tom Griggs, "PartyGaming warns of online poker slowdown," *ft.com*, Sept. 6, 2005 (noting that PartyGaming's IPO had raised $1.7 billion) (available at 2005 WLNR 14004566).

[25] Henry, *supra*, at Note 16.

[26] *See* Transcript of Speech by SEC Commissioner Roel C. Campos: Remarks Before the Consumer Federation of America Financial Services Conference, Dec. 1, 2006 (available at http://www.sec.gov/news/speech/2006/spch120106rcc.htm).

[27] *Id.*

[28] A copy of Sistema's prospectus is available for download at http://www.sistema.ru/i/files/sistema_final_ pdf_with_disclaimer.pdf). A discussion of related-party transactions appears at page 16 of that document.

[29] Michael Harrison "The Rosneft flotation should be stopped," *The Independent*, June 17, 2006 (available at http://www.findarticles.com/p/articles/mi_qn4158/is_20060617/ai_n16495109/print).

[30] *See* Joanna Chung, "Rosneft warns of 'risk factors' in IPO," *FT.com*, June 26, 2006 (available at http://www.ft.com/cms/s/bd836420-050d-11db-9b9e-0000779e2340.html).

[31] Paul Tharp, "Brits Get Bit - LAX British Marts Attract Frauds Along With U.S. Biz," *New York Post*, Jan. 8, 2007 (available at 2007 WLNR 344775).

[32] Manches, LLP, "UK fraud on the rise," Jan. 5, 2007 (available at http://www.manches.com/text/news/news.php?id=160).

[33] *Id.*

[34] Press Release – "Fraud costs rise 40% to record levels in 2006, but businesses only report 15% to the police," BDO Stoy Hayward, Jan. 2, 2007 (available at http://www.kelsopr.com/userimages/BDO%20SH%20FraudTrack%202007.pdf).

[35] John Berthelsen, "Heading for trouble: Asia's Unruly Stock Markets," *Asia Sentinel*, Aug. 7, 2006 (emphasis added) (available at http://www.asiasentinel.com/index.php?option=com_content&task=view&id=79&Itemid=32).

[36] *Id.*

[37] *Id.*

[38] *See* Oxera Consulting Ltd., "The Cost of Capital: An International Comparison," June 2006, at p. 4 ("**Underwriting fees** differ significantly depending on listing venue. While they are similar for transactions on the European exchanges (3–4% on average), on U.S. transactions underwriting fees are significantly higher (fees of 6.5–7% are most common). On average, therefore, IPO receipts are more than 3% lower in the USA than in Europe.") (emphasis in original) (available at http://www.londonstockexchange.com/NR/rdonlyres/B032122B-B1DA-4E4A-B1C8-42D2FAE8EB01/0/ Costofcapital_full.pdf).

[39] E&Y, *supra*, at Note 22, at p. 1.

[40] *Id.* at Appendix II.

[41] *Id.* at Appendix III..

[42] *Id.* at p. 1.

[43] *Id.* at p. 2.

[44] *Id.* at Appendix IV.

[45] *Id.* at Appendix I.

[46] "Accelerating Growth: Global IPO Trends 2006," Ernst and Young LLP, 2006 at p. 2 (copy available at http://www.ey.com/global/download.nsf/Internationl/IPO_-_Global_IPO_Survey_2006/$file/E&Y-SGM-GlobalIPOSurvey2006.pdf).

[47] E&Y, *supra*, at Note 22, at Appendix V.

[48] *Id.* at p. 4.

[49] *Id.*

[50] 17 C.F.R. §230.144.

[51] *See, e.g., Exxon Capital Holdings Corp.*, SEC No-Action Letter, 1988 WL 234336 (May 13, 1988); *Morgan Stanley & Co.*, SEC No-Action Letter, 1991 WL 178800 (June 5, 1991).

[52] 15 U.S.C. §§77a *et seq*.

[53] CCMR Report, *supra*, at Note 1, at p. 46.

[54] *Id.*

[55] Luzi Hail and Chritian Leuz, "Cost of Capital Effects and Changes in Growth Expectations around U.S. Cross-Listing," Working Paper, October 2006 at p. 36 (available at http://fic.wharton.upenn.edu/fic/papers/06/ 0619.pdf).

[56] *Id.* at Table 1.

[57] *Id.* at p. 3.

[58] *See, e.g.*, Michael Chafkin, "Studies Reveal Valuation Premium for U.S. Listing," citissb.com, 2003 (copy available at http://wwss.citissb.com/adr/www/adr_info/ mc0403.htm).

59 *See, e.g.*, Rene M. Stulz, "Corporate Governance and Financial Globalization," *NBER Reporter*, Fall 2005 (available at http://www.nber.org/reporter/fall05/ stulz.html).

60 A copy of this study is available for download at http://jfe.rochester.edu/02367.pdf.

61 NYSE Group, "The Exchange," Oct. 2005 (emphasis added) (available at http://www.nyse.com/about/publication/1131450075226.html).

62 Charles D. Niemeier, "American Competitiveness in International Capital Markets," Background Paper for *The Atlantic's* Ideas Tour Commemorating the Magazine's 150th Anniversary, Washington D.C., Sept. 30, 2006 (emphasis added) (copy available at http://www.pcaobus.org/News_and_Events/Events/2006/Speech/09-30_Niemeier.aspx) ("Niemeier").

63 CCMR Report, *supra,* at Note 1, at p. 4 (positing that "[i]n the 2003–2005 period, the average listing premium for foreign companies in the United States dropped by 19 percentage points and dropped more for companies from more developed markets").

64 *Id.* at p. 48.

65 *Id.* at p. 56.

66 *See, e.g.*, Niemeier, *supra*, at Note 62 (citing Doidge, Karolyi, and Stultz, "The Valuation Premium for Non-U.S. Stocks Listed in U.S. Markets," (2005)).

67 *See* Press Release – "FEI Survey: Sarbanes Oxley Compliance Costs are Dropping," *Financial Executives International*, Apr. 6, 2006 (emphasis added) (copy on file with the authors).

68 *See* Niemeier, *supra*, at Note 62.

69 Greg Ip, Kara Scannell and Deborah Solomon, "In Call to Deregulate Business, a Global Twist," *Wall Street Journal*, Jan. 25, 2007 (available at http://online.wsj.com/article/SB116968768622987022.html?mod=hps_us_pageone) ("Ip").

70 Simon Johnson, "Coase and the Reform of Securities Markets," *Conference Series; [Proceedings], Federal Reserve Bank of Boston*, June 2000, at p. 201 (noting that foreign locales have begun to embrace "investor protection measures modeled on U.S. securities laws and regulation along important dimensions") (available at http://www.bos.frb.org/economic/conf/conf44/cf44_15.pdf).

71 *See* Ip, *supra*, at Note 69.

72 15 U.S.C. §78j(b).

73 15 U.S.C. §78mm.

74 Private Securities Litigation Reform Act of 1995, Pub. L. 106-67, 109 Stat. 737 (1995) (codified in various sections of Title 15 of the United States Code).

75 Stephen Labaton, "Businesses seek new protection on legal front," *The New York Times*, Oct. 29, 2006 (available at 2006 WLNR 18761145) ("Labaton").

76 Testimony Of Arthur Levitt Concerning The Impact Of The Private Securities Litigation Reform Act Of 1995 Before The Subcommittee On Securities Committee On Banking, Housing, And Urban Affairs United States Senate, July 24, 1997 at p. 4 (available at http://www.sec.gov/news/testimony/testarchive/1997/tsty1197.txt).

77 *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (internal quotation marks and citations omitted).

78 *See, e.g.*, *Fratt v. Robinson*, 203 F.2d 627, 632 (9th Cir. 1953) ("We can think of nothing that... would more certainly tend to deter fraudulent practices in security transactions and thus make the Act more 'reasonably complete and effective' than the right of defrauded sellers or buyers of securities to seek redress in damages in federal courts."); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946) (upholding a private right of action under Section 10(b) and noting that "in view of the general purpose of the act, the mere omission of an express provision for civil liability is not sufficient to negative what the general law implies").

79 Carrie Johnson, "SEC Enforcement Cases Decline 9%," *Washington Post*, Nov. 9, 2006 (available at http://www.washingtonpost.com/wp-dyn/content/article/2006/11/02/AR2006110201701.html) ("Johnson").

80 "Getting It Wrong the First Time," Glass Lewis & Co., March 2, 2006 at p. 1. (available at http://www.glasslewis.com/downloads/Restatements2005Summary.pdf).

81 Backdating occurs when companies retroactively choose an option grant date with an exercise price below the current market value thereby generating an

instant paper profit. It is analogous to placing a bet on a horse race following its completion.

[82] Johnson, *supra*, at Note 79.

[83] Labaton, *supra*, at Note 75.

[84] *See* "News Briefs," *Accounting Today*, Nov. 27, 2006 (available at 2006 WLNR 20486744).

[85] *Id.*

[86] *See, e.g.*, Todd Fisher, "Microsoft appeases IBM with big payout," *Seattle Post-Intelligencer*, July 2, 2005 ("Microsoft reached an $850 million antitrust settlement with IBM yesterday, averting a lawsuit between two industry icons") (available at http://seattlepi.nwsource.com/business/231053_msftibm02.html).

[87] 488 A.2d 858 (Del. 1985).

[88] See, e.g., Daniel R. Fischel, "The Business Judgment Rule and the *Trans Union Case*," 40 Bus. Law. 1437, 1453 (1985) (stating that "[t]he most immediate effect of Trans Union will be that no firm considering a fundamental corporate change will do so without obtaining... documentation from outside consultants").

[89] 906 A.2d 27 (Del. 2006).

[90] John Ferreira, "Compensation committees have much to learn from Disney case," *Pittsburgh Business Times*, Apr. 1, 2005 (available at http://www.bizjournals.com/pittsburgh/stories/2005/04/04/focus4.html).

[91] *Id.*

[92] *In Re Worldcom, Inc. Sec. Litig.*, No. 02 Civ.3288 DLC (S.D.N.Y.).

[93] *See* Jay W. Eisenhofer and Gregg S. Levin, "Does Corporate Governance Matter To Investment Returns," *Corporate Accountability Report*, Vol. 3, No. 37 (Sept. 23, 2005) (available at http://www.gelaw.com/Attorney%20Articles/Art%20%20Does%20Corporate%20Governance%20matter%20JWE%20GSL%20with%20chart%20shell%20formatting.pdf).

[94] McKinsey, *supra,* at Note 5, at p. 103.

[95] *See* "Head Of NASD Arbitration Admits Lack Of Substantive Training For Arbitrators," *Securities Week*, Aug. 15, 2004 (reporting that "George Friedman, executive vp at NASD Dispute Resolution, admitted at a recent conference that his organization does not do 'substantive training' of arbitrators") (available at 2004 WLNR 4010895).

[96] *See, e.g.*, Jean R. Sternlight "Panacea Or Corporate Tool?: Debunking The Supreme Court's Preference For Binding Arbitration," 74 Wash. U. L.Q. 637, 685 (Fall 1996) (noting that "arbitrators may be consciously or uncon

sciously influenced by the fact that the company, rather than the consumer, is a potential source of repeat business").

[97] *See* Note 74, *supra*.

[98] For example, Senator Domenici stated that "society is suffering from hyperlexia, a serious disease caused by excessive reliance on law and lawyers. It is pervasive throughout our society but has reached epidemic dimensions in the court-created private actions brought under section 10(b) of the '34 Act." 138 Cong. Rec. S12,599 (daily ed. Aug. 12, 1992).

[99] *See* 138 Cong. Rec. S12,599 (daily ed. Aug. 12, 1992); H.R. Conf. Rep. No. 104-369, p. 31 (1995) (criticizing "abusive" practices including "the routine filing of lawsuits . . . with only a faint hope that the discovery process might lead eventually to some plausible cause of action").

[100] S. Rep. No. 104-98, at 14, reprinted in 1995 U.S.C.C.A.N. 679, 693.

[101] *Novak v. Kasaks*, 216 F.3d 300, 306 (2d Cir. 2000) (citing H.R. Conf. Rep. No. 104-369, at 31 (1995)).

[102] 15 U.S.C. §78u-4(b)(3)(B).

[103] 15 U.S.C. §78u-5(c).

[104] 15 U.S.C. §78u-4(b)(1) & (2).

[105] "Recent Trends in Shareholder Class Action Litigation: Filings Plummet, Settlements Soar," NERA Economic Consulting, Jan. 2007 at p. 4 (available at http://www.nera.com/image/BRO_Recent%20Trends_%201288_FINAL_online.pdf.)("NERA").

[106] See Labaton, *supra*, at Note 75.

[107] "Securities Class Action Case Filings – 2006: A Year in Review," Cornerstone Research, Jan. 2007 at p. 1 (available at http://securities.cornerstone.com/pdfs/ YIR2006.pdf).

[108] McKinsey, *supra*, at Note 5, at p. 76.

[109] "Securities Class Action Case Filings – 2006: Mid-Year Assessment," Cornerstone Research, 2006 at p. 14 (available at http://securities.stanford.edu/clearinghouse_research/2005_YIR/2006FilingsMidYearRelease.pdf).

[110] *See Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994).

[111] John C. Coffee, Jr., "Nobody Asked Me, But... ," *New York Law Journal*, Jan. 18, 2007 (available on Westlaw).

[112] McKinsey, *supra*, at Note 5, at p. 101.

[113] *Id.* at p. 74.

[114] "Recent Trends in Shareholder Class Action Litigation: Are Worldcom and Enron the New Standard?," NERA Economic Consulting, July 2005 at p. 5 (copy on file with the authors).

[115] *Id.*

[116] NERA, *supra*, at Note 105, at p. 8 (emphasis added).

[117] *Id.* at p. 6.

[118] *Id.* at p. 9.

[119] *See, e.g.*, Devin Leopard, "Black & Blue Shareholders are beating up Hollinger CEO Conrad Black over his huge, tricky pay packages. He calls them 'governance terrorists.'" *Fortune*, Oct. 13, 2003 (available at http://money.cnn.com/magazines/fortune/fortune_archive/2003/10/13/350878/index.htm).

[120] Jacob Freedman, "A Search for Clarity In Executive Pay Reports," *CQ Weekly*, May 12, 2006 (available at 2006 WLNR 8653195).

[121] Henry G. Manne, "The 'Corporate Democracy Oxymoron," *Wall Street Journal*, Jan. 2, 2007 (copy on file with the authors).

[122] See Michael A. Perino, "Institutional Activism through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions," *St. John's Legal Studies Research Paper No. 06-0055* (Oct. 2006) at p. 3 (finding that "attorneys' fee requests and fee awards are lower in cases with public pension lead plaintiffs") (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=938722). In this regard, data complied by NERA showed that average attorneys fees were 31.84% for the period from 1991 to 1996. Negotiated fee agreements are now common with percentages in the low 20% range, or even in the teens. In megacases like WorldCom, public funds have negotiated even lower, single-digit fee percentages.

[123] McKinsey, *supra*, at Note 5, at p. 129.