



SECURITIES CLASS ACTION LITIGATION REFORM

Statement of the Problem

Summary

America's securities class action system does not work as intended and, indeed, some would say that it is broken. Overall, the system harms U.S. competitiveness in the global business and financial markets due to the huge costs for market participants and has a negative economic effect on companies and the U.S. economy. Because plaintiffs' lawyers often use securities class action litigation to extort settlements from companies, it becomes a means of cost shifting which ultimately harms shareholders. Also, it does not serve its intended functions – to provide compensation to injured parties and to deter wrongdoing. Further, it requires procedural fixes in order to make the litigation proceed in a fair and expeditious manner. Several bipartisan reports have highlighted the problems with and abuses of the securities class action system. This paper summarizes some of these issues and proposes a broad array of solutions for consideration.

Competitiveness and Litigation Costs

One of the unique aspects of the US capital markets is the broad availability of private lawsuits to recover damages attributable to a wide range of conduct violative of the federal securities laws. Although many countries authorize private parties to institute lawsuits to recover damages relating to capital markets activities, no country permits claims that approach the size and scale of those that may be filed under US law. Further, while a few European countries have "group actions," the U.S. class action structure is tremendously more costly and voluminous." See *Commission on the Regulation of the U.S. Capital Markets in the 21st Century, An Independent Bipartisan Commission Established by the U.S. Chamber of Commerce, March 2007* ("Chamber Commission Report").

A common criticism of the U.S. capital markets is that our highly litigious legal environment imposes costs on companies doing business in the U.S. And, many companies now must carefully weigh the risks associated with listing stock or doing business in the U.S. – the risk of being sued and the particular risk of facing a

securities class action lawsuit. These lawsuits are hugely expensive. The expense has several components.

The settlements paid to resolve these cases – and virtually every case that survives a motion to dismiss is settled – are very large. In 2004 and 2005, nine cases settled for \$100 million or more, compared to four in 2002; 30 cases settled for more than \$20 million in 2005 compared to 23 cases in 2004.¹ Even excluding the Enron and WorldCom settlements, five cases settled in 2006 for more than \$500 million; four of those were for more than \$1 billion.² Cornerstone's analysis of the size of these claims filed in 2004 found that the average settlement size was \$883 million, with eight cases of \$5 billion or more and three cases of \$15 billion or more.³ Seven cases filed in 2005-2006 involved \$5 billion or more.⁴

The average size of settlement is increasing in dollar value. The average settlement in 2006 was \$34 million, excluding the four \$1 billion settlements.⁵ That is a 37% increase over the 2005 figure, which itself was 25% greater than the average in 2004.⁶ If the billion-dollar settlements are included, the average jumps to \$86.7 million – a record.⁷ The dramatic change in the cost of these cases is shown by comparing the average settlement value for 1996-2001 with the average for 2002-2006: the amount more than doubled, from \$11.5 million to \$24.3 million. An increasing percentage of settlement costs involve the very large mega-settlements.⁸

These sums are very large viewed in isolation; the total amount of money diverted to securities class action settlements is gargantuan. Settlements of 755 of the cases resolved between December 1995 and August 2005 totaled \$25.4 billion dollars.⁹ The total for 2004 and 2005 alone was \$6.5 billion (not including the \$6 billion WorldCom settlement).¹⁰

The settlements are only part of the cost of this litigation. Although fees for plaintiffs' attorneys are awarded out of the settlement amounts, the fees paid to defense lawyers, experts, and other consultants are additional – very large – costs. No data is collected regarding these defense costs, but they are likely to at least equal

¹ PricewaterhouseCoopers, *2005 Securities Litigation Study* 16 (2006).

² NERA, *Recent Trends in Securities Class Action Litigation* 5 (Jan.2007).

³ Cornerstone Research, *Securities Class Action Case Filings, 2004: A Year in Review* 10 & 11 (2005).

⁴ Cornerstone Research, *Securities Class Action Case Filings, 2005: A Year in Review* 11 (2006); Cornerstone Research, *Securities Class Action Case Filings, 2006: A Year in Review* 12 (2007). These size estimates are not damages projections, but they still provide a reasonable indication of the order of magnitude of these lawsuits.

⁵ *Id.*

⁶ *Id.* at 6.

⁷ *Id.* at 5.

⁸ *Id.*

⁹ Anjan V. Thakor with Navigant Consulting, *The Economic Reality of Securities Class Action Litigation* (2005).

¹⁰ Cornerstone Research, *Post-Reform Act Securities Settlements: 2005 Review and Analysis* 1 (2006)



– and probably exceed – the \$4.56 billion in fees awarded to plaintiffs’ attorneys in the 755 cases just discussed.¹¹ There is a surcharge for defense costs of at least 18% on each settlement. In addition, those companies that succeed in having a case dismissed do so at very significant expense.

Separate from the class action costs are those associated with government lawsuits. Companies doing business in the U.S. are also subject to significant costs and time required to gather information in administrative and enforcement actions. The *Chamber Commission Report* outlines civil penalties paid in securities litigation. It notes that civil penalties amounted to \$4.74 billion in the United States during 2004 alone compared to \$40.48 million in penalties imposed in the United Kingdom. Therefore, we need to think about how the private and public enforcement systems intersect and whether, in today’s heightened enforcement environment, private securities class actions are necessary.

Each of the three studies of the U.S. capital markets released in the last six months identifies securities litigation as an issue that policymakers must address. Senator Schumer and Mayor Bloomberg observed that “the legal environments in other nations, including Great Britain, far more effectively discourage frivolous litigation” and “the prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of business – and driven away potential investors.” Secretary Paulson has called the costs of abusive litigation “an Achilles heel for our economy.” The *Chamber Commission Report* states that there is a “strong need to investigate the accuracy of the widely held global perception that the U.S. securities litigation and regulatory environment makes it dangerous to participate in our capital markets.”

Thus, if the U.S. wants to remain competitive in the global marketplace, it must act to decrease these litigation costs. These costs are a substantial factor in decision-making regarding where to raise capital and where to do business. If we are to retain our global leadership, we must eliminate – or at least reduce – this significant competitive disadvantage.

Economic Losses Associated with Securities Class Action Litigation

Securities class action litigation has broader economic ramifications for companies overall (in addition to settlement and litigation costs) and, as a result, impacts the U.S. economy. Economists frequently refer to “the principle of unintended consequences,” which applies here.

¹¹ Because each case typically involves numerous defendants, many of whom retain separate counsel, defense costs probably exceed the fees received by plaintiffs’ lawyers in these cases.

Dr. Anjan V. Thakor, of Washington University's Olin School of Business, analyzed these issues in his paper, *The Unintended Consequences of Securities Litigation*. The focus of Thakor's review was on measurable economic consequences, rather than the unquantifiable adverse or beneficial effects of litigation on companies. The main findings were:

- At a minimum, information-disclosure-related litigation destroys on average approximately 3.5 percent of the equity value of a company (Thakor, Nielsen and Gulley (2005)). This implies that at least \$24.7 billion in shareholder wealth was wiped out just due to litigation over the past ten years.
- Firms invest more capital when stock prices are high and substitute capital investment with cost-cutting measures when stock prices are low. Hence, the lowering of a firm's stock price due to litigation could result in lower capital investments by firms, which has obvious implications for job creation and economic growth.
- The wealth destruction in litigation is *not* a zero-sum game of transfer payments from defendants to plaintiffs. The wealth destroyed for defendants far exceeds the wealth gained by plaintiffs. Thus, litigation seems to create deadweight losses.
- Smaller defendant firms seem to suffer greater percentage wealth losses in litigation.
- Information-disclosure-related litigation appears to create incentives for investors to sue "excessively" due to the possibility of predictably profitable trading strategies in "litigation-prone" securities.

For more details on this topic, see *The Unintended Consequences of Securities Litigation* which can be found at:

<http://www.instituteforlegalreform.com/issues/docload.cfm?docId=857>

Extortion Model

Companies almost always conclude that they are forced to settle securities cases because proceeding towards trial is simply too costly. A trial is often too risky with such high dollar values at stake and discovery costs can reach tens of millions of dollars or higher. Companies must further weigh the effects of media articles on their stock price and the ensuing reputational harm. Also, the size of these cases necessitates significant management attention. All of those demands take time away from the principal responsibility of management and directors: managing the business to maximize shareholder returns. All of these factors taken together assist plaintiffs' lawyers in essentially extorting settlements, often when there is not even a colorable claim for damages.

When just about every case settles, the settlement payment is much more a "cost of business" than a badge of infamy. As a result, the litigation is drained of most of its deterrent effect. Companies are much more likely to be cynical about the private litigation "game" in which a settlement is the inevitable outcome regardless of fault.

Analyses of settlements confirm that factors other than the merits of a claim are the principal determinants of settlement amounts. Thus, alleged investor losses "constitute the single most powerful publicly available determinant of settlements, explaining 50% of their variation." NERA, *Recent Trends in Securities Class Action Litigation* 7 (Jan.2007). In addition, "[s]ettlements increase with the depth of the defendants' pockets." *Id* at 8. Other factors associated with larger settlement amounts are whether cases involve securities other than common stock and whether the claims include accounting allegations.

Further, some plaintiffs' firms have gone so far as to track corporate announcements and immediately file a claim as soon as a change in circumstance occurs, often before they have enough evidence to support a valid claim. Some jurisdictions have pleading standards that allow for general statements of claims which serves to enable this behavior.

This overall extortion model of pursuing claims is becoming more prevalent and many companies feel that they cannot counter these activities. Fundamental change in the system is the only way to bring about a fair model.

Deterrence and Compensation Do Not Work

Compensation

The securities class action system is not serving the interests of investors. Private litigation is supposed to provide compensation for injured investors and deter wrongdoing. It is accomplishing neither goal. Far from compensating the most vulnerable investors, private litigation provides a windfall for sophisticated investors while often shortchanging individual investors.

Many observers of securities litigation have noted that diversified investors suffer little or no economic harm from fraud – they are beneficiaries of fraud (by selling shares at an artificially inflated price) as often as they are harmed by fraud (by buying at an inflated price and holding the shares until the fraud is discovered and the price drops.) But in this litigation system, these investors are entitled to recover damages in the latter situation while retaining the benefits gained from fraud in the former situation.

Perhaps, most important is the fact that undiversified investors who are often individual investors receive pennies on the dollar in securities class actions. See Anjan V. Thakor with Navigant Consulting, *The Economic Reality of Securities Class Action Litigation* (2005), available at: <http://www.instituteforlegalreform.com/issues/docload.cfm?docId=855>

The Economic Reality of Securities Class Action Litigation analyzes how investors fared in securities class action cases over the past ten years. It draws some striking conclusions about how large institutional investors and small undiversified investors are compensated in these actions and what factors contribute to a compensable trading loss, provoking thought about how such actions are structured.

In particular, the study concludes:

- Large institutional investors generally break even from their investment in stocks impacted by fraud allegations.
- Large institutional investors actually often receive a net benefit from their investment in stocks impacted by fraud allegations even before settlement proceeds are taken into account.

- Undiversified investors (often individual investors) are at greater risk to lose money as a result of their investment in stocks that have been impacted by fraud allegations. It notes that they often receive pennies on the dollar.
- To the extent that trading losses do result from trading in stocks impacted by fraud allegations, such losses arise primarily from the issuance of new common stock while the alleged fraud is ongoing.

See also, Donald C. Langevoort, *Capping Damages for Open-market Securities Fraud*, 38 Ariz. L. Rev. 639, 648 (1996); Richard Booth, *Who Should Recover What in a Securities Fraud Class Action?* (December 2005); Easterbrook, Frank H. and Daniel R. Fischel, "Optimal Damages in Securities Cases," 52 U. Chi.L. Rev. 611 (1985).

Deterrence

Deterrence is provided by the threat of enforcement action by the SEC and prosecutors, not by private lawsuits that piggyback on government enforcement efforts. Enforcement resources have skyrocketed compared to 20 years ago. Where once the SEC followed the plaintiffs' lawyers, now many observers believe that the plaintiffs' lawyers are following the SEC. Further, state law enforcement officers as well as self-regulatory organizations ("SROs") are also involved in investigations for violations of the securities laws.

Thus, in contrast to the questionable deterrent effect of private litigation, very substantial deterrence flows from the vigorous enforcement actions of the SEC, other regulators and the Department of Justice. The severe penalties that may be imposed by regulators and prosecutors, and the significant reputational harm resulting from even the pendency of an enforcement action, let alone an adverse decision, provide companies with very strong incentives for compliance with the securities laws.

In sum, the billions of dollars that flow through securities class actions do not compensate the most vulnerable investors or provide any real deterrence – they impose economic burdens on all investors without producing any real benefit in return.

Burden on Investors/Cost Shifting

Securities class actions impose a burden on investors. The structure of this system is fundamentally flawed and amounts to no more than a cost shifting process with the addition of a “tax” which is the legal fees paid in such actions. This system is unique in that one group of shareholders are generally paying another group of shareholders – amounting to cost shifting. Even if the company has insurance, the adverse effects in terms of higher insurance rates will be borne by the company’s shareholders.

The actual wrongdoers are not paying in these actions because the claims are against the existing company and the company is the shareholders. This “circularity” problem affects all cases – even those in which the claim is legitimate. Securities litigation thus involves a transfer of wealth from one set of investors to another, with a very substantial percentage – approximately one-third according to the data discussed above – skimmed off by plaintiff and defense lawyers. Of the 755 cases studied in *The Economic Reality of Securities Class Action Litigation*, plaintiffs’ legal fees amounted to over \$4.5 billion. Rather than reliably providing compensation to investors, the actual economic benefits to injured investors with legitimate claims are unclear.

This notion has been discussed extensively in the academic community. For example, Professor Jack Coffee, of Columbia School of Law, has written that securities class actions “impose costs on public shareholders in order to compensate public shareholders,” characterizing these lawsuits as a “circular process” with “perverse effects.”

And, Professor Donald Langevoort, of Georgetown University Law School, has noted that “[b]y all accounts, nearly all the money paid out as compensation in the form of judgments and settlements comes, one way or another, from investors themselves. Little if any of the sum is contributed by those who were the primary authors of the fraud; a recent study puts the figure at less than half of one percent.”

Procedural Reforms Are Needed

The Private Securities Litigation Reform Act (“PSLRA”) was enacted in 1995 in response to the ease with which plaintiffs were able to file legally questionable class actions and thereby force securities defendants into settlements rather than risk costly litigation. The PSLRA was designed to raise the standards for pleading securities fraud and to erect other procedural and substantive hurdles designed to allow valid claims of securities fraud to survive a motion to dismiss while making it easier for courts to dispense with frivolous actions at the pleading stage.

Further, after enactment of the PSLRA in 1995, plaintiffs' lawyers began to file securities claims in state court in order to avoid the provisions of the federal law—even though state courts had never before been a forum for such cases. In response, Congress in 1998 passed the Securities Litigation Uniform Standards Act ("SLUSA"), which bars securities class actions in state courts.

These two statutes produced considerable reform of securities litigation, deterring the filing of abusive cases and increasing incentives to pursue greater recoveries on meritorious claims. However, as discussed below changes to the procedures for litigating these cases are needed in order to insure fairness.

This memorandum outlines various securities litigation reform proposals that have been identified as changes that may improve the U.S. securities litigation environment.

Procedural/Targeted Reforms

- **Interlocutory appeals of motions to dismiss**

Issue: In virtually every case, the district court's ruling on the motion to dismiss is the only judicial evaluation of the merits of the plaintiff's claim. If the motion is denied, the defendant inevitably will settle before trial often due to substantial costs of discovery and the size of damage claims. Thus, if the district court erroneously denies a motion to dismiss, the defendants will be forced to pay a substantial settlement in a case that never should have been brought.

- o **Enact provision permitting appeals with permission along the lines of Rule 23(f); discovery stay would remain in effect until appeal is resolved**

The district court's ruling on the motion to dismiss is critical to the outcome of the case, because the case will settle if the motion is denied. And, while plaintiffs can appeal a decision granting a motion to dismiss, defendants have no such right to obtain appellate review to correct an erroneous denial of a motion to dismiss even though that decision is likely to be the only judicial assessment of the plaintiff's case. This imbalance should be corrected by permitting defendants to appeal denials of motions to dismiss. [Endorsed in Bloomberg/Schumer report]

- **Pleading standard**

Issue: The PSLRA recognized the importance of terminating unjustified claims at the pleading stage, because the huge damages sought in class actions would coerce defendants to pay large settlements regardless of the merits of the claim against them. It therefore required more detailed pleading of facts showing that the defendant acted with the required mental state and generally prohibited discovery until after the resolution of motions to dismiss.

- **Adopt Ninth Circuit standard pleading standard nationwide**

The courts of appeals have adopted different interpretations of the PSLRA standard requiring specific pleading of the facts showing the defendant acted with scienter. The issue is now before the Supreme Court in the *Tellabs* case. If the Supreme Court does not resolve the dispute, the issue should be revisited by Congress in order to establish an appropriate nationwide standard.

- **Require that loss causation be pleaded with particularity**

The Supreme Court recognized in its recent *Dura* decision the importance of the PSLRA's requirement that a plaintiff show a clear link between the challenged conduct and the defendant's loss. Yet under current law the complaint can survive dismissal even though it alleges that link in very general terms. Extending the PSLRA's specific pleading requirement to this element of a claim would give courts an additional tool to screen out unjustified claims.

- **Eliminate gaps in PSLRA discovery stay**

The PSLRA—with very limited exceptions—imposes a stay on discovery while a court considers a defendant's motion to dismiss. Some courts have expanded the exceptions, thereby defeating the purpose of the discovery stay, which is to prevent plaintiffs from using discovery as a fishing expedition. For example, some courts have required defendants to turn over to plaintiffs information provided to government agencies or permitted discovery from third parties. Congress should reaffirm its decision to preclude discovery until after a complaint is upheld by closing these loopholes in the discovery stay.

- **Impose time limit/limit on number of complaint amendments (or require a specified showing to permit the filing of an amended complaint)**

When a defendant's motion to dismiss is granted, courts almost always permit the plaintiff to file an amended complaint to cure the flaws identified in the

motion to dismiss. This process can be repeated three or four times. Congress should set a limit on the number of times that a defendant may be forced to incur the costs of disposing of an inadequate complaint.

- **Fix lead plaintiff/lead attorney provisions**

Issue: The PSLRA was intended to transfer control of securities class actions from plaintiffs' lawyers to investors. Despite the PSLRA's reforms, there is significant evidence that cases are still lawyer-driven. Additional reforms are needed to close loopholes that have developed in the protections enacted in the PSLRA.

- **Authorize auction for lead counsel role (perhaps require auction to be used unless court finds it is inappropriate and explains why)**

Chief Judge Vaughn Walker of the Northern District of California has pioneered use of an "auction" to choose a lead counsel. Under Judge Walker's original process, firms submitted sealed bids, which then were used both to select the attorney and set the fee. Other courts, however, have prohibited use of the mechanism. Auctions for lead counsel can offer advantages: courts will often choose the lawyer with the lowest fee, thus securing a larger share of any potential settlement for investors. Plaintiffs' lawyers uniformly oppose the auction approach.

- **Require certifications by lead plaintiffs**

Requiring that complaints contain a certification (modeled on SOX) by the plaintiff and lawyer stating that the plaintiff has received and will not receive any extra compensation for serving as a plaintiff would be useful. The certification would list every other case in which the plaintiff has served as lead plaintiff in any form of class action. The Milberg Weiss case shows that notwithstanding the PSLRA's efforts to eliminate "professional plaintiffs," the phenomenon seems to be continuing. These reforms would force increased public disclosure to try to stop the use of professional plaintiffs.

- **Eliminate "pay to play"**

Many government pension funds are controlled by elected officials. Frequently, it turns out that the law firm selected to represent a pension fund in class action litigation has been the source of campaign contributions to the public officials running the fund. Several years ago, to address a similar problem in the selection of underwriters for government bond offerings, the

SEC adopted a rule prohibiting “pay to play” by banning such contributions. Congress should enact a similar prohibition, barring a law firm from becoming lead counsel if any lawyer at the firm has contributed to the campaign of any public official who in any way oversees the fund (by serving on the fund’s board, selecting those who serve on the board, supervising those who serve on the fund’s board, etc.). [Endorsed in Scott/Hubbard report]

0 Bar aggregation of plaintiffs for purpose of determining lead plaintiff

The PSLRA permits either a “person or group of persons” to act as the most adequate plaintiff. Some courts allow large numbers of unrelated plaintiffs to aggregate themselves into a lead plaintiff “group” while others define the word “group” narrowly to allow only small coalitions that have common characteristics (such as membership in a partnership). The larger the group the more diffuse the responsibility and the more likely that the attorney will retain practical control of the litigation with little or no effective oversight. This reform would prohibit such aggregations of unrelated “persons.”

- **Outside directors**

Issue: The efforts by some plaintiffs’ lawyers to impose personal liability on outside directors deters qualified individuals from serving in these important roles.

0 Cap outside directors’ personal liability

This would help ensure that qualified outside directors will be available – especially for start-up companies. Congress should cap the personal liability of outside directors. [Endorsed in Scott/Hubbard report]

- **Damages distribution**

0 Require refunds of uncollected amounts of settlement funds, allowing each class member to take only his or her pro rata share of the settlement.

Settlements today invariably provide that the entire settlement fund will be divided among the class members who file claims: if only relatively few class members file, each receives a larger settlement than would have been the case if more class members filed claims. Some argue that this can lead to excess recoveries and that each class member should be limited to his or her proportionate share, with uncollected funds returned to the defendant.

o Coordinate SEC Fair Funds and litigation distributions

The SEC in 2002 obtained statutory authority to create “fair funds” to distribute to injured investors payments obtained by the Commission in enforcement actions through use of its civil penalty and disgorgement authority. Today, there is no coordination between the fair funds process and the litigation process – either with respect to investor recoveries or distribution mechanisms. Congress should by statute require such coordination. [Endorsed in Scott/Hubbard and Chamber Commission reports]

Moreover, the process for distribution of litigation settlements is not transparent. There is no information on the percentage of class members who file claims, and whether they are disproportionately sophisticated or small investors, and little information about the standards used to decide whether and how much to pay to each claimant. Congress or the SEC should study this process, and adopt appropriate reforms.

• Uniform Standards Act

Issue: The Uniform Standards Act (“SLUSA”) was adopted by Congress to prevent plaintiffs’ lawyers from using state law claims to circumvent the PSLRA. It authorized removal of state court class actions, or equivalent types of cases, to federal court.

o Permit appellate review of remand orders

The Supreme Court held in the *Kircher* case that a defendant may not appeal district court orders holding the SLUSA inapplicable and remanding a case to state court. Congress should correct that decision to allow defendants to obtain appellate review of erroneous district court orders.

o Fix holes in discovery stay

Some plaintiffs’ lawyers have used state law claims not subject to removal under the SLUSA to circumvent the PSLRA’s discovery stay. Congress should close that loophole

- **Preclude “spin-off” cases by institutional investors (or require that they be stayed until resolution of federal class action)**

Some plaintiffs’ lawyers have adopted a strategy of urging pension funds with large potential claims to opt out of securities class actions and instead file separate cases, usually in state court (because these state court claims are not class actions, they are not prohibited by SLUSA). These multiple claims impose huge costs on defendants and can be used to circumvent the protections enacted in the PSLRA and impose burdens on investors. Congress should amend SLUSA to require state courts to stay such cases until the final resolution of federal class actions raising the same claims.

Comprehensive Reforms

- **Redefine standard for calculating damages to focus on disgorgement of gain rather than “compensation” of plaintiffs**

Issue: Many observers have concluded that the “compensation” rationale of today’s damages standards hurts investors by encouraging huge claims that, in the end, impose financial burdens on investors/shareholders. They argue for a “deterrence” approach that calculates damages based on a multiple of the defendant’s gain.

- **Eliminate liability for business organizations and focus liability on individual wrongdoers**

This approach would fully address the “circularity” problem that has one group of investors/shareholders (the current owners of the defendant companies) paying another group of investors (the plaintiff class). But it seems unlikely that such a dramatic change would be acceptable.

- **Revise damages standard to focus on defendant’s gain, with capped liability for corporation that does not issue shares during the relevant period**

Congress could address this issue by adopting damages caps as suggested by – among others – Professors Langevoort and Coffee. [Suggested in Scott/Hubbard report]

0 Eliminate recoveries by diversified investors

The study by Anjan Thakor and Navigant Consulting, sponsored by ILR, demonstrated that large, diversified investors benefit from alleged fraud (by selling shares at the supposedly inflated price) to the same extent that they claim to be injured by fraud (by buying at the supposedly inflated price). Although that reality could provide grounds for precluding lawsuits by such investors, such a reform almost certainly would be rejected.

0 Give small investors priority in distribution of settlement funds

Because a change in the damages standard could reduce the amount of money distributed to defendants, Congress could give priority to small investors who do not obtain the benefits of diversification available to large investors.

- **Assess whether use of ADR is appropriate to resolve federal securities claims**

Issue: ADR is an efficient means of resolving disputes that is increasingly used by businesses. It is used by the securities industry for investor claims. Some have suggested that it also could be used for securities claims brought by investors against registrants and others. The SEC is considering this issue. This reform raises some concerns, however, such as whether class arbitrations should be permitted and whether such large claims should proceed without the procedural protections available in court. Also, it seems likely that, in addition to SEC approval, a company would have to provide for arbitration in its certificate of incorporation for this reform to be effective. [Endorsed in Scott/Hubbard and Schumer/Bloomberg reports]

- **Eliminate/limit/define fraud on the market test for establishing presumption of reliance**

Issue: The “fraud on the market” standard allows plaintiffs to avoid proving that they actually relied on the alleged false statement. It is the legal rule that permits plaintiffs’ lawyers to form huge classes. Many argue that the standard is wrong as an empirical matter. Others say it is wrong as applied to sophisticated investors, because they often make trading decisions based on their own assessment of the value of a security and do not rely on the market price. Others say it is applied too broadly by the district courts. There are a number of reform options, ranging from elimination of the standard, to modification of it, to limiting its availability to small investors. [Issue raised in Scott/Hubbard report, which suggested that

plaintiffs bear the burden of showing applicability of fraud on the market standard.]

- **Require SEC approval for commencement of private action**

Issue: Some observers have argued that the SEC should be the “gatekeeper” for private lawsuits, with SEC approval required for the filing of such claims. Or, similarly, the SEC may choose to file the action themselves or “allow” it to go forward privately. It seems unlikely that the Commission would want this responsibility, however, and the practical impact of such a reform would likely be to increase the cost of litigation because the SEC would not have the resources or information to perform a screening function effectively.

- **Limit damages claims against foreign registrant**

Issue: The Schumer/Bloomberg report noted that foreign companies that list their securities in the U.S. may find themselves subject to a class action on behalf of their foreign securities holders as well as their US securities holders. The report suggests that liability be limited to the latter group in order to make the US capital markets more attractive to foreign registrants.

- **Clarify “materiality” standard**

Issue: Some argue that the current standard for this element of securities fraud (the plaintiff must show that the defendant made a false statement about a “material” fact) is set too low: too many statements are characterized as material. The Scott/Hubbard report suggested adoption of a clear definition of materiality.

- **Eliminate “scheme” liability**

Issue: After the Supreme Court held in *Central Bank* that plaintiffs in private actions could not sue on an “aiding and abetting” theory, some plaintiffs’ lawyers tried to reach the same result by proposing a theory of “scheme” liability. That theory has been endorsed in part by the Ninth Circuit and is now before the Supreme Court in the *Stoneridge* case, which will be argued next fall. Consideration of reform proposals should await the decision in that case. [Reform endorsed in Chamber Commission Report]