UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

April 15, 1997

President William J. Clinton
The White House
Washington, D.C. 20500

Dear Mr. President:

I am pleased to send you the enclosed "Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995," prepared by the Commission's Office of the General Counsel. I believe that the Report provides a careful analysis of what has transpired since the law was enacted, and I commend the staff for the energy, enthusiasm, and thoughtfulness they brought to the task.

The Commission endorses the ultimate conclusion of the report: it is too early to assess with confidence many important effects of the Reform Act and therefore, on this basis, it is premature to propose legislative changes. The one-year time frame has not allowed for sufficient practical experience with the Reform Act's key provisions, or for many court decisions (particularly appellate court decisions) interpreting those provisions.

The Reform Act's interpretation and implementation -- and how it is affecting the disclosure system as well as private litigation -- is at an early stage of development. You can rest assured that we will continue to monitor closely its progress. As decisions are handed down by the courts, and as we obtain more experience with the Act's key provisions, including the effect of the "safe harbor" from liability for forward-looking statements, a fuller picture will emerge. If we find substantial evidence of a negative impact on investor protection or that the purpose of a particular provision is being frustrated, we will report back to you and recommend appropriate action.

The Commission remains dedicated to the protection of investors, efficient capital formation, enhanced disclosure, and the diligent oversight of the securities markets. We look forward to continuing to work with you and Congress to achieve these goals.

Sincerely,

Arthur Levitt

Enclosure

cc: The Honorable Alphonse M. D'Amato
The Honorable Paul S. Sarbanes
The Honorable Phil Gramm
The Honorable Christopher J. Dodd
The Honorable Thomas J. Bliley
The Honorable John D. Dingell
The Honorable Michael G. Oxley
The Honorable Thomas J. Manton

# STATEMENT OF ADDITIONAL VIEWS OF COMMISSIONER WALLMAN REGARDING THE REPORT ON THE FIRST YEAR OF PRACTICE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

The staff Report is an excellent review of litigation under the Act. I add these additional views, however, because I do not believe the Report supports the conclusion that no legislative changes should be recommended at this time.

I have concerns about the methodology underlying the Report, which relies primarily on an examination of cases brought since passage of the Act. A review of case law under the Act is necessary, of course, to see whether the cases are at odds with legislative intent and whether legislative corrections are needed. Reviewing cases alone is not sufficient, however, to reach a determination as to whether the Act is achieving or failing in its essential purposes. There can be no substitute for a detailed and comprehensive review of the impact on affected parties.

Until last week, all the information in the Report, other than that referring to specific cases, was obtained from lawyers from the plaintiffs or defense bar, or from institutional investors (regarding the lead plaintiff provision). Only after the Report had been reasonably finalized were corporate officers contacted to obtain information. In this context, as the Report now states, we have been informed that a principal reason issuers are not providing forward-looking information of the nature sought to be elicited under the Act's safe-harbor is the specter of state court liability. (Regardless of whether this concern is valid, the result is that the safe-harbor, a key feature of the Act, is failing to elicit more of the type of information that investors value most.) Moreover, the Report reflects no contact with analysts, investor groups or others who might be able to provide, for example, information as to the use, or non-use, of the safe harbor for forward-looking statements, or a view on whether the Act has hurt or advanced investor interests.

Based on the information we do have, and as the Report states, it appears the most significant development stemming from the Act has been the increase in state court litigation, apparently as an attempt to avoid some of the provisions of the Act. This development is troubling. Regardless of whether the increased use of state litigation is undermining the utility of provisions such as the discovery stay provision in the Act, or the safe-harbor for forward looking information, this phenomenon is clearly balkanizing the federal securities laws. In this context, disparate state litigation procedures create differing substantive legal standards which the corporate decision maker, with potentially significant liability at risk, cannot determine until after the fact. I understand that some believe the Act went too far, while others believe the Act did not go far enough. But for those who believe the Act is flawed, a better answer might be to work to improve the Act at the federal level, rather than accept fragmentation of our national system of securities litigation.

Consequently, I cannot support the conclusion that no further legislative change is needed at this time. The Report does not supply us with enough factual information and analysis to say whether this is true or false. Instead, I believe a more appropriate process designed to address better the underlying policy issues is necessary before that conclusion can be reached.

April 11, 1997

# STATEMENT OF ADDITIONAL VIEWS OF COMMISSIONER HUNT REGARDING THE REPORT ON THE FIRST YEAR OF PRACTICE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

I offer separate and brief views regarding the Commission staff's report on the first year of practice under the Private Securities Litigation Reform Act of 1995. I endorse the report's ultimate conclusion: that no legislative changes are needed at this time. That conclusion should not be terribly surprising, for the one-year time frame simply was too short to allow for many court decisions (particularly state and federal appellate court decisions) interpreting the Act's provisions.

I agree with another important conclusion of the report: that the effectiveness of the Act's "safe harbor" provision needs further study. To date, however, I have heard only limited anecdotal evidence regarding the reasons why issuers have not provided more and better forward-looking disclosure than they provided prior to the Act's enactment.

But there is more that the Commission should study than the effectiveness of the safe harbor. For example, the Commission also may wish to study the effect of the Act's heightened pleading standards, when coupled with the discovery stay provisions, on the complaint process.

Once again, I endorse the ultimate conclusion of this report. I thank the staff for its hard work.

April 15, 1997

Securities Reform Litigation

# Report to the President and the Congress

on the First Year of Practice Under the

# PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

*U. S. Securities and Exchange Commission*
*Office of the General Counsel*
*April 1997*

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE
GENERAL COUNSEL

April 14, 1997

Dear Mr. Chairman and Commissioners:

I am pleased to submit this "Report to the President and the Congress on the First Year of Practice Under the Securities Litigation Reform Act of 1995." As you know, President Clinton wrote to Chairman Levitt requesting that the Commission advise him and the Congress about the impact of the Act on the effectiveness of the securities laws and on investor protection, and on the extent and nature of litigation under the Act. This Office has prepared the Report in response to the President's request.

The staff discussed the effects of the Reform Act with a variety of interested parties, reviewed the complaints from federal securities class action lawsuits filed in 1996, and analyzed the court decisions under the Act. In addition, the staff has reviewed a sample of complaints from securities class actions brought in state courts during 1996.

It is important to note that the number of court decisions under the Reform Act and the availability of other objective data that could be used to evaluate the effectiveness of the Act are still very limited. In particular, the federal appellate courts have had virtually no opportunity to interpret the provisions of the Act. Although it is too soon to draw definitive conclusions about the impact of the Act on the effectiveness of the securities laws and on investor protection, the Report makes some preliminary observations.

We believe the Report will be helpful to the President and the Congress in assessing the impact of the Reform Act to date. While we are not currently recommending any legislative revisions, the staff expects to continue carefully monitoring the Act. In the future, if we determine that revisions are necessary or desirable, we will report back to you.

Sincerely,

Richard H. Walker
General Counsel

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# REPORT TO THE PRESIDENT AND THE CONGRESS ON THE FIRST YEAR OF PRACTICE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

## I. EXECUTIVE SUMMARY.

Following passage of the Private Securities Litigation Reform Act of 1995, President Clinton wrote to Commission Chairman Arthur Levitt requesting that the Commission advise him and the Congress about the impact of the Reform Act on the effectiveness of the securities laws and on investor protection, and on the extent and nature of any litigation under the Act. The Commission's Office of the General Counsel prepared this report in response to the President's request.

In preparing this report, the staff discussed the effects of the Reform Act with a variety of interested parties, reviewed the complaints from federal securities class action lawsuits filed in 1996, and analyzed the court decisions under the Reform Act. In addition, the staff has reviewed a sample of complaints from securities class actions brought in state courts during 1996.

The number of court decisions under the Reform Act and the availability of other objective data that could be used to evaluate the effectiveness of the Act are still very limited. In particular, the federal appellate courts have had virtually no opportunity to interpret the provisions of the Reform Act. Although it is too soon to draw definitive conclusions about the impact of the Reform Act on the effectiveness of the securities laws and on investor protection, some preliminary observations can be made.

The number of companies sued in securities class actions in federal court is down for the twelve months following passage of the Reform Act. This may be a temporary aberration, however, as the first three months of the year following passage of the Act are unrepresentative -- only 15% of the cases were filed in this quarter. More time is necessary to determine whether the number of cases has been affected by the Reform Act. It also appears that the "race to the courthouse" has slowed somewhat. Although a few cases were filed within days of the release of negative news by the issuer, most were filed after at least several weeks had passed.

The discovery stay imposed by the Act during the pendency of a motion to dismiss, coupled with the heightened pleading standards, has made it more difficult for plaintiffs to bring and prosecute securities class action lawsuits. No cases to date have been dismissed without leave to amend because of the new pleading standards. Plaintiffs who are unable to uncover evidence of wrongdoing sufficient to meet those new standards prior to filing their complaints, however, may find it difficult to amend their complaints without access to discovery.

Although the Reform Act sought to increase the participation of institutional investors in securities class actions, institutional investors have not become active in many cases. Securities class actions generally continue to be controlled by plaintiffs' law firms.

Secondary defendants, such as accountants and lawyers, are being named much less frequently in securities class actions. This may, however, largely be the result of a 1994 Supreme Court decision eliminating aiding and abetting in private actions.

The number of securities class actions filed in state court has reportedly increased. Moreover, many of the state cases are filed parallel to a federal court case in an apparent attempt to avoid some of the procedures imposed by the Reform Act, particularly the stay of discovery pending a motion to dismiss. This may be the most significant development in securities litigation post-Reform Act. While the allegations contained in state court complaints are generally similar to those of the federal complaints, state complaints having no parallel federal action are more likely to be based solely on forecasts which have not materialized and less likely to include insider trading allegations.

To date, the reported federal judicial decisions have mainly focussed on issues that arise at the beginning of the litigation process. These decisions have concerned (i) the Act's requirements for pleading fraud; (ii) the stay of discovery during the pendency of a motion to dismiss; and (iii) the procedure for appointing a lead plaintiff. In addition, the Court of Appeals for the Ninth Circuit considered the retroactive application of the Reform Act provision allowing the Commission to bring actions based on aiding and abetting.

There have as yet been no decisions on several other important provisions of the Act. These include the adequacy of cautionary language under the safe harbor for forward-looking statements, sanctions for violations of Rule 11(b) (other than one case that simply found no violation), proportionate liability, and the limitation on damages.

Finally, based on discussions with the issuer community and review of filings with the Commission, the staff believes that the quality and quantity of forward-looking disclosure has not significantly improved following enactment of the safe harbor for forward-looking statements. So far, it appears that companies have been reluctant to provide significantly more forward-looking disclosure than they provided prior to enactment of the safe harbor.

There are still many uncertainties about the effects of the Reform Act and the staff expects to continue carefully monitoring the cases. The staff believes that it is too soon to draw any firm conclusions about the effect of the Reform Act on frivolous securities litigation, or, for that matter, on meritorious litigation. Accordingly, the staff does not recommend any legislative changes at this time.

## II. INTRODUCTION TO THE REPORT.

After the Private Securities Litigation Reform Act of 1995 (the "Reform Act" or the "Act")[1] was passed, President Clinton wrote to Commission Chairman Arthur Levitt requesting that the Commission "advise me and the Congress within a year about the impact of the act on the effectiveness of the securities laws and on investor protection, and on the extent and nature of any litigation under the act." The Commission's Office of the General Counsel has prepared this report in response to the President's request.

In preparing this report, the staff has discussed the effects of the Reform Act with a variety of interested parties, including plaintiffs' and defense attorneys, public and private institutional investors, and issuers. The staff has also reviewed the complaints from federal securities class action lawsuits filed in 1996 and the court decisions to date under the Reform Act. In addition, the staff has reviewed a sample of complaints from securities class actions brought in state courts during 1996.

The number of court decisions under the Reform Act and other objective data that could be used to evaluate the effectiveness of the Act are still very limited. In



1. Pub. L. No. 104-67, 109 Stat. 737 (1995).

particular, the federal appellate courts have had virtually no opportunity to interpret the provisions of the Act. As cases reach the courts of appeals, a more complete picture of how the Act will be interpreted should emerge. Accordingly, the conclusions reached in this report are necessarily tentative and subject to change as more decisions are handed down by the courts.

### A. Summary of Conclusions.

Although it is too soon to draw any definitive conclusions about the impact of the Reform Act on the effectiveness of the securities laws and on investor protection, some preliminary observations can be made:

- The number of companies sued in securities class actions in federal court is down for the twelve months following passage of the Reform Act. This may be a temporary aberration, however, as the first three months following passage of the Act are unrepresentative -- only 15% of the cases were filed in this quarter. Plaintiffs' lawyers may have been hesitant to test unchartered waters. More time is necessary to determine whether the number of cases has been affected by the Reform Act.

- Most securities class action complaints filed in federal court post-Reform Act appear to contain detailed allegations specific to the action. Few appear to be cookie-cutter complaints and a substantial majority include allegations beyond a mere failed forecast.[2]

- The race to the courthouse has slowed somewhat. Although a few cases were filed within days of the release of negative news by the issuer, most were filed after at least several weeks had passed.

- Secondary defendants, such as accountants and lawyers, are being named much less frequently in securities class actions. It is unclear whether this decline can be attributed to the Reform Act. It may be the result of the Supreme Court's 1994 decision in the *Central Bank* case which eliminated private liability for aiding and abetting.

2. The staff, however, did no comparative review of pre-Reform Act complaints.

- The discovery stay imposed by the Act during the pendency of a motion to dismiss, coupled with the heightened pleading standards required by the Act, has made it more difficult for plaintiffs to bring and prosecute securities class action lawsuits. No case to date has been dismissed without leave to amend because of the new pleading standards. Plaintiffs who are unable to uncover evidence of wrongdoing sufficient to meet those new standards prior to filing their complaints, however, may find it difficult to amend their complaints without access to discovery.

- Institutional investors have not yet actively sought to become involved in securities class actions, which continue to be controlled by plaintiffs' law firms.

- The number of state filings reportedly has increased. Moreover, many of the state cases are filed parallel to a federal court case in an apparent attempt to avoid provisions of the Reform Act.

- While the allegations contained in state court complaints are generally similar to those of the federal complaints, state complaints having no parallel federal action are more likely to be based solely on forecasts which have not materialized and less likely to include insider trading allegations.

- Companies have been reluctant to provide significantly more forward-looking disclosure beyond what they provided prior to enactment of the safe harbor. Companies are primarily concerned about the lack of judicial guidance as to the sufficiency of the required "meaningful" cautionary language and about potential liability under state law, where the statements may not be protected by the federal safe harbor.

**B. Background.**

The Reform Act became effective on December 22, 1995, revising both substantive and procedural law governing private actions under the federal securities laws. For the most part, the Reform Act applies only to private actions. Except with respect to its authority to bring aiding and abetting actions, the Act does not directly affect the law enforcement program of the Securities and Exchange Commission.

The Reform Act was intended to address concerns that had been raised about abuses believed to be associated with securities class action lawsuits.[3] While the Statement of Managers that accompanied the Conference Committee Report acknowledges the importance of private securities litigation to "promote public and global confidence in our capital markets and help to deter wrongdoing," it also notes that this important system can be undermined by "abusive and meritless suits."[4] In an effort to protect "investors, issuers, and all who are associated with our capital markets from abusive securities litigation," and to "discourage frivolous litigation,"[5] the Reform Act made many changes to the system of private litigation, and particularly class action litigation, under the federal securities laws.

Proponents of the Reform Act, including accountants, securities firms, and the high-technology industry, believed that they were victims of meritless lawsuits which alleged "fraud by hindsight." In such suits, a sudden drop in a company's stock price was claimed to be evidence that the issuer and its agents had been misrepresenting the company's operations or performance in order to inflate its stock price. Critics of securities class actions alleged that plaintiffs' lawyers were filing such suits against "deep pocket" defendants -- whether or not these defendants actually committed fraud -- solely for their settlement value.[6] According to the Report of the House Committee on Commerce, plaintiffs' lawyers were filing suits "citing a laundry list of cookie-cutter complaints" against companies "within hours or days" of a substantial drop in the company's stock price.[7] Once the complaint was filed, plaintiffs' lawyers were free to impose "massive costs" on defendants in the form of discovery requests.[8] As noted in the Report of the Senate Committee on Banking, Housing, and Urban Affairs, the availability of wide-ranging discovery gave plaintiffs' lawyers incentives to "file [frivolous] lawsuits in order to conduct discovery in the hopes of finding a

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3. Statement of Managers -- The "Private Securities Litigation Reform Act of 1995," H.R. Rep. 104-369, 104th Cong. 1st Sess. at 31); 141 Cong. Rec. H13699 (daily ed. Nov. 28, 1995) ("Statement of Managers").

4. *Id.*

5. *Id.*

6. *Id.* at 32.

7. H.R. Rep. 104-50, 104th Cong., 1st Sess. 16 (1995) ("H. Rep.").

8. H. Rep. at 16.

sustainable claim not alleged in the complaint."[9] Faced with the cost of discovery, defendants contended that "the pressure to settle becomes enormous,"[10] thus forcing even "innocent parties to settle frivolous securities class actions."[11] Even if a company were willing to bear the expense of litigation, critics charged that companies inevitably settled rather than face a potentially ruinous jury verdict.[12]

Opponents of the Reform Act, while generally recognizing the need for some reforms, countered that the empirical evidence did not support these charges, and that in fact, the securities class action served an essential role in protecting investors from fraud.[13] Putting obstacles in the way of private enforcement of the securities laws would cause investors to lose confidence in the markets.[14]

The second theme driving the debate over securities litigation reform was the question of how successful securities class actions were in protecting investors. In particular, concerns were aired that plaintiffs' lawyers, rather than faithfully representing investors, were serving primarily their own interests. Critics charged that the plaintiff class action law firms dominated the actions brought by the "100 share plaintiff," setting their own fees, making all strategic decisions, and often

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9. S. Rep. 104-98, 104th Cong., 1st Sess. 14 (1995) ("S. Rep.").

10. H. Rep. at 17.

11. Statement of Managers at 37.

12. H. Rep. at 17.

13. Prepared Statement of William S. Lerach, Before the Subcommittee on Telecommunications and Finance, House Committee on Commerce on Legislation on Securities Fraud Litigation, January 19, 1995 at 45 (testifying on behalf of the National Association of Securities and Commercial Law Attorneys ("NASCAT")) ("we believe the empirical case for the major changes in the [House bill] has not been made and those proposals would leave those defrauded in the securities markets essentially without a remedy"); Prepared Statement of Sheldon H. Elsen, Hearing on Securities Litigation Reform Proposals: Subcommittee on Securities, Senate Committee on Banking, Housing, and Urban Affairs, March 22, 1995, at 195 (representing the New York Bar Association) (predicting that obstacles to securities class actions would lead to "many more violations of the law").

14. Prepared Statement of David J. Guin, Hearing on Securities Litigation Reform Proposals: Subcommittee on Securities, Senate Committee on Banking, Housing, and Urban Affairs, March 22, 1995, at 193 (representing NASCAT) (arguing that strengthened securities laws are necessary to maintain investor confidence).

reaching settlements that favored the law firm at the expense of investors. The Senate Report states:

> Under the current system, the initiative for filing 10b-5 suits comes almost entirely from the lawyers, not from genuine investors. Lawyers typically rely on repeat, or "professional," plaintiffs who, because they own a token number of shares in many companies, regularly lend their names to lawsuits. Even worse, investors in the class usually have great difficulty exercising any meaningful direction over the case brought on their behalf. The lawyers decide when to sue and when to settle, based largely on their own financial interests, not the interests of the purported clients.[15]

The Senate Report further charged that plaintiffs' lawyers recruited these "professional plaintiffs" through "the payment of a 'bonus' far in excess of their share of any recovery."[16] With plaintiff in pocket, the Senate Report observed, plaintiffs' lawyers often rushed to the courthouse after spending a "minimal time preparing [the] complaint[]" because "[c]ourts traditionally appoint the lead plaintiff and lead counsel in class action lawsuits on a 'first come, first serve' basis."[17] Congress also found abuses in the settlement process. Plaintiffs' lawyers typically received a third of the settlement, with the plaintiffs often receiving pennies on the dollar.[18] Members of the plaintiff class often received inadequate notice of the terms of the settlement.[19]

In response to these perceived abuses, Congress enacted a series of provisions intended to "empower investors so that they -- not their lawyers -- exercise primary control over private securities litigation."[20] As we discuss in detail below, the Reform Act restricts who can serve as the class representative, adopting a presumption



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15. S. Rep. at 6.

16. S. Rep. at 10.

17. *Id.*

18. H. Rep. at 17.

19. Statement of Managers at 36.

20. S. Rep. at 4.

that the investor with the largest damage claim is the best representative of the class and should serve as the "lead plaintiff." The Act also seeks to insure that members of the plaintiff class will receive adequate notice of both the class action and any settlement of the suit. In addition, the Act attempts to make it more difficult for plaintiffs to sue a company and force a settlement simply because its stock price dropped. It does this by adopting stringent new pleading standards and a safe harbor for so-called "forward-looking statements." The Act also protects "secondary" defendants, such as accountants and corporate counsel, by adopting a system of proportionate, rather than joint and several, liability. The Act further protects defendants by imposing a discovery stay when a motion to dismiss the complaint has been filed, thus sparing defendants the costs of discovery until the court has determined that the allegations of the complaint have merit.

Critics of these provisions raised concerns that they may tend to frustrate meritorious lawsuits, thus diluting the deterrent effect of private litigation. In his veto message, the President supported the goals of the legislation "to end frivolous lawsuits and to ensure that investors receive the best possible information by reducing the litigation risk to companies that make forward-looking statements."[21] But he stated that he was unwilling to sign legislation that would have the effect of "closing the courthouse door on investors who have legitimate claims . . . . Those who are victims of fraud should have recourse to the courts. Unfortunately, changes made in this bill during conference could well prevent that."[22]

In the sections that follow, this Report assesses the impact of these changes on securities class action litigation and investor protection. The Report begins by



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21. 141 Cong. Rec. H15214 (daily ed. Dec. 20, 1995) ("Veto Message").

22. *Id.* The President's veto message expanded on this point:

> While it is true that innocent companies are hurt by frivolous lawsuits and that valuable information may be withheld from investors when companies fear the risks of such suits, it is also true that there are innocent investors who are defrauded and who are able to recover their losses only because they can go to court. It is appropriate to change the law to ensure that companies can make reasonable statements and future projections without getting sued every time earnings turn out to be lower than expected or stock prices drop. But it is not appropriate to erect procedural barriers that will keep wrongly injured persons from having their day in court.

*Id.* at H15215.

summarizing the provisions of the Reform Act. The Report then evaluates the effect of the Act on the quantity and quality of securities class actions that have been brought following its enactment. The Report also considers the effect of the safe harbor for forward-looking statements. Next, the Report analyzes the decisions to date under the Act and discusses some practical issues that have been raised by the implementation of the Act. Finally, the Report discusses the reported increase in state court securities class actions since passage of the Act.

## III. SUMMARY OF PRINCIPAL PROVISIONS OF THE REFORM ACT.

The most significant measures instituted by the Reform Act are: (i) a statutory "safe harbor" for forward-looking statements; (ii) heightened pleading standards; (iii) a stay of discovery during the pendency of a motion to dismiss; (iv) a system of proportionate, as opposed to joint and several, liability for defendants in private actions who are not found to have "knowingly" committed a violation of the securities laws; (v) mandatory sanctions for violations of Rule 11(b) of the Federal Rules of Civil Procedure;[23] and (vi) a requirement that courts choose a lead plaintiff in securities class actions to represent the class, with the presumption that the most capable representative is the person or group with the largest financial interest in the case. The Act also expressly provides authority to the Commission to bring actions based on aiding and abetting.

In addition, the Reform Act places limitations on damages in certain cases, eliminates securities fraud as a predicate offense in a civil RICO action, and requires auditors to report promptly illegal acts discovered during an audit. Finally, the Act eliminates the payment of bonuses to named plaintiffs, restricts settlements under seal, provides for enhanced disclosure of settlement terms, modifies the manner of awarding attorneys' fees, prohibits brokers and dealers from receiving referral fees, and makes a number of other changes.

23. Rule 11(b) provides, in relevant part, that by presenting to the court a pleading, written motion or other paper, the attorney is certifying that the claims, defenses and other legal contentions therein are warranted by existing law or by a nonfrivolous argument for the extension, modification or reversal of that law or the establishment of new law; and that the allegations and other factual contentions have, or after discovery are likely to have, evidentiary support.

The following is a summary of those provisions of the Reform Act that either have raised issues during the course of the first year following the adoption of the Act or are expected to have a significant impact on private litigation under the Act.

### A. Safe Harbor for Forward-Looking Statements.

One of the key provisions of the Reform Act is the statutory safe harbor for forward-looking statements.[24] This provides shelter from private liability under the federal securities laws for projections and other forward-looking statements that were not known to be false when made or that were accompanied by "meaningful" cautionary statements. Meaningful cautionary statements must identify important factors that could cause actual results to differ from the projected ones.[25]

The purpose of the safe harbor is to encourage companies to provide projections and other forward-looking information to investors by giving them some protection from lawsuits if the projections do not prove accurate. The Statement of Managers quotes testimony from former SEC Chairman Richard Breeden that: "Shareholders are also damaged due to the chilling effect of the current system on the robustness and candor of disclosure . . . . Understanding a company's own assessment of its future potential would be among the most valuable information shareholders and potential investors could have about a firm."[26] The Conference Committee stated that it had adopted a statutory safe harbor "to enhance market efficiency by encouraging companies to disclose forward-looking information."[27]



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24. A safe harbor is provided for private actions brought under both the Securities Act of 1933 and the Securities Exchange Act of 1934. 1933 Act § 27A; 1934 Act § 21E.

25. The safe harbor provides for a specific stay of discovery (other than discovery directed to the applicability of the safe harbor) during the pendency of any motion for summary judgment based on the safe harbor.

26. Statement of Managers at 42-43.

27. *Id.* at 43.

Specifically, the safe harbor provides protection from liability in any private action under the federal securities laws as a result of any forward-looking statement,[28] whether written or oral, if --

> (a) the statement (i) is identified as a forward-looking statement, and (ii) is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement; *or*
>
> (b) the plaintiff fails to prove that the statement was made with actual knowledge that it was false or misleading.[29]

The safe harbor is limited with respect to the type of person making the statement, applying primarily to statements by or about reporting companies.[30] There are also a number of important exclusions from the protection of the safe harbor.[31]

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28. For purposes of the safe harbor, "forward-looking statement" is defined as:

> (A) a statement containing a projection of revenues, income or other financial items; (B) a statement of management's plans and objectives for future operations (including products or services); (C) a statement of future economic performance; (D) a statement of the assumptions underlying any of such statements; (E) any report issued by an outside reviewer retained by the issuer that assesses a forward-looking statement made by the issuer; or (F) a statement containing projections or estimates of such other items as the Commission may specify.

29. The safe harbor also provides that a forward-looking statement is protected if it is immaterial.

30. The safe harbor is limited to forward-looking statements made by (1) an issuer that is a reporting company; (2) an officer, director or employee of such an issuer; (3) an outside reviewer retained by such an issuer making a statement on behalf of such issuer; or (4) an underwriter with respect to information provided by such an issuer. In the case of an oral statement, the requirement for cautionary language is deemed satisfied if the speaker identifies a readily available written document that contains the required cautionary language. The speaker must also make a cautionary statement that the particular oral statement is forward-looking and that actual results could differ materially.

31. Excluded from the safe harbor are:

> (1) statements (A) made within 3 years after the maker of the statement has been found responsible for certain securities law or related violations; (B) made by "blank-check" companies; (C) made by "penny stock" issuers; (D) made in connection with

The two prongs of the safe harbor operate independently (i.e., the defendant prevails if the forward-looking statement is accompanied by appropriate cautionary disclosure *or* if the plaintiff fails to establish actual knowledge of falsity). Unless the plaintiff can refer to subsequent events or other sources of information to allege facts demonstrating that the forward-looking statements were false or that the cautionary statements themselves were misleading, the safe harbor contemplates that courts will dismiss the case without any inquiry into the defendants' state of mind.[32]

## B. Heightened Pleading Standards.

Under the Reform Act, plaintiffs must meet strict new pleading standards. The Statement of Managers found that the pleading requirements set forth in Rule 9(b) of the Federal Rules of Civil Procedure had not "prevented abuse of the securities laws by private litigants."[33] Furthermore, the courts of appeals had interpreted the rule in

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> rollup transactions; and (E) made in connection with going private transactions; as well as
>
> (2) statements that are (A) included in GAAP financial statements; (B) made by investment companies; (C) made in connection with a tender offer; (D) made in connection with an initial public offering: (E) made by partnerships and other direct participation investment programs; (F) made in 1934 Act § 13(d) reports of beneficial ownership.

The Commission may, by rule or regulation, expand the scope of the statutory safe harbor.

32. The Statement of Managers explains, at 44:

> The use of the words "meaningful" and "important factors" are intended to provide a standard for the types of cautionary statements upon which a court may, where appropriate, decide a motion to dismiss, without examining the state of mind of the defendant. The first prong of the safe harbor requires courts to examine only the cautionary statement accompanying the forward-looking statement. Courts should not examine the state of mind of the person making the statement.

It should be noted that one of the issues upon which the President based his veto of the bill was his concern that the discussion of the safe harbor in the Statement of Managers, which, he noted, would be used by the courts as a guide to the intent of Congress, "attempts to weaken the cautionary language that the bill itself requires." As a result, he said, "investors [may] find their legitimate claims unfairly dismissed." Veto Message at H15215.

33. Statement of Managers at 41.

conflicting ways, "creating distinctly different standards among the circuits."[34] The Conference Committee adopted this strict pleading standard for private securities lawsuits "based in part on the pleading standard of the Second Circuit, * * * regarded as the most stringent pleading standard."[35] Specifically, the Reform Act provides that where the plaintiff files a complaint in a private action under the Exchange Act seeking money damages that are available only on a showing that the defendant acted with a particular state of mind, the complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[36]

The Reform Act also requires a plaintiff in a private action under the Exchange Act to specify each statement alleged to have been misleading and the reasons why the statement is misleading. If an allegation is made on information and belief, the plaintiff must state with particularity all facts on which the belief is formed.[37] The court is required to dismiss a complaint that does not meet these statutory pleading requirements.[38]

### C. Stay of Discovery During the Pendency of a Motion to Dismiss.

In order to avoid the high costs of discovery when the plaintiff cannot meet the new pleading standards, the Reform Act provides for a stay of discovery during the pendency of any motion to dismiss unless the court finds that particularized discovery is necessary to preserve evidence or prevent undue prejudice.[39] The Statement of Managers noted that the House and the Senate had heard testimony that discovery in

34. *Id.*

35. *Id.*

36. 1934 Act § 21D(b)(2). In private actions under both the Exchange Act and the Securities Act, when requested by a defendant, the court is required to submit written interrogatories to the jury on the question of the defendant's state of mind. The application of this provision is limited to actions in which money damages may be recovered, and, in the case of actions under the Securities Act, actions in which such damages may be recovered only on proof of the defendant's state of mind. 1933 Act § 27(d); 1934 Act § 21D(d).

37. 1934 Act § 21D(b)(1).

38. 1934 Act § 21D(b)(3)(A).

39. 1933 Act § 27(b)(1); 1934 Act § 21D(b)(3)(B).

securities class actions "often resembles a fishing expedition."[40] The cost of this discovery "often forces innocent parties to settle frivolous securities class actions."[41]

### D. Lead Plaintiff Provision; Notice to Class.

Under the Reform Act, the court must appoint a lead plaintiff from among class members who seek to act as such, with a procedure for national publication of a notice advising class members of the filing of the action. There is a rebuttable presumption that the most adequate plaintiff is the class member or group of members that has the largest financial interest in the relief sought in the case.[42] That presumption may be rebutted by proof that the presumptive plaintiff will not fairly and adequately protect the interests of the class or is subject to unique defenses foreclosing adequate representation.[43] The lead plaintiff selects counsel for the class, subject to court approval.

This provision was intended in part to discourage the "race to the courthouse" by plaintiffs' counsel to be the first to file a securities class action complaint. Noting that courts often appoint as lead plaintiff and class counsel those who are the first to file a complaint, the Statement of Managers states that the Conference Committee believed that "the selection of the lead plaintiff and lead counsel should rest on considerations other than how quickly a plaintiff has filed its complaint." Hence, the Act allows any class member to move to be appointed lead plaintiff. Further, believing that greater involvement by institutional investors "will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions," the Conference Committee sought "to increase the likelihood that institutional investors will serve as lead plaintiffs by requiring courts to presume that

40. Statement of Managers at 37.

41. *Id.*

42. 1933 Act § 27(a)(3); 1934 Act § 21D(a)(3).

43. A plaintiff is entitled under appropriate circumstances to conduct discovery as to the adequacy of the presumptively most adequate plaintiff.

the member of the purported class with the largest financial stake in the relief sought is the 'most adequate plaintiff.'"[44]

### E. Sanctions; Security for Payment of Costs.

The Reform Act requires mandatory sanctions for violations of Rule 11(b) of the Federal Rules of Civil Procedure.[45] Finding that Rule 11 "has not deterred abusive securities litigation,"[46] the Conference Committee determined to "give teeth" to the rule by "requiring the court to include in the record specific findings, at the conclusion of the action, as to whether all parties and all attorneys have complied with each requirement of Rule 11(b)."[47] Thus, upon final adjudication, the court is required to make a finding of compliance with Rule 11(b) with respect to any complaint, responsive pleading, or dispositive motion. Failure to comply results in mandatory sanctions against a party or an attorney.

Payment of the other party's reasonable attorneys' fees and expenses directly relating to the violation is presumed to be the appropriate sanction,[48] except that upon the substantial failure of a complaint to comply with Rule 11(b), the amount of the sanction is presumed to be the defendant's reasonable attorneys' fees and expenses incurred in the action.[49] In order to ensure that the sanctions will be paid, the court

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44. Statement of Managers at 34. The Act further provides that a person is prohibited from being a lead plaintiff, or an officer, director or fiduciary of a lead plaintiff, in more than five class actions in any three-year period, except as permitted by the court consistent with the purposes of the section. 1933 Act § 27(a)(3)(B)(vi); 1934 Act § 21D(a)(3)(B)(vi).

45. 1933 Act § 27(c); 1934 Act § 21D(c).

46. Statement of Managers at 39.

47. *Id.*

48. Reasonable attorneys' fees are presumed to be the appropriate sanction for a violation unless the party or attorney shows that (i) the award would impose an unreasonable burden and would be unjust, and the failure to make such an award would not impose a greater burden on the party in whose favor sanctions are to be imposed; or (ii) the violation was de minimis.

49. This difference in treatment between a complaint and other papers was one of the reasons given for the President's veto of the bill. The President objected that the provision treated plaintiffs "more harshly than defendants in a manner that comes too close to the 'loser pays' standard" that he opposed. Veto Message at H15215.

may require an undertaking for the payment of fees and expenses from the plaintiff class or from the defendant or from the attorneys for either.[50]

### F. Proportionate Liability; Contribution; Settlement Discharge.

The Reform Act institutes a system of proportionate, as opposed to joint and several, liability for "covered defendants" in private actions who are not found to have "knowingly committed a violation" of the securities laws.[51] In proposing this measure, the Conference Committee found that: "One of the most manifestly unfair aspects of the current system of securities litigation is its imposition of liability on one party for injury actually caused by another."[52] The system of joint and several liability "creates coercive pressure for entirely innocent parties to settle meritless claims rather than risk exposing themselves to liability for a grossly disproportionate share of the damages in the case," the Committee stated.[53]

Under the Act, "covered defendants"[54] are jointly and severally liable only if they "knowingly" commit a violation of the securities laws.[55] For violations that are not made "knowingly," such defendants are proportionately liable based on the

50. 1934 Act § 21D(a)(8). The provision erroneously refers to fees and expenses that may be awarded under "this subsection." However, the subsection does not expressly provide for any award of fees or expenses.

51. 1934 Act § 21D(g).

52. Statement of Managers at 37.

53. *Id.* at 37-38.

54. Covered defendants are defined as all defendants in actions brought under the Exchange Act and outside directors in actions under the Securities Act. The liability of an outside director under subsection (e) of Section 11 of the Securities Act must be determined in accordance with the new provisions of the Exchange Act regarding proportionate liability. 1933 Act § 11(f). The cross-reference in this provision to the proportionate liability provisions of the Exchange Act is erroneous.

55. The Act provides that a defendant "knowingly" commits a violation of the securities laws if the defendant (i) makes an untrue statement of a material fact, with actual knowledge that the representation is false, or omits to state a fact necessary in order to make the statement made not misleading, with actual knowledge that, as a result of the omission, one of the material representations of the defendant is false, and persons are likely to reasonably rely on that misrepresentation or omission; or (ii) in cases not involving false representations, the defendant engages in conduct with actual knowledge of the facts and circumstances that make such conduct a violation of the securities laws. 1934 Act § 21D(g)(10)(A).

defendant's percentage of responsibility. If a defendant's share cannot be collected from that defendant or from a jointly and severally liable defendant, each proportionately liable defendant is then liable for a proportionate share of the uncollectible amount, up to an amount equal to an additional 50% of such defendant's initial share.[56]

The Act provides an express right of contribution in private actions under the Exchange Act, with a six-month statute of limitations for contribution claims. The Act also expressly provides for the discharge of liability of a settling defendant in private actions under the Exchange Act. Upon a settlement, the judgment that may be obtained against the other non-settling defendants is reduced by the greater of the settling party's percentage of responsibility or the amount actually paid.

There have been no judicial decisions to date regarding the proportionate liability provision.

### G. Limitation on Damages.

In cases in which a plaintiff seeks to establish damages by reference to the market price of a security, the Reform Act limits the plaintiff's damages to the difference between the price paid by the plaintiff and the mean value of the security during the 90-day period following correction of the misstatement or omission.[57] This provision was intended to rectify the uncertainty in calculating damages by providing a "look back" period which, the Committee contended, would limit damages "to those losses caused by the fraud and not by other market conditions."[58]

The Reform Act also provides a limitation on damages in certain cases brought under Section 12(2) of the Securities Act. Under the Reform Act, a defendant may



56. Also, where the plaintiff is an individual whose net worth is less than $200,000, and the plaintiff's damages were more than 10% of his or her net worth (as defined), the proportionately liable defendants are jointly and severally liable for any uncollectible amount.

57. 1934 Act § 21D(e).

58. *Id.*

avoid rescission under Section 12(2) and reduce the damages upon proof that part of the plaintiff's loss was the result of factors unrelated to the fraud.[59]

### H. Auditor Detection and Disclosure of Fraud.

The Reform Act imposes a requirement on auditors who detect or otherwise become aware of illegal acts by issuers to report such acts to the issuer's board and, if the board does not take appropriate action, report such acts to the Commission.[60] On March 12, 1997, the Commission adopted revisions to its rules to implement the reporting requirements.[61] In sum, the rules (i) provide that these reports will be non-public and exempt from disclosure under the Freedom of Information Act to the same extent as the Commission's investigative records, (ii) designate the Commission's Office of Chief Accountant as the appropriate office to receive the reports, and (iii) set forth the required contents of the issuer's notice to the Commission.

### I. RICO Liability.

Under the Reform Act, no person may rely upon conduct that would have been actionable as fraud in the purchase or sale of securities to establish a predicate offense in a civil RICO action. The prohibition does not apply if the defendant has been criminally convicted in connection with the fraudulent securities activities.[62]

There have been several judicial decisions regarding the retroactive application of this provision. Most courts have determined that the provision does not apply to actions brought prior to enactment of the Reform Act.[63]

59. 1933 Act § 12(b).

60. 1934 Act § 10A.

61. Securities Exchange Act Release No. 34-38387.

62. 18 U.S.C. § 1964(c).

63. *See, e.g.*, In re Prudential Sec. Inc. Ltd. Partner. Lit., 930 F. Supp. 68, 80-81 (S.D.N.Y. 1996); District 65 v. Prudential Sec., 925 F. Supp. 1551, 1570 (N.D. Ga. 1996).

### J. Aiding and Abetting in Commission Actions.

The Reform Act authorizes the Commission to bring an enforcement action against any person who knowingly provides substantial assistance to another in violation of a provision of the Exchange Act.[64] Such a person is deemed to be in violation of the provision to the same extent as the person assisted.

This provision was intended to confirm the Commission's authority to pursue aiders and abettors after the Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,[65] which held that there was no aiding and abetting liability in a private right of action. By limiting this provision to persons who act knowingly, however, the Commission's authority may be more limited than it was assumed to be prior to *Central Bank*.

## IV. Effect of the Reform Act On the Number and Nature of Federal Cases Filed.

### A. The Numbers.

We have identified 105 companies sued in federal securities class actions during the first year following passage of the Reform Act.[66] By contrast, *Securities Class Action Alert* ("SCAA") has reported that approximately 153 companies were sued in federal securities class actions during 1993, 221 during 1994, and 158 during 1995.[67] Accordingly, there is a 34% drop-off from the number of companies sued in federal court class actions in 1995, a 52% drop-off from the number of suits in 1994, and a

64. 1934 Act § 20(f). The provision applies only to Commission actions under Section 21(d)(1) or (3) of the Exchange Act.

65. 511 U.S. 164 (1994).

66. The leading jurisdictions for securities class action suits are California (24), New York (18), Florida (10), Massachusetts (8), and Texas (8).

67. The Commission's Office of Economic Analysis ("OEA") identified 148 class actions filed in 1995, 200 in 1994, and 142 in 1993. Unlike SCAA, OEA limited its count to "fraud-on-the-market" class actions.

31% drop-off from the number of suits in 1993. At the same time, there has been an increase in the number of reported state securities class actions.[68]

A recent study by the National Economic Research Associates ("NERA") finds that following an initial decline in companies sued in securities class actions, the number of new suits in recent months is now on pace with the number of suits last year.[69] According to the NERA Study, no significant decline in federal class action filings has occurred since the passage of the Reform Act. NERA arrives at this conclusion by excluding the number of class actions filed during January to March of 1996, the first three months of the Act, and focusing solely on the number of class actions filed between April and October 1996. According to NERA, 81 suits were filed during this time compared to 81 suits filed during the same period in 1995. As NERA itself notes, however, going back to 1994, 135 cases were filed during the period from April to October (60% more than the 81 filed during the same period in 1996); 97 were filed in 1993 (a 20% increase); and 125 were filed in 1992 (a 54% increase).

The first three months following passage of the Reform Act are unrepresentative. It has been reported that many class actions were rushed in under the wire in December 1995 to avoid the strictures of the Reform Act. Other lawsuits were likely delayed by attorneys hesitant to test unchartered waters as the first to file under the new Act. Thus, the drop may be a temporary aberration caused by a sharp drop in the number of cases filed during the first few months of the year -- only 15% of the cases were filed during the first quarter. More time is necessary to determine whether the Act will reduce the number of federal cases.

We caution against evaluating the effectiveness of the Reform Act on a purely statistical basis. Data on the number of new filings does not point to any clear conclusions as to whether the Reform Act has eliminated the practices that it targeted. In any event, 1996 witnessed a bull market. This is not an environment lending itself to the inception, or unraveling, of fraudulent schemes designed to cook the books and artificially inflate income.



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68. *See* Section VII below.

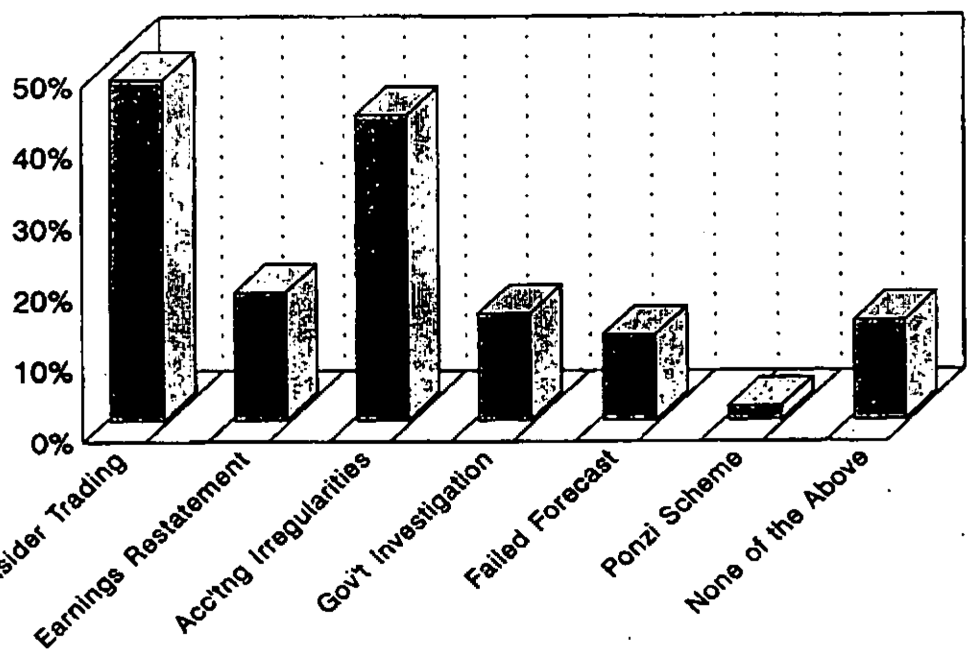
69. Denise N. Martin, Vinita M. Juneja, Todd S. Foster & Frederick C. Dunbar, *Recent Trends IV: What Explains Filings and Settlements in Shareholder Class Actions?*, National Economic Research Associates (1996), at i ("NERA Study").

## B. The Nature of the Allegations.

We have reviewed the allegations in each of the 105 federal securities class actions. Members of both the plaintiffs' and defense bar have told us that greater research and investigation is going into the typical class action complaint and that few are premised solely on a drop in the stock price.

Our review of the complaints filed post-Reform Act suggests that most complaints do not have the type of glaring errors which would suggest that they were the product of a hurried word processing "cut-and-paste." Few of the complaints (12%) are based solely on forecasts that have not proved true, while many are premised on allegations of either insider trading (48%) or accounting irregularities (43%).[70] A smaller percentage contain allegations of restatement of previously reported financial results (18%), government investigations (15%), or outright Ponzi schemes (2%). Fourteen percent contain allegations not fitting into any of the above categories. The graph below presents these numbers.

FEDERAL ALLEGATIONS




70. A recent study found that prior to the Reform Act, 20.7% of securities class actions contained allegations of insider trading and 33.9% contained allegations of misrepresentations in financial statements. Laura E. Simmons, Cornerstone Research, The Importance of Merit-Based Factors in 10b-5 Litigation, Table 2 (Nov. 14, 1996).

### C. The Race to the Courthouse.

The "race to the courthouse" has slowed somewhat. We were able to identify the date for both the end of the class period and the filing of the first complaint for 96 of the 105 securities class actions filed during 1996. The average lag time was 79 days, and the median lag time was 38 days. By comparison, NERA has observed that from January 1991 through December 5, 1995, the average lag time was 49 days. We also observed that 11% of the 96 complaints were filed within one week of the end of the class period, 21% within two weeks, and 33% within three weeks. At the opposite spectrum, 27% of the 96 complaints were filed three months or more after the end of the class period, and 14% were filed after six months. The heightened pleading standards and the lead plaintiff provision are likely responsible for this slowdown.

### D. Effect of the Act on Secondary Defendants.

Congress acted to reduce the liability exposure of secondary defendants in the Reform Act by replacing the traditional regime of joint and several liability with a system of proportionate liability. To date there have been no cases interpreting this provision.

Our review of complaints in the 105 class actions filed under the Act reveals that accounting firms have been named in six cases, corporate counsel in no cases, and underwriters in 19 cases.[71] By contrast, a report of the Big Six accounting firms concluded that the number of audit-related suits filed against these firms for the years 1990 to 1992, was 192, 172, and 141 respectively,[72] although these numbers are not limited to securities class actions. Moreover, this report concludes that during these

71. These numbers could increase as plaintiffs begin to conduct discovery and file amended complaints. Moreover, even though these actors are not being named in securities class actions they may still face liability exposure. *See, e.g.*, Karen Donovan, *Bean Counters in a Bind: Trade-Off Expands Duties*, NAT'L L.J., April 29, 1996, at B1 (discussing derivative suit filed against Ernst & Young L.L.P. for negligent audit). We note that underwriters are typically charged with Securities Act Section 11 claims, which impose strict liability (subject to a due diligence defense) upon underwriters for material misstatements or omissions in the prospectus. 15 U.S.C.A. § 77k(a) (West 1981).

72. Letter from Mark H. Gitenstein & Andrew J. Pincus, Mayer Brown & Platt, to Walter P. Schuetze, Chief Accountant, Securities and Exchange Commission, at 14, Table VIII, (June 11, 1993).

same years the number of cases either settled or dismissed against the Big Six firms which involved claims under Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") was 18, 35, and 58 respectively.[73] The NERA Study reports that during the period 1991 through June 1996, accountants were defendants in 52 reported settlements (as opposed to complaints), underwriters were defendants in 80, and law firms were defendants in 7.[74] Thus, there seems to be a real decline in the number of lawsuits against secondary defendants.

In our discussions with members of the plaintiffs' bar, they attributed part of this decline to their inability to get discovery which might reveal misconduct by secondary defendants. Secondary defendants are not being named in initial complaints, and because complaints are customarily met with a motion to dismiss, discovery can be stayed for a year or more after the complaint is filed. The Supreme Court's decision in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*,[75] however, requires that class actions under Section 10(b) of the Exchange Act be brought within one year from the date that the plaintiff discovered the alleged fraud. As a consequence, plaintiffs may find it difficult to name secondary defendants in either the original or amended complaints.[76]

The decrease in cases against accountants and lawyers is not wholly attributable to the Reform Act. Rather, this decrease may largely result from the Supreme Court's decision in *Central Bank*,[77] in which the Court held that a private aiding and abetting action will not lie under Section 10(b) of the Exchange Act. Aiding and abetting was the theory most often charged against these defendants. Private plaintiffs

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73. *Id.* at 16, Table IX.

74. These numbers, relying on the number of settlements, rather than the number of times named in a complaint, understate the litigation burden faced by these defendants.

75. 501 U.S. 350, 364 (1991).

76. These difficulties may prove unfounded as the statute of limitations arguably will not begin to run until plaintiffs are in a position to obtain knowledge of wrongdoing by the peripheral actor. *Fidel v. Nat'l Union Fire Ins. Co.*, 1996 U.S. App. LEXIS 33388 (9th Cir. Aug. 7, 1996) ("Inquiry notice that triggers the running of the statute of limitations exists 'when a plaintiff has notice or information of circumstances to put a reasonable person on inquiry, or has the opportunity to obtain knowledge from sources open to his [or her] investigation (such as public records or corporation books).'" (citation omitted)).

77. 511 U.S. 164 (1994).

now must allege that these defendants are primarily liable for the fraud, a standard that is considerably more difficult to both plead and prove.

## V. UTILIZATION OF THE SAFE HARBOR AND QUALITY OF SAFE HARBOR CAUTIONARY STATEMENTS.

By enacting a safe harbor for forward-looking statements, Congress intended to encourage companies to provide more and better disclosure of financial projections and other forward-looking information to investors. As noted above, under one prong of the safe harbor such statements must be identified as forward-looking and accompanied by "meaningful cautionary" statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement.[78]

The staff spoke with corporate officers and outside counsel for issuers. In addition, the Commission's Division of Corporation Finance has reviewed forward-looking statements, as well as their accompanying cautionary language, in the normal course of its review of issuer filings. Based on these sources, the staff believes that, in general, companies have been reluctant to provide significantly more forward-looking disclosure than they had prior to enactment of the safe harbor. Several reasons have been advanced to account for this reluctance. The two most frequently cited reasons are: (i) the safe harbor provision is still new and companies are waiting to see how courts will interpret it and how other companies are using it; and (ii) fear of state court liability, where forward-looking statements may not be protected by the federal safe harbor. Another often cited reason is a concern that including a complete



78. To date, there have been no judicial decisions construing the safe harbor provision. *But see* Weiner v. Quaker Oats Co., 928 F. Supp. 1372, 1387 (D.N.J. 1996) (a non-Reform Act case stating that had the safe harbor been applicable, it would have provided a basis for dismissing the complaint). Most of the complaints filed during the first year following enactment of the statute involve forward-looking statements made prior to enactment. These statements were not, therefore, made with the intention of seeking safe harbor protection and the courts have not been faced with the issue of the sufficiency of cautionary language that was tailored to conform to the requirements of the statute. Furthermore, plaintiffs have argued that the safe harbor does not apply to statements made prior to the effectiveness of the Reform Act; this issue, however, remains undecided.

list of cautionary statements would be "cumbersome" and might "water down" the company's disclosures.[79]

We also note that on April 10, 1997, the American Electronics Association[80] sent a letter to Congressman Thomas J. Bliley, Jr. stating the following:

> [T]he 'safe harbor' protections do not apply in state courts. As leaders of our industry, we want to give the investing public as much voluntary information as possible, so that they may make informed decisions about their investments. Without the protections of the 'safe harbor' provisions of the [Reform Act], we cannot do so. Without a change in the law, the net effect is that investors may get less information than they need.

The letter was signed by 181 corporate officers.

Although Companies do not appear to be disclosing much additional forward-looking information, they do appear to be seeking safe harbor protection for essentially the same type of forward-looking information that they disclosed prior to the Reform Act. The quality of the cautionary language that they are using to invoke the safe harbor, however, has been criticized. Chairman Levitt expressed dissatisfaction concerning this cautionary language: "[R]ather than taking advantage of the new safe harbor to communicate forecasts more clearly companies are using even more boilerplate, in the form of cautionary language. It appears that the legal requirements of the safe harbor are being 'over-lawyered.'"[81]

The staff will continue to study the safe harbor and consider what steps might be desirable to encourage companies to provide more forward-looking information and to improve the quality of the accompanying cautionary language.



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79. Other reasons that were offered include the following: fear of liability in a Commission enforcement action where the safe harbor is inapplicable; fear of damaged credibility should projections prove wrong; and difficulty of making projections where a company has multiple sources of revenues from diverse businesses.

80. The Association represents the electronics, software and information technology industries.

81. SEC Chairman Arthur Levitt, Remarks at the 24th Annual Securities Regulation Institute, San Diego, California (January 23, 1997).

## VI. Judicial Decisions and Practical Problems.

Judicial implementation of the Reform Act is still in its early stages, with most judicial decisions at the district court level. We have reviewed these decisions and the most important cases are summarized below. In addition, we have identified certain practical problems of litigating under the Act that have come to light based on the experiences of the first year following its enactment.

To date, the reported judicial decisions have mainly focussed on issues that arise at the beginning of the litigation process. These decisions, discussed below, have concerned (i) the Act's requirements for pleading fraud; (ii) the stay of discovery during the pendency of a motion to dismiss; and (iii) the procedure for appointing a lead plaintiff. In addition, the Court of Appeals for the Ninth Circuit considered the retroactive application of the provision of the Reform Act allowing the Commission to bring actions based on aiding and abetting.

There have as yet been no decisions on several other important provisions of the Act. These include the adequacy of cautionary language under the safe harbor for forward-looking statements, sanctions for violations of Rule 11(b) (other than one case that simply found no violation), proportionate liability, and the limitation on damages.

### A. Cases Involving Pleading Standards.

#### 1. Background.

The Statement of Managers notes that Congressional hearings had "included testimony on the need to establish uniform and more stringent pleading requirements."[82] Prior to the Reform Act, the circuits were split on the issue of securities fraud pleading requirements. The Ninth Circuit had the most liberal pleading standard, allowing scienter to be averred generally, *i.e.* simply by saying it exists.[83] By contrast, the Second Circuit had the strictest pleading standard,



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82. Statement of Managers at 41.

83. *See* In re Glenfed Inc. Sec. Litig., 42 F.3d 1541, 1547 (9th Cir. 1994) ("We conclude that plaintiffs may aver scienter generally . . . that is, simply by saying that scienter existed."); Robbins v. Hometown Buffet, Inc., 1995 U.S. Dist. LEXIS 17870 (S.D. Cal. March 16, 1995) (stating that the *Glenfed* standard is an "easily met pleading requirement"); Securities Investor Protection Corp. v. Vigman, 764 F.2d 1309, 1313 (9th Cir. 1985) ("When considering a Section 10(b) and Rule 10b-5

requiring that plaintiffs state facts with particularity and that these facts give rise to a "strong inference" of fraudulent intent.

In response to these concerns, the Conference Committee adopted language based in part on the pleading standard of the Second Circuit, then "[r]egarded as the most stringent pleading standard."[84] The Second Circuit standard was first announced in *Ross v. A.H. Robins Co.*[85] There the court of appeals said:

> It is reasonable to require that the plaintiffs specifically plead those events which they assert give rise to a strong inference that the defendants had knowledge of the [facts] or recklessly disregarded their existence.

The language of Section 21D(b)(2) clearly reflects this standard, although, as noted in the Statement of Managers which accompanied the Conference Committee Report, the provision was also "specifically written to conform the language to Rule 9(b)'s notion of pleading with 'particularity.'"[86]

The Reform Act, therefore, brings federal pleading standards nationwide in line with the highest pleading standard existing before passage of the Act. However, the Act leaves the question of what constitutes a "strong inference" to be decided by the courts.[87] Under Second Circuit case law, a plaintiff can adequately plead scienter pursuant to a two prong test by alleging either: (1) a "motive" and an "opportunity" on the part of the defendant to commit fraud; or (2) facts that constitute strong



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claim for relief, the court should liberally construe that claim in order to effectuate the policies underlying the federal securities laws.").

84. Statement of Managers at 41.

85. 607 F.2d 545, 558 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980).

86. Statement of Managers at 41.

87. *See* Melvin R. Goldman, *The Reform Act – One Year Later: The Next Generation*, Prepared for the 24th Annual Securities Regulation Institute, January 22 - 24, 1997, San Diego, CA, at 11 ("While Congress borrowed the 'strong inference' standard from Second Circuit case law, Congress did not say how this standard could be satisfied and it is not at all clear from this language alone that Congress intended to import the Second Circuit's two-part test as the means for satisfying this new standard.").

circumstantial evidence of conscious behavior or recklessness.[88] Although an amendment that would have tracked this test had been included in the Senate version of the bill, the language was dropped from the final version of the bill. The Conference Committee explained the deletion of this language as follows:

> Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard.[89]

The Reform Act's heightened pleading standard as construed in the Statement of Managers was one of the reasons offered by President Clinton for his veto of the Act. In his veto message, President Clinton stated:

> I believe that the pleading requirements of the Conference Report with regard to a defendant's state of mind impose an unacceptable procedural hurdle to meritorious claims being heard in Federal courts. I am prepared to support the high pleading standards of the U.S. Court of Appeals for the Second Circuit -- the highest pleading standard of any Federal circuit court. But the conferees make crystal clear in the Statement of Managers their intent to raise the standard even beyond that level. I am not prepared to accept that.[90]

Despite the President's concerns, however, a majority of the cases thus far have adopted the Second Circuit test. To date, we are aware of ten written opinions (four in California) in which district courts have construed the Act's heightened pleading standards. Six have adopted the Second Circuit test. Of these six, four denied motions to dismiss with respect to pleading standards, one denied in part and granted in part such a motion, and one granted the motion. In the two cases in which the



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88. Beck v. Manufacturers Hanover Trust Co., 820 F.2d 46, 50 (2d Cir. 1987); Shields v. Citytrust Bancorp., Inc., 25 F.3d 1124, 1128 (2d Cir. 1994). Motive is defined to include "concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged." *Shields*, 25 F.3d at 1130. Opportunity is defined as "the means and likely prospect of achieving concrete benefits by the means alleged." *Id.*

89. Statement of Managers at 41.

90. Veto Message at H15215.

motion to dismiss was granted, the plaintiffs were given leave to amend with respect to most allegations.

Three courts have adopted a standard more stringent than the Second Circuit test. They have required plaintiffs to allege conscious misbehavior -- allegations of motive, opportunity, and recklessness would not suffice. Applying this strict test, two of the courts found that the plaintiffs had adequately pled conscious misbehavior and refused to grant the motions to dismiss. The third court dismissed the complaint but gave leave to amend with respect to most of the allegations.

In the ninth case, the court construed the language of the statutory pleading standard as written without reference to prior case law, dismissing the complaint with leave to amend. Although no reported case as yet has been dismissed without leave to amend, which would shut the courthouse door to the plaintiffs, these decisions make clear that the threshold established by the new pleading standard is at least as high as the Second Circuit test.

### 2. Cases Adopting the Second Circuit Test for Pleading Facts Giving Rise to a Strong Inference.

Six of the cases that have addressed the new pleading standards have adopted, in large part, the Second Circuit test for determining when a complaint has adequately stated with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind. These courts have looked to (i) motive and opportunity, or (ii) circumstantial evidence of conscious misbehavior or recklessness, in assessing the sufficiency of a complaint.

#### a. *Marksman Partners, L.P. v. Chantal Pharmaceuticals Corp.*[91]

The complaint in this case alleged that Chantal Pharmaceuticals and its Chairman and CEO, Chantal Burnison, engaged in a scheme to boost the company's share price. Specifically, the complaint alleged that Chantal violated generally accepted accounting principles ("GAAP") by immediately recognizing millions of

91. 927 F. Supp. 1297 (C.D. Cal. 1996).

dollars in sales revenue on items that were sold on consignment.[92] As Chantal's stock price began to rise, the complaint alleges, the company made a private placement of common and preferred stock totaling $7,350,000, and Burnison sold 300,000 shares of her own personally held stock, netting in excess of $6,300,000.[93]

The defendants moved to dismiss, arguing that Marksman failed to satisfy the Reform Act's heightened pleading standard. Recognizing that the Act "leaves little doubt, however, that the lenient GlenFed standard [formerly applied in the Ninth Circuit] can no longer be said to constitute the sum of scienter pleading requirements,"[94] the court turned to the two prong Second Circuit test for guidance. The defendants argued that the Act had rejected the Second Circuit's "motive and opportunity" test, citing the language from the Statement of Managers that the Conference Committee "was strengthening existing pleading requirements, and therefore did not intend to codify the Second Circuit's case law interpreting this pleading standard."[95] The *Chantal* court was not persuaded, however, concluding that the "'motive and opportunity' test has not been discarded."[96] In reaching this conclusion, the court relied on several factors, including the fact that the "strong inference" language of the Reform Act's pleading standard mirrors the Second Circuit standard, and that Congress failed to specifically disapprove of the test in the text of the statute.[97]

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92. *Id.* at 1302.

93. *Id.* at 1303.

94. *Id.* at 1309.

95. *Id.* at 1310.

96. *Id.*

97. The court explained:

> The Court is unimpressed with the defendants' enthusiastic reliance on an oblique reference to "motive, opportunity and recklessness" in a footnote to the Conference Committee Report for their argument that the "motive and opportunity" test has been jettisoned. The footnote, embedded as it is in the legislative history and not the body of the statute, implies that Congress chose not to codify motive and opportunity as pleading requirements but does not indicate that Congress chose to specifically disapprove the motive and opportunity test. The Court has little doubt that when Congress wishes to supplant a judicially-created rule it knows how to do so explicitly, and in the body of the statute.

In finding that motive was adequately pled, the court held that "[a]llegations that a corporate insider either presented materially false information, or delayed disclosing materially adverse information, in order to sell personally-held stock at a huge profit can supply the requisite 'motive' for a scienter allegation."[98] The court qualified this holding, however, by adding that "a plaintiff . . . must demonstrate that the insider trading activity was 'unusual'"[99] Adopting pre-Reform Act case law, the court defined "unusual" as "'amounts dramatically out of line with prior trading practices, at times calculated to maximize personal benefit from undisclosed inside information.'"[100] The court was swayed by the fact that Burnison had not sold any of her Chantal stock during the three prior years and that she sold 20% of her holdings.[101] Because Burnison controlled issuance of all accounting and financial statements, the court found the "opportunity" requirement was also satisfied.[102]

The court next turned to the circumstantial evidence prong of the Second Circuit test. Here the court found that plaintiffs had successfully pled scienter by making circumstantial allegations supporting the strong inference that the defendants acted with an intent to defraud the market. The court stated that a violation of GAAP "may be used to show that a company overstated its income, which may be used to show the scienter for a violation of Section 10(b) and Rule 10b-5."[103] The court further explained that: "Although it is true that a violation of GAAP in itself will generally not be sufficient to establish fraud, . . . when combined with other circumstances suggesting fraudulent intent, however, allegations of improper accounting may support a strong inference of scienter."[104] The court found that the test had been satisfied because the complaint coupled the alleged violation of GAAP

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*Id.* at 1311 (footnote omitted).

98. *Id.* at 1312.

99. *Id.*

100. *Id.* (quoting Alfus v. Pyramid Technology Corp., 764 F.Supp. 598, 605 & n.1 (N.D. Cal. 1991)).

101. *Id.* at 1313.

102. *Id.* at 1312.

103. *Id.* at 1313.

104. *Id.*

with proof of substantial insider sales, the private placements, and revenue overstatements of a large magnitude.[105] Accordingly, defendants' motion to dismiss was denied.[106]

b. *Zeid v. Kimberley*[107]

In *Zeid*, plaintiffs filed suit against Firefox Communications, Inc., a software company, and three of its officers and directors, alleging that the defendants engaged in a fraudulent scheme to inflate the price of the company's stock prior to a planned merger. The defendants moved to dismiss the complaint for failure to meet the pleading requirements. The complaint contained general allegations that Firefox's "sales and marketing expansion plan was failing" and that "demand for Firefox products was weak."[108] The court found that these allegations lacked the necessary specificity: "Plaintiffs have not sufficiently alleged the reason or reasons why the statements [made to the public] are misleading. * * * [C]onclusory allegations are insufficient to support a claim of fraud."[109]

In analyzing whether the heightened pleading standards for scienter were satisfied, the *Zeid* court, like the *Chantal* court, applied the Second Circuit test. Unlike the *Chantal* court, however, the court here found that the complaint fell short

105. *Id.* at 1314-15.

106. In a footnote, the court dismissed the defendants' argument that the Reform Act had abolished securities fraud liability for reckless conduct:

> First, defendants' suggestion that strengthening the pleading standard for scienter must necessarily result in a change to the nature of the scienter required makes little sense. Second, while it is true that the PSLRA elevates the mental state requirement to "actual knowledge" for certain specified situations, the Court finds no basis to conclude that Congress altered the mental state requirement for the type of Section 10(b) and Rule 10b-5 violation at issue in this case.

*Id.* at 1309, n.9.

107. 930 F. Supp. 431 (N.D. Cal. 1996).

108. *Id.* at 436.

109. *Id.*

under either prong of the analysis.[110] The "motive and opportunity" prong was found not to be satisfied because, although the plaintiffs alleged a motive of obtaining a high acquisition price for Firefox, the company had actually released its disappointing earnings results *prior* to the merger, thus causing its stock price (and the merger price) to plummet. Moreover, plaintiffs failed to allege any facts supporting their contention that the defendants intended to complete the merger prior to announcing the results.[111] Plaintiffs also did not satisfy the "circumstantial evidence" prong because they did "not sufficiently specify any reasons why [d]efendants' statements were misleading when they were made,"[112] and they did "not set forth any contemporaneous facts to support their assertions of knowledge and recklessness."[113] Accordingly, the complaint was dismissed with leave to amend.[114]

In granting leave to amend, the court rejected the defendants' argument that since the complaint did not satisfy the Act's pleading standards, the language and legislative history of the Reform Act compelled that it be dismissed without leave to amend. "Contrary to Defendants' assertions, there is nothing in [the language of the Act] to indicate that district courts are required to dismiss securities fraud claims without leave to amend. Further, without a clear directive from Congress, this Court refuses to read into the Reform Act any limitation on the ability of trial courts to permit an opportunity to amend."[115]

c. *STI Classic Fund v. Bollinger Industries, Inc.*[116]

On November 12, 1996, the district court adopted a magistrate's report and recommendation which refused to dismiss, in large part, an amended class action



110. *Id.*

111. *Id.*

112. *Id.*

113. *Id.*

114. Claims that various boilerplate warnings were themselves false and misleading because they were not specific enough were dismissed without leave to amend.

115. 930 F. Supp. at 438.

116. No. 3:96-CV-823-R (N.D. Tex. Nov. 12, 1996).

complaint filed against Bollinger Industries. The complaint alleged that Bollinger engaged in a financial fraud. Relying on the *Chantal* decision, the magistrate concluded that the Second Circuit's "motive and opportunity" test was the "persuasive interpretation" of the Reform Act's heightened pleading requirements.[117] The magistrate further concluded that the individual defendants, owning substantial shares in Bollinger, had ample motive to engage in the alleged financial fraud. Specifically, the magistrate stated: "Materially inflated reports concerning Bollinger's financial health . . . benefited the value of Bollinger's shares and likewise increased the value of the Brothers Bollinger's interest in the Company."[118]

Although the defendants argued that "these facts would 'indict' any small, family dominated business," the magistrate responded that: "The flaw in Defendants' argument is that it seeks to isolate an element of the circumstances alleged in Plaintiffs' amended complaint rather than to consider them in their totality."[119] The magistrate did not specify what other facts were part of this "totality" of circumstances.

#### d. *Fischler v. AmSouth Bancorporation*[120]

In *Fischler*, the court also adopted the Second Circuit test as the pleading standard required by the Reform Act. The plaintiffs alleged that the company violated the antifraud provisions of the federal securities laws by selling annuities without disclosing certain hidden surrender charges.[121] Defendants moved to dismiss on several grounds, including failure to adequately plead fraud.

The *Fischler* court noted that because both the Reform Act and the traditional Second Circuit test require that a "strong inference" of scienter be pled, the court

117. Report and Recommendation of United States Magistrate Judge at 2; 2 SEC. REF. ACT LITIG. REP. 99 (Oct. 1996).

118. *Id.* at 2-3.

119. *Id.* at 3.

120. No. 96-1567-CIV-T-17A, 1996 U.S. Dist. LEXIS 17670 (M.D. Fla. Nov. 14, 1996).

121. *Id.* at *3.

could look to the Second Circuit for interpretive guidance.[122] The court noted that the motive and opportunity test is a "common method" for establishing this strong inference.[123] The court held, "In the present case, Plaintiff alleges facts showing motive and opportunity. Plaintiff's Complaint meets the requirements of §21D(b)(3)(A)."[124] No indication is given as to what the court found to be an adequate motive. A review of the complaint shows that the pleading standard may more readily be satisfied by reference to the other prong of the Second Circuit test, which permits the pleading of facts giving rise to circumstantial evidence of at least reckless behavior. Here, the complaint alleged that the defendants were the subject of two NASD investigations during the class period, as well as investigations by Alabama and Florida state securities regulators. Moreover, a report by an outside consultant concluded that systematic wrongdoing was occurring. This information should have put the defendants on notice of the fraud.

e. *Rehm v. Eagle Finance Corporation*[125]

In *Rehm*, the Northern District of Illinois became the fifth court post-Reform Act to adopt the Second Circuit pleading test. The court found that the Act "adopts the Second Circuit standard but declines to bind courts to the Second Circuit's interpretation of its standard."[126] Like the *Chantal* court, this court was swayed by the fact that the language of the Reform Act mirrored the language traditionally employed by the Second Circuit that a "strong inference" of fraudulent intent be pled.[127] The court also looked to the legislative history:

> The Committee does not adopt a new and untested pleading standard that would generate additional litigation. Instead, the Committee chose a uniform standard modelled upon the pleading standard of the Second Circuit. . . . The Committee does not



122. *Id.* at *7-*8.

123. *Id.* at *8.

124. *Id.*

125. No. 96 C 2455, 1997 U.S. Dist. LEXIS 767 (N.D. Ill. Jan. 27, 1997).

126. *Id.* at *16.

127. *Id.*

intend to codify the Second Circuit's case law interpreting this pleading standard, although courts may find this body of law instructive.[128]

Although it was not bound to follow the Second Circuit test in applying the pleading standard, the *Rehm* court concluded that test was "consistent with the language and purpose of the PSLRA and therefore an appropriate standard to apply in this case."[129] The court found that the Second Circuit test struck an appropriate balance between curtailing abusive securities lawsuits and leaving the courthouse door open for valid lawsuits. The court proceeded to analyze the two prongs of the test.

The lawsuit alleged that Eagle, a financial services company, materially misrepresented its known credit losses and net income.[130] The court found that it was insufficient to establish motive simply by alleging that the company was facing an impending risk that it would lose access to the capital markets if the truth about its credit losses was known. The court observed that "allegations of motives that are generally held by similarly positioned executives and companies are insufficient."[131] The court found it significant that plaintiffs did not allege that Eagle actually attempted to raise capital during the class period.[132] Next, the court found insufficient allegations that the individual defendants owned substantial Eagle stock.[133] Allowing motive to be inferred from stock ownership would mean that "virtually every company in the United States that experiences a downturn in stock price would be forced to defend securities fraud actions" based on the statements of its officers and directors.[134] Lastly, the court deemed insufficient allegations that one of the individual defendants engaged in insider trading during the class period. The court

128. *Id.* at *17 (quoting S. Rep. at 15).

129. *Id.* at *18.

130. *Id.* at *3.

131. *Id.* at *20-*21.

132. *Id.* Conversely, the conduct of a public offering of securities or a significant private placement during the class period may well satisfy the motive prong.

133. *Id.* at *22.

134. *Id.* at *23 (citation omitted).

noted that this person's trading -- 6% of his Eagle holdings -- was not "*dramatically* out of line with [his] prior trading practices."[135]

The *Rehm* court nonetheless did not dismiss the complaint because it held that the second prong of the Second Circuit test had been satisfied. The court found that plaintiffs had adequately pled facts demonstrating at least reckless behavior. Again following *Chantal*, the court held that, "in addition to bare allegations of GAAP violations, the complaint must show that defendants recklessly disregarded the deviance [from GAAP] or acted with gross indifference towards the purported material misrepresentations contained in the financial statements."[136] The court also focussed on the "magnitude of [the] reporting errors" and the "optimistic and reassuring 'spin'" the individual defendants put on the matter in public remarks.[137] The court held that the magnitude of the reporting errors combined with these remarks satisfied the heightened pleading standard.

f. *Fugman v. Aprogenex, Inc.*[138]

The pleading standard codified in the Reform Act is applicable to any private action under the Exchange Act -- it is not limited to class actions. Although not a class action, the adequacy of the pleadings in this securities case was considered in accordance with the Act. Following the earlier decision in *Rehm*, the court determined that the required "strong inference" that the company made the allegedly false statements "either knowing their falsity or with recklessness regarding their falsity"[139] could be established by the two prong Second Circuit test. "[W]e believe that the plaintiffs' Complaint alleges facts which 'constitute strong circumstantial

135. *Id.* at *24 (emphasis added). *Compare Chantal, supra* (sales by Chantal Burnison of 20% of her holdings during the class period deemed "unusual"). The court also found it relevant that the other two individual defendants did not sell stock during the class period, *Rehm* at *23, although this fact seems irrelevant as to the scienter of the insider who actually traded.

136. *Id.* at *28.

137. *Id.* at *29-*30.

138. No. 96 C 5817, 1997 WL 136323 (N.D. Ill. Mar. 19, 1997).

139. *Id.* at *3.

evidence of conscious misbehavior or recklessness' by Aprogenex."[140] In an accompanying footnote, the court added: "Because we conclude that the plaintiffs satisfy part (b) of the Second Circuit's test, we need not consider whether they have satisfied the more intricate 'motive and opportunity' requirement of part (a)."[141]

### 3. Cases Rejecting the Second Circuit Test -- Requiring the Pleading of Conscious Misbehavior.

#### a. *In re Silicon Graphics, Inc. Securities Litigation*[142]

On September 25, 1996, a judge in the Northern District of California refused to look to Second Circuit case law to interpret the heightened pleading standard. The *Silicon Graphics* class action alleged that the company and nine of its officers and directors violated the antifraud laws in connection with both historical and forward-looking statements about the company's growth targets.[143] The plaintiffs alleged that the company and the individual defendants issued false and misleading information after a disappointing first quarter in an effort to inflate the stock price so that the individuals could sell their own stock at a substantial profit.[144] The defendants moved to dismiss.

Primarily based on the language in the Statement of Managers, the court found that "Congress did not simply codify the Second Circuit standard," but "intended to

140. *Id.* at *4.

141. *Id.* at *8 n.5. The court dismissed certain allegations with respect to forward-looking statements on account of the safe harbor provided by the Commission's Exchange Act Rule 3b-6. The court noted at *5 that "[a]s in the case of scienter, Rule 9(b)'s particularity requirement is heightened ever further with respect to forward-looking statements, which are protected by a 'safe harbor' provision unless they are made in bad faith or without a reasonable basis." The court found that the allegations did not support the view that the company lacked a reasonable basis in making the forward-looking statements. The opinion does not refer to the statutory safe harbor contained in the Reform Act.

142. Fed. Sec. L. Rep. (CCH) ¶ 99,325 (N.D. Cal. 1996); 1996 U.S. Dist. LEXIS 16989.

143. *Id.* at 95,959-60.

144. *Id.*

strengthen it."[145] Reviewing the legislative history of the Reform Act, the court found it particularly significant that the Conference Committee had eliminated the amendment to the pleading provision of the Senate version of the bill that would have tracked the two prong Second Circuit test. The Conference Committee explained the deletion of this language as follows, "Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard."[146] Footnote 23 in the Statement of Managers further explained that, "[f]or this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness."[147]

Since footnote 23 specifically referred to motive, opportunity, and recklessness, but not to conscious behavior, the court appears to have determined that Congress must have intended that only evidence of conscious behavior would suffice to meet the strong inference test. This conclusion was reached despite the fact that in deleting the clarifying amendment, the Conference Committee deleted not only the language regarding motive, opportunity, and recklessness, but also the language regarding conscious misbehavior.

As stated by the court: "Because Congress chose not to include that language from the Second Circuit standard relating to motive, opportunity, and recklessness, Congress must have adopted the Conference Committee view and intended that a narrower first prong apply."[148] The "narrower first prong" to which the court referred was the language contained in the clarifying amendment that was not specifically mentioned in footnote 23, *i.e.*, conscious behavior. Accordingly, the court held that a "plaintiff must allege specific facts that constitute circumstantial evidence of conscious behavior by defendants."[149] The court held that the plaintiffs must allege facts that would " create a strong inference of knowing misrepresentation

145. *Id.* at 95,961-62.

146. Statement of Managers at 41.

147. *Id.* at 48 n. 23.

148. Fed. Sec. L. Rep. (CCH) ¶ 99,325 at 95,962.

149. *Id.*

on the part of the defendants."[150] The court noted that its opinion conflicted with the holdings in *Chantal* and *Zeid*, but "respectfully disagreed" with those decisions.[151] Determining that the plaintiff's allegations were not specific enough to raise a strong inference of fraud, the court dismissed the complaint with leave to amend.[152]

The plaintiffs amended their complaint and the defendants again moved to dismiss. In connection with this motion, on February 3, 1997, the Commission filed an *amicus curiae* brief urging the district court to reconsider its earlier decision.[153] By requiring the plaintiffs to allege conscious behavior, the court effectively eliminated recklessness as a sufficient state of mind for liability under Section 10(b) of the Exchange Act. The Commission argues that the Act did not alter the state of mind required to be shown in a private action, except in the case of certain forward-looking statements entitled to the protection of the "safe harbor."[154] The Commission's brief further argues that a retreat from the recklessness standard would greatly erode the deterrent effect of Section 10(b) actions.[155]

The Commission's brief reviews the Reform Act's legislative history and concludes that the Act does not eliminate recklessness as a scienter standard. The Commission points out that:

> Nowhere did the Conference Committee suggest that it was eliminating recklessness as satisfying the scienter requirement, or, indeed, that it was eliminating evidence of motive and opportunity or circumstantial evidence of fraudulent intent (be it conscious or

150. *Id.* at 95,963.

151. *Id.* at n.4.

152. Following the court's order granting the Motion to Dismiss, the plaintiffs filed a First Amended Complaint on October 17, 1996. The defendants moved to dismiss the Amended Complaint on December 13, 1996. This motion is pending.

153. Brief of the Securities and Exchange Commission, amicus curiae, In re Silicon Graphics Sec. Litig., Fed. Sec. L. Rep. ¶ 99, 325 (N.D. Cal. 1996).

154. *Id.* at 7-8.

155. *Id.* at 3.

reckless) as factors that the courts might consider in determining whether the strong inference had been established. Instead, Congress simply elected not to attempt to codify the guidance provided in Second Circuit case law, preferring to leave to the courts the discretion to create their own standards for determining whether a plaintiff has established the required strong inference.[156]

The Commission concluded that: "If plaintiffs can state with particularity facts giving rise to a strong inference that defendants acted recklessly, their complaint is sufficient under [the Reform Act]."[157] A hearing on the motion to dismiss the amended complaint is set for April 1997.

b. *Friedberg v. Discreet Logic Inc.*[158]

This case involved an alleged violation of Section 10(b) of the Exchange Act in connection with a public offering by Discreet Logic. The plaintiffs alleged that the prospectus and other statements made in connection with the offering were false and misleading. On a motion to dismiss, the court considered the question of "what must a plaintiff plead in order to create [a] 'strong inference' of scienter."[159]

Citing language from the Statement of Managers, the court determined that the Reform Act pleading standard was intended to be "even stronger than the existing Second Circuit pleading standard."[160] The court also noted that the Conference Committee "purposely chose not to include in its pleading standard language derived



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156. *Id.* at 12-13. *See also* Michael A. Perino, *A Strong Inference of Fraud? An Early Interpretation of the 1995 Private Securities Litigation Reform Act*, 1 SEC. REF. ACT LITIG. REP. 397, 403 (June & July 1996) ("Like the statements in the earlier Senate Report, the language in the Statement of Managers is ambiguous. It does not clarify whether Congress intended to make its standard more stringent than the Second Circuit's standard, whether the Second Circuit standard was meant to be the norm, or whether the Managers were only attempting to formulate a standard that was higher than that used by Circuits other than the Second Circuit.").

157. *Id.* at 13.

158. Civ. A. No. 96-11232-EFH, 1997 U.S. Dist. LEXIS 2893 (D. Mass. Mar. 7, 1997).

159. *Id.* at *20.

160. *Id.* at *22.

from Second Circuit case law relating to motive, opportunity or recklessness,"[161] and that the Conference Committee had not adopted language from the Senate bill that would have expressly set forth the Second Circuit test.

Adopting what it called a "conscious behavior" pleading approach, the court rejected the Second Circuit "motive and opportunity" test, as well as the recklessness prong. Instead, the court adopted a test requiring the plaintiff to "plead a 'strong inference' of scienter by alleging facts constituting circumstantial evidence of conscious behavior."[162] Applying this standard to the allegations of the complaint, the court denied the motion to dismiss. Among other things, the court relied on sales of shares by insiders to provide strong circumstantial evidence of conscious misbehavior.

c. *Powers v. Eichen*[163]

This class action filed against Proxima Corporation and certain of its officers and directors alleged that the defendants had artificially inflated the company's stock by falsely representing that Proxima had successfully developed new products that would lead to substantial revenue and earnings growth. The defendants moved to dismiss, arguing that the plaintiffs had failed to plead scienter with the particularity required under the Reform Act. The court agreed with the reasoning of the court in *Silicon Graphics* and adopted its strict standard, but held that the plaintiffs had met the standard and denied the motion to dismiss. Like the court in *Discreet Logic*, the court here relied in large part on sales of stock by insiders in finding a strong inference of intent to defraud.



161. *Id.*

162. *Id.* at *25.

163. Case No. Civil 96-1431-B (AJB) (S.D. Cal. Mar. 13, 1997).

4. A Decision Construing the Pleading Standard Without Adopting or Rejecting the Second Circuit Test -- *Myles v. Midcom Communications, Inc.*[164]

The court in this case also considered the applicability of the Second Circuit test to the Reform Act requirements for pleading scienter. The plaintiffs argued that the Second Circuit test should apply, citing *Chantal*. The defendants argued for a tougher test, citing *Silicon Graphics*. The court found this dispute to be unwarranted: "The statute itself defines the standard and the statute is clear."[165] Since recklessness was sufficient for scienter, the court held that "a complaint must 'state with particularity facts giving rise to a strong inference that the defendant acted' either with an intent to deceive, manipulate or defraud or with recklessness."[166]

A strong inference is created by circumstantial evidence, the court found. "[T]he two are essentially the same. That is, direct evidence of one fact (e.g., bad accounting practices) that creates an inference as to a second fact (i.e., fraudulent intent) is circumstantial evidence of the second fact."[167] Thus, the court concluded, "[w]hether this is lower or higher than the Second Circuit test is irrelevant."[168]

Applying this test, the court found that the allegations were not sufficient to demonstrate scienter, but granted the plaintiffs leave to amend.

5. A Reform Act Case Dismissed on Other Grounds -- *Steckman v. Hart Brewing, Inc.*[169]

*Hart Brewing* did not involve the heightened pleading requirements of the Act. The complaint alleged only violations of Sections 11 and 12(2) of the Securities Act and not violations of the Exchange Act. In connection with an initial public offering

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164. No. C96-614D (W.D. Wash. Nov. 19, 1996).

165. *Id.* at 9.

166. *Id.* at 9-10.

167. *Id.* at 10 (footnote omitted).

168. *Id.* (footnote omitted).

169. Civ. Case No. 96-1077-K (RBB) (S.D. Cal.).

by Hart Brewing, the plaintiff claimed that Hart failed to disclose material information indicating an "adverse trend" of declining sales. Relying on pre-Reform Act case law, the court held that the plaintiff must allege facts showing that the defendants had a duty to disclose the adverse trend, but that such a duty arises only upon a showing of an "extreme departure" from prior earnings trends. Finding no such extreme departure, and finding further that Hart Brewing's prospectus contained many warnings directly addressing the plaintiff's allegations of omissions, the court dismissed the complaint on the grounds that the plaintiff had failed to state a claim upon which relief could be granted. The dismissal was made with prejudice since the plaintiff conceded that he could not meet the pre-Reform Act extreme departure standard.

### B. Cases Involving the Stay of Discovery.

The Reform Act requires that all discovery be stayed in a private action under the Exchange Act during the pendency of any motion to dismiss, unless the court finds that particularized discovery is "necessary to preserve evidence or prevent undue prejudice." Members of the plaintiffs' bar have informed us that at least one, and perhaps several, motions to dismiss are now being made in virtually every case. Because defendants no longer incur the cost of discovery during this time period, they are extremely reluctant to settle before a motion to dismiss has been decided.

#### 1. <u>The Discovery Stay Is Being Strictly Applied.</u>

A court may grant relief from the discovery stay upon a showing that particularized discovery is necessary either (1) to preserve evidence, or (2) to prevent undue prejudice.[170] Three decisions to date have interpreted these exceptions strictly, allowing no relief from the stay.[171] The decisions demonstrate that unsubstantiated allegations of an existing risk of destruction of evidence will not satisfy the first prong, and that under the second prong the relevant standard will be a showing of harm which is greater than mere prejudice but less than irreparable harm.



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170. 1934 Act § 21D(b)(3)(B).

171. In March 1997, the discovery stay was made even more stringent in the Northern District of California. A new local rule requires that a discovery stay be imposed in securities class actions not just during the pendency of a motion to dismiss, but also until a lead plaintiff is chosen by the court. N.D. Cal. Civil L.R. 26-6 (d).

a. *Novak v. Kasaks*[172]

In *Novak v. Kasaks*, after the defendants moved to dismiss, the plaintiffs argued that discovery should proceed because there was "'great risk' that highly relevant evidence will be lost or destroyed and that undue prejudice will result if discovery is stayed."[173] The court disagreed, granting the requested stay. "[P]laintiffs have provided no evidence to bolster their wholly speculative assertions as to the risk of lost evidence and undue prejudice."[174]

b. *Medical Imaging Centers of America, Inc. v. Lichtenstein*[175]

On January 10, 1996, Medical Imaging filed a complaint in the Southern District of California seeking injunctive relief and damages against several Medical Imaging shareholders. The case is unusual in that the corporation is suing certain of its shareholders, rather than vice-versa. Medical Imaging alleged that the defendant shareholders filed an incomplete and misleading Schedule 13D disclosure document in an ongoing proxy contest for control of the corporation.[176] Medical Imaging asked that the defendants be ordered to correct their disclosures on matters necessary for an informed vote to take place.

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172. 96 Civ. 3073 (AGS), 1996 U.S. Dist. LEXIS 11778 (S.D.N.Y. Aug. 16, 1996).

173. *Id.* at *3.

174. *Id.* The plaintiffs also argued that if the discovery stay was imposed, non-parties would not feel obligated to maintain relevant documents. The court found this concern "easily remedied," and imposed an order directing all non-parties upon whom subpoenas had been served to preserve all potentially relevant evidence. The result of this order is that plaintiffs continue to have an incentive to serve subpoenas on non-parties to the extent permitted by local rules, even if a discovery stay is on the horizon, or perhaps already in place, in order to ensure that relevant evidence is not destroyed. *See also* Order Denying Plaintiffs' Motion to Compel Non-Party Cisco Systems, Inc. to Produce Documents, Kane v. Made Networks N.V., Case No. C96-20652 RMW PVT (N.D. Cal. Jan. 13, 1997) (staying third-party discovery *prior* to motion to dismiss pursuant to Rule 26(c), Fed. R. Civ. P., because "[s]uch discovery is unnecessary and burdensome because it may require considerable production prior to an assessment of the viability of the pleadings").

175. 917 F. Supp. 717 (S.D. Cal. 1996).

176. *Id.* at 718.

The defendant shareholders filed a motion to dismiss. Medical Imaging argued that it would suffer "undue prejudice" if discovery was stayed because the shareholder vote to replace the board of directors was imminent.[177] The magistrate reviewed the legislative history of the Act and noted that the only example provided that would justify a discovery stay was "the terminal illness of an important witness."[178] The magistrate went on to conclude that the harm required to establish "undue prejudice" must be essentially irreparable.[179]

Medical Imaging appealed the magistrate's ruling to the district court. The Commission filed an amicus brief urging the district court to reject the magistrate's ruling. The Commission contrasted this case, where an event (proxy contest) had not yet occurred, with the type of case envisioned by the Act's legislative history -- money damages sought for events occurring in the past.[180] The Commission argued that:

> [T]he "undue prejudice" standard for allowing limited discovery should not be restricted to situations where irreparable harm can be demonstrated. Rather, in a case where, as here, the plaintiff seeks emergency equitable relief with respect to an on-going contest for control of a corporation, it is possible that the time pressure of upcoming events may result in substantial prejudice, although less than irreparable harm, accruing from a stay of discovery. In such cases, a showing of harm, <u>which is greater than mere prejudice but less than irreparable harm</u>, should satisfy the "undue prejudice" criterion.[181]

At the hearing, the district court judge stated that he agreed with the statutory analysis articulated in the Commission's brief. After considering evidence from both sides, however, the judge concluded that Medical Imaging had demonstrated

177. *Id.* at 719.

178. *See* Medical Imaging Centers v. Lichtenstein, Civ. No. 96-0039 (AJB), 1996 U.S. Dist. LEXIS 7641, at *5 (S.D. Cal. Jan. 22, 1996).

179. *Id.* at *7.

180. Brief of the Securities and Exchange Commission at 6-7, amicus curiae, Medical Imaging Centers of America, Inc. v. Lichtenstein, 917 F. Supp. 717 (S.D. Cal. 1996).

181. *Id.* at 2 (emphasis supplied).

insufficient prejudice and left the discovery stay in place pending resolution of the motion to dismiss.[182] The motion to dismiss was eventually denied and Medical Imaging obtained an injunction.

c. *Levy v. United HealthCare Corp.*[183]

The defendants in this case sought to use the discovery stay as both a shield and a sword. After making a motion to dismiss, the defendants sought relief from the discovery stay so they could depose the plaintiff in order to test the veracity of the statements in the certification filed with his complaint.[184] Finding that neither of the exceptions to the discovery stay had been met, the court denied defendants' motion.[185]

2. <u>The Discovery Stay Likely Will Encompass FRCP 26 Disclosure.</u>

A question not specifically addressed by the Reform Act is whether the discovery stay applies to the disclosure requirements of Rule 26(a) of the Federal Rules of Civil Procedure. Rule 26(a) requires the "disclosure" of certain information by plaintiffs as well as defendants, including: identification of persons likely to possess discoverable information relevant to disputed facts; identification of all parties expected to be called as expert witnesses at trial; exchange of reports concerning the opinions to be expressed by expert witnesses; and exchange of witness lists.[186] The Ninth Circuit has held that the discovery stay does apply to Rule 26(a) disclosures.

182. *Medical Imaging*, 917 F. Supp. at 723.

183. Civ. No. 3-96-750 (D. Minn. Sept. 10, 1996).

184. *Id.* at 2.

185. *Id.* at 3.

186. FED. R. CIV. P. 26.

a. *Hockey v. Medhekar*[187]

In *Hockey*, a California federal district court held that the stay does not encompass the disclosures mandated by Rule 26(a) of the Federal Rules of Civil Procedure.[188] The court noted that recent amendments to Rule 26 inserted the term "disclosure," and added that the court "assumes . . . that Congress is fully cognizant of the difference between the terms 'discovery' and 'disclosure.'"[189]

The Ninth Circuit disagreed.[190] The appellate court noted that "[t]he federal discovery rules contain numerous examples in which disclosures are treated as a subset of discovery."[191] The Ninth Circuit added that "the time and expense involved in the identification and production of documents and other items required by the disclosure rule is exactly the type of burden sought to be eliminated by the Act"[192] and "Congress clearly intended that complaints in these securities actions should stand or fall based on the actual knowledge of the plaintiffs rather than information produced by the defendants after the action has been filed."[193] Accordingly, the appellate court vacated the district court's decision.[194]

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187. 932 F. Supp. 249 (N.D Cal. July 11, 1996), *vacated*, Medhekar v. Unites States, 99 F.3d 325 (9th Cir. Oct. 31, 1996).

188. *Id.*

189. *Hockey*, 932 F. Supp. at 251.

190. Medhekar v. United States, 99 F.3d 325 (9th Cir. Oct. 31, 1996).

191. 99 F.3d at 328.

192. *Id.*

193. *Id.*

194. On a related issue, a new local rule adopted in the Northern District of California addresses when disclosure is to take place in securities class actions. Disclosure information must be exchanged no later than 10 days before a case management conference, which is scheduled by the court after its designates a lead plaintiff. N.D. Cal. Civil L.R. 26-6(b).

b. . *Levy v. United HealthCare Corp.*[195]

When faced with the same issue as to whether the Reform Act discovery stay applies to "disclosure," the Minnesota district court in *Levy v. United HealthCare Corp.*, followed the district court decision in *Hockey*.[196] The court in *Levy* stated two reasons for allowing "disclosure" to go forward. First, the court was influenced by the text of the Reform Act, noting, "we are confident that had Congress intended to relieve the parties from the disclosures intended by Rule 26(a), it was fully capable of so stating."[197] Next, the court stated that to hold otherwise would run counter to the views of the FRCP's Advisory Committee. In the Notes to the 1993 Amendments to Rule 26(a), the Committee states, "[t]he obligation to participate in the planning process [*i.e.* a FRCP Rule 26 disclosure conference] is imposed on all parties that have appeared in the case, including defendants who, because of a pending Rule 12 motion, may not have filed an answer in the case."[198] The Eighth Circuit was not given an opportunity to resolve the conflict between *Levy* and *Hockey* because the *Levy* plaintiffs voluntarily dismissed their complaint.

## C. Procedure for Appointing a Lead Plaintiff.

The Reform Act directs the court to appoint a "lead plaintiff" from among class members who seek to act as such, with a procedure for national publication of a notice advising class members of the filing of the action.[199] Congress believed that this new system would encourage more responsible control of class actions. The presumption that the most adequate plaintiff is the one with the largest financial stake in the lawsuit is intended to "encourage institutional investors to take a more active role in securities class action lawsuits."[200]

195. Civ. No. 3-96-750 (D. Minn. Sept. 10, 1996).

196. *Id.* This decision was handed down before the Ninth Circuit's decision in *Hockey*.

197. *Id.* at 3-4.

198. *Id.* at 4.

199. 1933 Act § 27(a)(3); 1934 Act § 21D(a)(3).

200. Statement of Managers at 34.

### 1. The Early Results.

Congress' efforts to encourage more active participation by institutional and other large investors has not yet taken hold. With few exceptions, traditional plaintiffs' firms continue to run class actions, representing investors, or groups of investors, with only relatively small holdings in the issuer. In the 105 cases filed in the first year after passage of the Reform Act, we have found only eight cases in which institutions have moved to become lead plaintiff.[201] In seven of those eight cases, the institution has been represented by a group of law firms which includes at least one traditional plaintiffs' law firm.[202] Indeed, in two of these seven cases the lead plaintiff is represented by *thirty* and *thirty-three* law firms respectively, most of which are familiar names in securities class actions.[203] This phenomenon of multiple law firms representing the class was a familiar pattern prior to the Reform Act. Although an institution's choice of a traditional plaintiffs' firm to represent it does not preclude the institution from exercising control over the litigation, even the most active institutional investor may have difficulty controlling thirty or more law firms.

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201. Gluck v. Cellstar Corp., C.A. No. 3:96 Civ. 1353-R (N.D. Tex., complaint filed May 14, 1996) (State of Wisconsin Investment Board); Malin v. IVAX Corp., C. No. 96-1843-CIV-Moreno (S.D. Fla., complaint filed July 15, 1996) (Pennsylvania School Employees Retirement System Pension Fund); Mark v. Fleming Cos., Civ. Act. No. CIV-96-0506-M (W.D. Okla., complaint filed Apr. 4, 1996) (City of Philadelphia, acting through its Board of Pensions and Retirement); In re Summit Technology Sec. Litig., Civ. Act. No. 96-11589-JLT (D. Mass., complaint filed Aug. 2, 1996) (Teachers' Retirement System of Louisiana); Teachers' Retirement System of Louisiana v. Micro Warehouse, Inc., Ca. No. 396CV02166 (D. Conn., complaint filed Oct. 25, 1996) (Teachers' Retirement System of Louisiana & Pennsylvania School Employees Retirement System Pension Fund); In re Cephalon, Inc. Sec. Litig., Civ. Act. No. 96 CV-0633 (E.D. Pa., complaint filed Jan. 29, 1996) (Sands Point Partners, L.P.); Sweetwater Inv., Inc. v. Pepsi-Cola Puerto Rico Bottling Co., No. 96-8671-CIV-ZLOCH (S.D. Fla., N.Div., complaint filed Oct. 15, 1995) (Sweetwater Investments, Inc.); Chan v. OrthoLogic Corp., No. CIV 96-1514 PHX RCB (D.Ariz., complaint filed June 24, 1996) (City of Philadelphia).

202. The only exception is *Cellstar*, in which the State of Wisconsin Investment Board is represented by Blank, Rome, Comisky & McCauley.

203. The two cases are, respectively, *IVAX*, C. No. 96-1843-CIV-Moreno (S.D. Fla., complaint filed July 15, 1996) (30); and *Summit*, Civ. Act. NO. 96-11589-JLT (D. Mass., complaint filed Aug. 2, 1996) (33).

### 2. Will Institutions Become More Active?

Even though the legislative history makes clear that the Reform Act "does not confer any new fiduciary duty on institutional investors -- and courts should not impose such a duty," it nonetheless reflects Congress' hope that institutions would seek to be named lead plaintiff.[204] Our discussions with institutional investors, however, suggest that there are substantial disincentives for institutional investors considering intervention in securities class actions. Those disincentives fall into two categories: cost and perceived liability exposure.

As the Reform Act allows potential lead plaintiffs to conduct discovery of other potential lead plaintiffs, institutions may find key personnel being subjected to costly and time-consuming discovery by plaintiffs and then to a second round of discovery by defendants. Moreover, private institutional investors, such as investment companies, may be forced to open their books during discovery, thus revealing proprietary information.[205] In addition, many institutions may not want to advance the costs of litigation for the class. Adding to the expense is the time needed to manage the litigation.

Some institutions have also expressed concerns about added liability exposure when acting as lead plaintiff. The fear is that other plaintiffs may sue them for actions such as selecting incompetent counsel, settling for an inadequate amount, or dismissing what the institution deemed to be a meritless suit. Further, institutions can still opt out of the class, proceed separately, and not be faced with this added exposure. Some institutions have informed us that they always obtain a better recovery when they opt out and proceed separately. Moreover, one representative of a major mutual fund group stated that the fund is disinclined to get involved as lead plaintiff because traditionally recoveries have been insignificant to overall fund performance. Whether or not institutions will look beyond these disincentives remains to be seen.

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204. Statement of Managers at 34 ("[T]he Conference Committee nevertheless intends that the lead plaintiff provision will encourage institutional investors to take a more active role in securities class action lawsuits.").

205. Public institutions generally do not share this problem as they are subject to state public record laws which make their books and records available for public inspection.

Notwithstanding these disincentives, several of the institutional representatives have stated that they do plan to get involved and seek lead plaintiff status when the right case surfaces. Moreover, the staff is aware of at least two major institutions not only willing to get involved, but also to have their in-house general counsel serve as class counsel in an effort to reduce fees. In short, while institutional involvement is still limited, institutions may become more active in securities class action litigation in the future.

3. The Lead Plaintiff Provision Has Added Delay and Expense.

Members of the plaintiff class may attempt to rebut the presumption that the class member having the largest financial stake in the litigation is the most adequate plaintiff by demonstrating that this plaintiff "will not fairly and adequately protect the interests of the class" or "is subject to unique defenses that render such plaintiff incapable of adequately representing the class."[206] A class member demonstrating a reasonable basis for a finding that the presumptive most adequate plaintiff will not adequately represent the class is entitled to conduct discovery of the presumptive plaintiff.[207] Thus, when an institution asserts that it is the most adequate plaintiff, other would-be lead plaintiffs may use the above provisions to challenge the institution in court, resulting in added delay and expense.[208]

a. *Micro Warehouse*[209]

In a securities class action pending against Micro Warehouse, Inc., at least eight plaintiffs filed separate, but related complaints.[210] Four competing motions for

206. 1933 Act § 27(a)(3)(B)(iii)(II); 1934 Act § 21D(a)(3)(B)(iii)(II).

207. 1933 Act § 27(a)(3)(B)(iv); 1934 Act § 21D(a)(3)(B)(iv).

208. The staff has been unable to locate any court orders dealing with lead plaintiff challenges among individual plaintiffs only. To the extent these disputes have arisen, they appear to have been resolved by agreement among the parties. The challenges decided by courts during the first year all have involved institutions seeking to be named lead plaintiff.

209. Ca. No. 396CV02166 (D.Conn., complaint filed Oct. 25, 1996).

210. These multiple filings are somewhat curious as the Reform Act allows any plaintiff to simply *move* to be named lead plaintiff after an initial complaint is filed, thereby making the filing of additional (and costly) complaints unnecessary. A possible reason for these multiple complaints is discussed below in Section VI(C)(5)(c).

lead plaintiff status were subsequently filed. After negotiation, a group was formed (the "Micro Warehouse Group") to represent movants in three of the four motions. This group included two institutional investors, the Teachers' Retirement System of Louisiana ("TRSL") and the Pennsylvania School Employees Retirement System Pension Fund ("PSERS").

The Micro Warehouse Group alleged that TRSL had purchased 141,504 shares of Micro Warehouse during the class period at a market value in excess of $5.4 million, and had suffered a loss of $2.1 million. The papers also alleged that PSERS had purchased 306,900 shares and had suffered a loss of $3.6 million (the largest loss of any movant seeking lead plaintiff status).

Two individual plaintiffs, John Turner and John Schultz, who were represented by traditional plaintiffs' lawyers, opposed the institutions. These two individuals claimed to have lost over $250,000 during the class period.[211] They moved for the appointment of Turner as lead plaintiff. To rebut the Reform Act's presumption that the Micro Warehouse Group was the most adequate plaintiff, the two argued that TRSL would not fairly and adequately represent the interests of the class. Specifically, they objected to the bid by William Reeves, General Counsel of TRSL, to serve as class counsel in an effort to reduce fees. In a certification filed with the court, TRSL declared:

> The General Counsel of [TRSL] is participating as one of the attorneys for the plaintiff in this litigation and, if the present action is successful and results in the creation of a fund for the compensation of Class Members, the plaintiff will apply to this Court for reimbursement of its expenses and said General Counsel will apply to the Court for an award of a reasonable attorney's fee said expenses [sic] with any award of such attorney's fee and expenses being subject to the approval of the Court.[212]

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211. *See* Memorandum of Law in Support of Motion of Plaintiff John Turner For Appointment as Lead Plaintiff and to Conduct Certain Discovery Pursuant to Section 21D(a)(3)(B) of the Securities Exchange Act of 1934, at 5, Payne v. Micro Warehouse, Inc., Civil Action No. 3:96CV01920 (DJS) (D.Conn. Dec. 2, 1996).

212. *Id.* at 13.

Turner and Schultz argued that, to the extent that Reeves turned over to TRSL any fee he obtained from representing the class, his actions would violate a Reform Act provision which limits the lead plaintiff's claim to its pro rata share of the final judgment or settlement. The two individuals further argued that "the different allegiances TRSL's General Counsel will possess as an employee of the class representative and as counsel for the Class will cause a conflict -- either in fact or in appearance -- between the interests of TRSL and the interests of the Class that may result in the denial of TRSL as the class representative."[213] They added a motion to conduct discovery of TRSL.

TRSL subsequently withdrew its proposal that Reeves serve as co-lead counsel to resolve the conflict, but that did not end the dispute. Rather, Turner and Schultz began opposing PSERS participation as co-lead plaintiff.[214] They made two arguments. First, the decision for PSERS to enter the class action was made by Pennsylvania's then-Treasurer, Catherine Baker Knoll. In January 1997, a new Treasurer took office. Turner and Schultz complained that "[t]here has been no proffer by the Commonwealth of their interest in continuing the lawsuit."[215] Second, they argued that Knoll had not documented her authority from PSERS to commence this litigation, even though as Treasurer, she was custodian for PSERS. The two concluded by asking the court to name Turner co-lead plaintiff with TRSL, or alternatively, to allow discovery of Knoll. The court did not resolve the dispute, however, as an agreement was reached by which a new lead plaintiffs' group was formed including Turner and the two institutions.

213. *Id.* at 14.

214. *See* Plaintiffs John Turner and John Schultz' Opposition or Statement Relating to the Motions of Catherine Baker Knoll, State Treasurer of the Commonwealth of Pennsylvania as Custodian for the Pennsylvania School Employees Retirement System Pension Fund, the Motion of Teacher's Retirement System of Louisiana and others, and the Motion of Bruce Payne, Roberto Espinosa, Lawrence Bober, Bruce Banker, and Melvin Levine for Appointment as Lead Plaintiffs, In re Micro Warehouse Sec. Litig., Civil Action No. 3:96CV01920 (DJS) (D. Conn. Dec. 23, 1996).

215. *Id.*

b. *Cephalon*[216]

A second example of the disputes between competing plaintiffs is the class action against Cephalon, Inc. On March 27, 1996, one of the plaintiffs, Sands Point Partners, moved to be named lead plaintiff. Sands Point, a private fund managing $12 million, claimed to have lost $677,876 trading in Cephalon securities.

A competing group of four individual plaintiffs moved the court to take discovery of Sands Point to determine whether or not Sands Point had properly characterized itself to the court as an "institutional investor."[217] The statutory basis for this request is unclear, as the Reform Act's lead plaintiff provision does not use the term "institutional investor;" rather, it presumes that the lead plaintiff will be the person or group of persons having "the largest financial interest in the relief sought by the class."[218] Nonetheless, the court granted discovery: "As Sands Point has asserted that it is a uniquely situated institutional investor to which the Act affords preference in appointing the lead plaintiff, and as the [competing group of] plaintiffs have raised concerns challenging this position, this court finds that discovery on the issue of determining the most adequate plaintiff is appropriate."[219]

The court's order sweeps broadly, providing that "*[a]ny* plaintiff in this matter is granted leave to take discovery of *any other* plaintiff in this matter on the appointment of lead plaintiff and lead counsel." In allowing broad-based discovery by any plaintiff of any other plaintiff, the order conflicts with the text of the Reform Act which allows narrow discovery by a moving plaintiff "*only if* the plaintiff *first demonstrates a reasonable basis* for a finding that the presumptively most adequate plaintiff is incapable of adequately representing the class."[220] The issue was later resolved when the two groups of plaintiffs proposed that they be appointed co-lead plaintiffs, which the court accepted.

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216. Civ. Act. No. 96 CV-0633 (E.D. Pa., complaint filed Jan. 29, 1996).

217. *See* Memorandum of Law in Support of Motion for Leave to Take Discovery, In re Cephalon Sec. Litig., Civil Action No. 96-CV-0633 (E.D. Pa. July 12, 1996).

218. 1933 Act § 27(a)(3)(B)(iii)(I)(bb); 1934 Act § 21D(a)(3)(B)(iii)(I)(bb).

219. Memorandum and Order, In re Cephalon Sec. Litig., Civil Action No. 960CV-0633 (E.D. Pa. July 18, 1996).

220. 1933 Act § 27(a)(3)(B)(iv); 1934 Act § 21D(a)(3)(B)(iv).

### c. *OrthoLogic*[221]

In other cases, recycled pre-Reform Act challenges have been made that institutional investors, as sophisticated investors, are subject to unique defenses and are incapable of adequately representing the class. This argument is being made despite the Reform Act's clear bias toward institutional investors as lead plaintiffs. To the extent this argument is successful, the potential effectiveness of the lead plaintiff provision will be eroded if not eliminated. In the two cases to date, the courts have rejected this argument.[222]

In the class action pending against OrthoLogic Corp., a lead plaintiff motion was made by a group including the City of Philadelphia.[223] A group of individuals competing for the lead plaintiff position ("Group B") argued that under Rule 23 of the Federal Rules of Civil Procedure, the defendants would be able to challenge Philadelphia as a class representative, because as a sophisticated investor, "it operates according to methods and investment criteria which are not typical of those employed by the smaller individual investors."[224] In making their argument, Group B cited a number of pre-Reform Act cases which held that sophisticated investors are atypical of the class under Rule 23. The court was not persuaded. First, the court found that the pre-Reform Act cases had essentially been superseded. "[I]n light of the [Reform Act], the landscape under which [these prior decisions were made] has clearly shifted in favor of institutional investors."[225] The court also concluded that the fraud-on-the-market theory, essential to the bringing of a securities class action, applies equally to institutional and individual investors. Here, the court held, "[d]ifferences in sophistication, etc., among purchasers have no bearing in the impersonal market fraud



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221. No. CIV 96-1514 PHX RCB (D. Ariz., complaint filed June 24, 1996).

222. Aside from *OrthoLogic*, discussed below, another case where these arguments have been raised is *Cellstar*, discussed *infra* at n.227 and accompanying text.

223. *See* Order, *Chan v. OrthoLogic Corp.*, No. CIV 96-1514 PHW RCB (D. Ariz. Dec. 19, 1996).

224. *Id.* at 9.

225. *Id.* at 11.

context, because dissemination of false information necessarily translates through market mechanisms into price inflation which harms each purchaser identically."[226]

4. <u>*Gluck v. Cellstar*[227] -- The State of Wisconsin Investment Board Becomes the First Institutional Investor to Control a Class Action.</u>

The potential benefits of institutional investors becoming lead plaintiff, as envisioned by Congress, can best be seen in this class action filed against Cellstar Corp. The State of Wisconsin Investment Board ("SWIB"), represented by Blank, Rome, Comisky & McCauley, moved to be named lead plaintiff.[228] SWIB, which manages $40 billion for the Wisconsin Retirement System, purchased one million shares of Cellstar during the class period. SWIB alleged that it lost more than $14 million on its investment during the class period, the most significant financial interest in the action, and therefore, it should be named lead plaintiff.

Another group of plaintiffs, represented by a traditional plaintiffs' law firm ("Group 2"), opposed SWIB's motion. Group 2, echoing the arguments made in *OrthoLogic*, claimed that SWIB would not satisfy the requirements of Rule 23 of the Federal Rules of Civil Procedure because, as a sophisticated investor, it was subject to defenses atypical of the class. Group 2 argued that it should be named co-lead plaintiff and its lawyers should be named co-lead counsel. Following a hearing, the court issued an order, without written opinion, naming SWIB the lead plaintiff, and denying Group 2's motion. The court has not yet ruled on SWIB's selection of Blank, Rome as class counsel.

SWIB's management of the class action may provide a blueprint for future class actions involving institutions. Keith Johnson, Assistant General Counsel for SWIB, describes SWIB's management of the case as follows:



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226. *Id.* at 11.

227. *Gluck v. Cellstar Corp.*, C.A. No. 3:96 Civ. 1353-R (N.D. Tex., complaint filed May 14, 1996).

228. *See* Brief of the State of Wisconsin Investment Board in Support of its Motion for Appointment as Lead Plaintiff, Larson v. Cellstar Corp., No. 396CV1436 (N.D. Tex. July 22, 1996) (hereinafter "SWIB Brief").

A committee with internal and external legal expertise and portfolio management representation was established to review SWIB's CellStar claim. Several qualified law firms that had previously expressed an interest in providing securities class action legal advice to SWIB were invited to make presentations to the committee on their evaluation of SWIB's claim. The selected law firms included representation from the traditional plaintiffs' bar. Firms were asked to include in their presentations an evaluation of the case, a plan for pursuing the claim, a review of their expertise, and a proposed fee schedule. At the conclusion of this process, SWIB selected Blank, Rome . . .

Blank, Rome agreed to represent SWIB, and the class if approved as lead counsel by the court, on a contingent fee basis that *SWIB believes could save the class as much as several million dollars in legal fees from customary fee levels*. The fee arrangement is based on a sliding percentage scale, which increases both as the size of the recovery increases and as the matter progresses through the litigation process. It starts at 12.5 percent of first dollar recoveries and tops out at 25 percent of amounts in excess of $15 million,[229] and includes any post-trial appellate work. SWIB also agreed to support a fee bonus of up to 1.5 percent if the case can be promptly prepared and scheduled for trial within set target dates. The fee structure was designed to align the interests of the law firm with those of its clients.[230]

229. By contrast, a recent study found that the average award of attorney fees in securities class actions, measured as a percentage of settlement, is as follows: 30.38% for settlements of less than $1.00 million; 31.88% for settlements ranging from $1.00 - $1.99 million; 32.11% for settlements ranging from $2.00 - $9.99 million; 31.72% for settlements ranging from $10.00 - $49.99 million; and 31.48% for settlements in excess of $50 million. NERA Study, at Table 9.

230. Keith Johnson, *Institutional Investors and Securities Class Action Reform: A Report From the Trenches*, THE CORPORATE GOVERNANCE ADVISOR, January/February 1997, at 3-4 (emphasis and footnote supplied).

SWIB's efforts to negotiate attorneys' fees should work to the benefit of investors.[231] The process employed by SWIB is similar to an attorney bidding process ordered by Judge Vaughn Walker of the Northern District of California in pre-Reform Act class actions against California Micro Devices, Wells Fargo, and Oracle Systems.

5. The Notice Procedure.

Not later than 20 days after the complaint is filed, the plaintiff filing the complaint must publish "in a widely circulated national business-oriented publication or wire service, a notice advising members of the purported plaintiff class . . . of the pendency of the action, the claims asserted therein, and the purported class period," and "not later than 60 days after the date on which the notice is published, any member of the purported class may move the court to serve as lead plaintiff of the purported class."[232]

This procedure, in conjunction with the presumptive lead plaintiff provision, reduces the incentives for plaintiffs' attorneys to race to the courthouse to file a complaint, although there are still advantages to being the first to file because it allows the attorney to control the content of the notice. Because "first in time" no longer assures lead plaintiff status, the courthouse race has been replaced by strategies designed: (1) to identify and collect the group of shareholders with the largest stake in the action; and (2) as discussed above, to show that rival groups will not adequately represent the class.

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231. On a related note, on September 27, 1996, the Commission filed an amicus curiae brief in the class action pending against PaineWebber arguing that the fees sought by class counsel were excessive. Brief of the Securities and Exchange Commission, amicus curiae, In re PaineWebber Inc. Ltd. Partnerships Litig., 94 Civ. 8547 (SHS) (S.D.N.Y. Sept. 27, 1996). Class counsel stated an intent to submit a petition for attorneys' fees in the amount of 27.5% of the $125 million in immediate cash consideration, plus 27.5% of the cash portion of "Additional Benefits" to be paid under the settlement agreement. *Id.* at 1. The value of the total requested fees, based on Lead Class Counsel's valuation of Additional Benefits at over $75 million, was at least $34.4 million, and might have approached $55 million. *Id.* The Commission's brief argued that the attorneys' fees being sought were excessive because they substantially exceeded those normally awarded in cases involving large settlements and the case did not involve unusually large risks. *Id.* at 2-3. A decision has not yet been rendered.

232. 1933 Act § 27(a)(3)(A)(i); 1934 Act § 21D(a)(3)(A)(i).

The limited experience to date suggests that the notice provision does create an obstacle to securing lead plaintiff status by the first plaintiff to file, as courts are interpreting the provision strictly. The strict interpretation of the notice provision increases the likelihood that other class members will both receive the notice and inform themselves of the suit's allegations, so that they can make an educated decision whether to seek lead plaintiff status. Moreover, the early returns demonstrate that the notice provision may have created an added obstacle in that defendants, too, may have standing to object to the adequacy of the notice.

a. *Means of Publication.*

The first written opinion ruling on a motion to become lead plaintiff was issued in *Greebel v. FTP Software, Inc.*,[233] addressing several issues relating to the notice provision under the Act. Greebel's complaint alleged that FTP Software, Inc. ("FTP") made material misrepresentations and omissions concerning its business. Four days after filing its complaint, Greebel issued a press release to *Business Wire* for transmission over its computer database to inform other potential class members of their right to move to be appointed lead plaintiff. The entire text of the notice was picked up by *Bloomberg Business News Wire*. Subsequently, a group of three persons -- Greebel, Robinson, and Crane -- moved to be appointed lead plaintiff.

The Reform Act requires a plaintiff to file with his or her complaint a sworn certificate describing, among other things, the plaintiff's transaction in the security and his or her prior appearances as plaintiff in other securities class actions, and stating that the plaintiff has read the complaint and authorized its filing.[234] This procedure is intended to slow the race to the courthouse. Here, only Greebel filed the required certificate; Robinson and Crane (who were not named in the caption of the complaint) did not.

Defendant FTP raised three objections to the motion: (1) that it was premature to determine whether Greebel and the others met the class-representation requirements of Rule 23 of the Federal Rules of Civil Procedure; (2) that Greebel's notice over *Business Wire* failed to satisfy the Act's publication requirement; and (3) that Robinson and Crane failed to comply with the certification requirement. The movants

233. 939 F. Supp. 57 (D. Mass. 1996).

234. 1933 Act § 27(a)(2)(A); 1934 Act § 21D(a)(2)(A).

responded that FTP did not have standing to oppose a motion for appointment of a lead plaintiff.

The court first held that defendant FTP had standing to object to the adequacy of the notice and certification because these are procedural prerequisites to becoming lead plaintiff. According to the court, "[p]ermitting a defendant to object on these grounds enhances effective judicial administration of the case," *i.e.* if notice is defective, the court cannot rely on other class members to proffer opposition.[235] The court further held, however, that FTP could not object to the movants' adequacy to serve as lead plaintiffs at this point in the proceedings. On this issue the court stated, "The text of the [Act] clearly indicates that this issue is one over which only potential plaintiffs may be heard. For example, Congress provided that rebuttal of the lead plaintiff presumption shall be limited to 'proof by a member of the purported plaintiff class.'"[236] The court ruled that FTP could be heard on this issue later when a motion for class certification was made.

Next, FTP claimed that Greebel's notice over *Business Wire* failed to satisfy the Act's publication requirement, arguing that *Business Wire* did not qualify as a "wire service" and was not "widely circulated."[237] On the first point, the court held that the "mere fact that *Business Wire* arrives at a print publication via an electronic signal, rather that [sic] in the manner of a traditional wire service, does not disqualify it as a 'wire service' within the meaning of the statute."[238] The court also held that *Business Wire* is "widely circulated" as hundreds of print publications and other wire services subscribe to it and individuals can access it directly through on-line services and databases.

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235. *Id.* at 60.

236. *Id.* at 60. *But see* Order Requiring Further Information for Plaintiff's Motion to be Appointed Lead Plaintiff, at 6 & 7, Howard Bunty Profit Sharing v. Quantum Corp., Civil No. 96-20711 SW (N.D. Cal. Feb. 6, 1997) ("While defendants may not offer evidence or conduct discovery relating to who is the most adequate plaintiff, it is appropriate for defendants to bring to the attention of the court a flaw in the papers of a party moving for the appointment as lead plaintiff," and "defendants [may] make a limited, facial challenge to a plaintiff's motion for appointment as lead plaintiff.").

237. *Id.* at 62.

238. *Id.* at 62.

The court implied that notice over *Business Wire* might be more effective than notice via newspapers because spotting the notice in a newspaper is "subject to the happenstance" of purchasing the newspaper that day whereas notice transmitted via computers remains accessible. Finally, the court noted that *Business Wire* is likely to reach institutional investors, the Reform Act's favored class members.

The court went on to hold that the certification need only be filed by the plaintiff who files the complaint, and not by class members who subsequently file motions to become lead plaintiff. The court relied on the language of Section 21D(a)(2)(A), which requires "each plaintiff seeking to serve as a representative party on behalf of a class . . . [to] provide a sworn certification, which shall be . . . *filed with the complaint*." The court bolstered this conclusion with legislative history which states that parties moving to be named lead plaintiff need not file the certificate.[239] As no other party moved to become lead plaintiff, the court granted Greebel, Robinson and Crane's lead plaintiff motion.

b. *Content of Notice.*

The Reform Act specifies that the notice must advise potential class members of four items: (1) the "pendency of the action;" (2) the "claims asserted therein;" (3) the "purported class period;" and (4) that class members may move to be named lead plaintiff within 60 days of publication of the notice.[240] While the first, third, and fourth items appear non-controversial, the second item has resulted in litigation.

In *SyQuest Technology, Inc.*,[241] Judge Vaughn Walker of the Northern District of California addressed what notice of "claims asserted" required. In that case, a group of plaintiffs ("Group 1"), represented by three firms, moved to be appointed lead plaintiff.[242] Group 1 had published a notice, which read as follows:



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239. *Id.* at 62 (The Senate Committee Report explains that it "does not intend for the members of the purported class who seek to serve as lead plaintiff to file with this motion the certification described above." (citation omitted)).

240. 1933 Act § 27(a)(3)(A)(i); 1934 Act § 21D(a)(3)(A)(i).

241. No. C-96-1224-VRW (N.D. Cal.).

242. Order, *Ravens v. Iftikar*, No. C-96-1224-VRW (N.D. Cal. Jan. 7, 1997).

> TO: All purchaser [sic] of SyQuest Technology, Inc. common stock during the period October 21, 194 [sic] to February 1, 1996[:]
>
> On April 2, 1996, a class action, Ravens, et al. v. Iftikar, et al., C-96-1224-VRW, was filed in the U.S. District Court for the Northern District of California, which asserts claims for violations of §§ 10(b) and 20(a) of the Securities Exchange Act of 1934. Any member of the proposed class may move the Court to serve as lead plaintiff no later than 60 days from the date of this Notice. For more information contact [name and phone number of plaintiffs' counsel].[243]

Sixty days expired, and no prospective class members moved to be named lead plaintiff. Later, a rival group of plaintiffs, also represented by three traditional plaintiff class action firms, opposed Group 1's motion, challenging the adequacy of Group 1's notice.

Judge Walker held that the notice was deficient, reasoning that:

> The notice provisions are only effective . . . if qualified investors are notified of the nature and character, not just the existence, of the claims asserted. An investor can only make an informed determination whether intervention [is] appropriate to protect his interests if he is provided information describing the legal and factual basis of the claims. A mere recitation of the statute, or statutes, under which the claim is brought is simply inadequate to give an investor the information necessary to make the decision to intervene or not.[244]

In addressing the inadequacies of the notice, Judge Walker observed that the following details would be required to give notice of the "claims asserted": an explanation of the

243. *Id.* at 8. A more detailed notice of the lawsuit was issued over *Business Wire*. *See Class Action Suit Filed Against SyQuest Technology and Its Officers and Directors Alleging Misrepresentations, False Financial Statements and Insider Trading*, BUSINESS WIRE, April 10, 1996. This notice was not addressed by Judge Walker.

244. *Id.* at 5-6.

legal theory underlying plaintiffs' suit; a discussion of who committed the alleged violations; and a description of the alleged wrongdoing that forms the basis of the complaint.[245] As these details were lacking from the notice at issue, he denied Group 1's lead plaintiff motion. Judge Walker also ordered that a case management conference be set up to discuss how the plaintiffs could correct the notice's deficiencies.

By contrast, Judge Fern Smith, also of the Northern District of California, held a virtually identical notice to be adequate. In her order, Judge Smith held that the notice "advised the potential class members of the claims and of the opportunity to file a motion to be lead plaintiff." It appears, however, that the notice at issue, unlike in *SyQuest*, was not challenged by other plaintiffs. Thus, it remains to be seen whether the content required by the notice may only be an impediment for plaintiffs' attorneys when rival attorneys challenge the notice. When such a challenge is brought, however, minimalist notice may not suffice.

c. *Advertising Through the Notice Provision.*

While the lead plaintiff provision and its accompanying publication requirement are intended to shift control from plaintiffs' lawyers to the plaintiffs themselves, plaintiffs' attorneys have garnered at least two benefits from the publication of notice. First, the publication of notice can help uncover relevant facts. The notice can help attract witnesses, including disgruntled ex-employees and others who may possess useful information. This source of information may help develop a case given the automatic discovery stay imposed by the Act upon a motion to dismiss.

Second, the notice may be used as a form of advertising by lawyers representing one or more investors with only a small financial stake in the class action. The Reform Act allows the court to select as lead plaintiff not just individuals but alternatively a "group of persons," whose financial interests in the suit may be aggregated in determining if they have the "largest financial interest in the relief sought by the class."[246] Taking advantage of this provision, lawyers have used the notice to recruit investors as additional clients. Notices are phrased in a way more likely to attract clients, rather than competition from investors (and other law firms)



245. *Id.* at 8.

246. 1933 Act § 27(a)(3)(B)(iii)(I)(bb); 1934 Act § 21D(a)(3)(B)(iii)(I)(bb).

independently vying to be named lead plaintiff. While not required by the Act, notices routinely end with two boilerplate paragraphs consisting of a firm biography and a form of sales pitch to investors. A standard example follows:

> [Plaintiffs' firm] has been actively engaged in commercial litigation emphasizing securities and antitrust class actions . . . . The firm has offices in [nationwide] and is active in major litigations pending in federal and state courts throughout the United States. The firm's reputation for excellence has been recognized on repeated occasions by courts which have appointed the firm to major positions in complex multi-district or consolidated litigations. [Plaintiffs' firm] has taken a lead role in numerous important actions on behalf of defrauded investors, and has been responsible for a number of outstanding recoveries . . . .
>
> If you are a member of the Class described above, you may, no later than 60 days from today, move the Court to serve as lead plaintiff of the Class, if you so choose. In order to serve as lead plaintiff, however, you must meet certain legal requirements. If you wish to discuss this action or have any questions concerning this notice or your rights or interests, please contact [name of lawyer at firm] at [firm phone number].

#### d. *Need for a Centralized Notice Repository?*

While the Reform Act requires a "widely circulated national business-oriented publication or wire service," it does not mandate a precise location for publication. Representatives of institutional investors have informed us that they are having difficulty discovering and reviewing notices in a timely fashion. Moreover, other representatives have informed us that once they discover the notice, they have insufficient time to complete the process required to get approval by the institution's board of directors to enter the suit. A possible solution would be to require the notice of each class action to be posted on a designated internet site.[247]

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247. As of March 1997, lawyers in securities class actions filed in the Northern District of California are required to post certain enumerated litigation documents to "Designated Internet Sites ('DIS')." N.D. Cal. Civil L.R. 23-3. The Commission is considering creating links from its web site to each DIS.

### D. Sanctions for Violations of Rule 11(b).

In order to discourage frivolous pleadings in securities class actions, Congress mandated that courts make a finding of compliance with Rule 11(b) of the Federal Rules of Civil Procedure with respect to any complaint, responsive pleading, or dispositive motion.[248] Only one court to date has undertaken this mandatory inquiry. On December 24, 1996, in the class action against Hart Brewing, Inc. in the Southern District of California, the court granted Hart's motion to dismiss for failure to state a claim.[249] The opinion ends with the Court finding, "that no parties violated the pleading requirements of FRCP 11(b) in this matter. Sanctions are therefore not appropriate in this case."[250] As more cases are decided, the effect of this provision will become clearer.

### E. Retroactive Effect of the Reform Act.

In October 1996, the Ninth Circuit upheld a permanent injunction against H. Thomas Fehn, a California securities law attorney, for aiding and abetting violations of the federal securities laws. Fehn assisted in the creation and filing with the Commission of quarterly reports on behalf of a company that falsely described the role of the company's president and promoter and that misleadingly failed to disclose contingent liabilities stemming from earlier securities law violations. With knowledge that statements made about the company's president were false, and with knowledge that the company faced substantial undisclosed potential liabilities, Fehn asserted that the company need not make the legally required disclosures because they were protected by the president's Fifth Amendment privilege.

The district court had enjoined Fehn shortly before the Supreme Court's decision in *Central Bank*,[251] which declared that the Exchange Act creates no private right of action for aiding and abetting a primary violation of the securities laws. Fehn argued on appeal that *Central Bank* applied to Commission actions as well as private

248. 1933 Act § 27(c)(1); 1934 Act § 21D(c)(1).

249. Order Granting Defendants' Motion to Dismiss, Steckman v. Hart Brewing, Inc., Civ. Case No. 96-1077-K (RBB), (S.D. Cal. Dec. 24, 1996).

250. *Id.* at 9.

251. 511 U.S. 164 (1994).

actions. The Commission argued that *Central Bank* does not apply to Commission actions.

Two months after oral argument in the appeal, Congress enacted a provision as part of the Reform Act expressly authorizing the Commission to bring actions against persons who knowingly aid and abet violations of the Exchange Act. The Ninth Circuit held that the Reform Act's aiding and abetting provision applied retroactively. After emphasizing Congress' rejection of *Central Bank* to the extent it might be "extended" to Commission actions, the court noted that the new legislation expressly provides an effective date for private actions, the date of enactment, but was silent with respect to any effective date for Commission actions. This congressional silence as to any intended retroactive effect permitted the court of appeals to apply the standard governing retroactive application of an intervening civil statute to antecedent events.[252] Applying that analysis, the court concluded it was appropriate to apply the aiding and abetting provision retroactively.

## VII. Securities Cases Filed in State Court.

During the first year following enactment of the Reform Act, state courts have seen a reported increase in both stand-alone securities class actions and class actions that are parallel to federal actions.[253] The NERA Study found that 78 cases had been filed in the first ten months of 1996 (for an annualized total of 94), as compared to 48 for the previous year.[254] Another source reported that 40% of the securities class actions filed in the first ten months of 1996 were filed in state courts, compared

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252. Landgraf v. USI Film Products, 511 U.S. 244 (1994). *Landgraf* set forth a number of factors that should be considered, including "fair notice, reasonable reliance, and settled expectations."

253. In preparing this Report, the Commission staff found it difficult to obtain data about the number of securities-related cases filed in state court. Although the staff has been closely tracking all *federal* securities class actions (a less difficult task since the Reform Act requires that a public notice be given), the staff has relied on data compiled by others in assessing the incidence of securities class actions in state courts.

254. NERA Study, *supra* at n.69.

to slightly more than 20% during 1995.[255] Indeed, one source reports that there were 65 securities class actions filed in state court between January 2, 1996 and December 26, 1996 -- 64% of the number filed in federal court during this period.[256] This apparent shift to state court may be the most significant development in securities litigation post-Reform Act.

### A. Reasons for the Increase in State Court Filings.

Following enactment of the Reform Act, some plaintiffs appear to have been drawn to state court by the potential for obtaining discovery during the pendency of a motion to dismiss, a procedure that is not available under the Act. These plaintiffs may be able to use state discovery procedures to uncover facts necessary to frame allegations sufficient to withstand a motion to dismiss, either in the state court proceeding or in a subsequently filed federal complaint. To the extent that state courts can be used to avoid the discovery stay in cases that would otherwise have been brought under the federal securities laws, one of the goals of the Reform Act may be frustrated.

It should be recognized, however, that state courts may offer other advantages to plaintiffs, including non-unanimous jury verdicts, punitive damages, and aiding and abetting liability, depending on the jurisdiction. On the other hand, few states provide state law remedies for private plaintiffs that are as broad as the federal remedies for securities fraud. Furthermore, jurisdiction over the defendants must be established in the particular state, and state law must provide a private right of action for the plaintiffs' alleged securities claims. For these reasons, state court has not traditionally been the primary forum for securities class actions. But if state law provides advantages to plaintiffs in a particular case, it is reasonable to expect that plaintiffs' counsel will file suit in state courts.



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255. *See* Walter Hamilton, *Lawyers' End Run Around Legal Reforms*, INVESTOR'S BUSINESS DAILY, Oct. 21, 1996, at A1.

256. *Securities Class Action Clearinghouse – State Complaints* at 1-7 (last modified Jan. 8, 1997) (located at http://securities.stanford.edu).

Of the 105 federal actions filed in 1996, we have identified 26 that are tied to a parallel state action.[257] In these actions, defendants are forced to respond on two fronts, thus incurring greater litigation expense than pre-Reform Act. The remaining state actions -- 39 as measured by the Stanford Securities Class Action Clearinghouse[258] -- are stand-alone state court actions. Some of these cases may migrate to federal court after discovery has taken place. Some may be forced into federal court if a national class cannot be certified at the state level. Others, however, may proceed to the merits in state court. Of the 39 stand-alone state court actions, 24 are in California.

Three factors, two of which operate together only in California, make state court an alternative for many cases. The first, which applies to all state court actions, is the Supreme Court's recent ruling in *Matsushita Elec. Indus. Co. v. Epstein*,[259] which held that a state court judgment dismissing a state class action suit pursuant to a settlement agreement could include a provision barring federal securities fraud class actions arising out of the same transaction. The Court concluded that the state court judgment would be entitled to res judicata effect, despite the exclusive federal court jurisdiction over cases brought under the Exchange Act, including Section 10(b) and Rule 10b-5 claims. By allowing defendants to obtain a global settlement in state court, *Matsushita* made state court class actions more advantageous for plaintiffs.

The second and third factors currently converge only in California. The second factor is the absence of a requirement that an individual plaintiff prove that he relied on a misstatement or an omission. In *Mirkin v. Wasserman*, the California Supreme Court stated that plaintiffs need not plead or prove actual reliance in an action under the state's securities law.[260] Eliminating the reliance requirement makes possible a

257. This number is subject to change as additional federal or state cases are filed. A separate study found 30 parallel state actions out of a total of 108 federal actions. *See* Joseph A. Grundfest & Michael A. Perino, Cornerstone Research, Securities Litigation Reform: The First Year's Experience (Feb. 27, 1997).

258. *Securities Class Action Clearinghouse Litigation – State Complaints* at 1-7 (last modified Jan. 8, 1997) (located at http://securities.standford.edu).

259. 116 S. Ct. 873 (1996).

260. 858 P.2d 568, 580 (Cal. 1993). At least three other states do not require reliance for common-law fraud actions, *see* Rosenthal v. Dean Witter Reynolds, Inc., 908 P.2d 1095, 1106 (Colo. 1996); State v. Superior Court of Maricopa Cty., 599 P.2d 777 (Ariz. 1979); Weatherly v. Deloitte

class action for securities suits. The third factor is the availability of jurisdiction over high-technology firms, who are frequently named as defendants in securities suits.[261] The largest concentration of high-technology firms in the United States is located in Silicon Valley. High-technology firms tend to have a volatile share price, plus officers and directors who receive a large portion of their compensation in company stock and stock options, which means they will be more likely to be selling shares during a period of volatility. Volatility and insider sales are frequently relied upon by plaintiffs in pleading their cases. Thus, California provides a convenient alternative to federal court post-Reform Act.

At this point, it appears that state court actions are not being filed to circumvent the federal court reforms intended to protect secondary defendants. In federal court, plaintiffs face both the Reform Act's proportionate liability provision and the Supreme Court's *Central Bank* decision, which held that there is no private right of action for aiding and abetting under Section 10(b) of the Exchange Act. A review of 41 post-Reform Act state securities class action complaints discloses only one naming accountants, none naming corporate counsel, and nine naming underwriters.

### B. Analysis of State Court Complaints.

For the most part, the allegations in state court complaints are similar to those found in the federal complaints -- although it should be noted that we have no view on the merits of any complaints we have examined. We reviewed a sample of state court complaints -- 10 complaints for which there is a parallel federal action and 16 complaints for stand-alone state actions.[262] The results are as follows:

- 15% of the state court complaints we reviewed are based solely on failed forecasts (as compared to 12% at the federal level);

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& Touche, 905 S.W.2d 642, 648-49 (Tex.Ct.App. 1995), while one state trial court has adopted the fraud-on-the-market doctrine under that state's blue sky law, *see* Bierman v. Thompson, No. DV-96-124A (Mont. 11th Jud. Ct., Flathead Cty., Oct. 15, 1996).

261. NERA Study, *supra* note at Table 10c (finding that suits naming high-technology firms as defendants comprised 22.85% of all securities class actions between 1991 and October 1996, and 26.92% of all filings between January and October 1996).

262. This sample was selected to mirror the overall percentage (40%) of parallel (26 out of 65) versus stand-alone (39 out of 65) state actions, as reported by the *Securities Class Action Clearinghouse*.

- 46% contain insider trading allegations (as compared to 48% at the federal level);

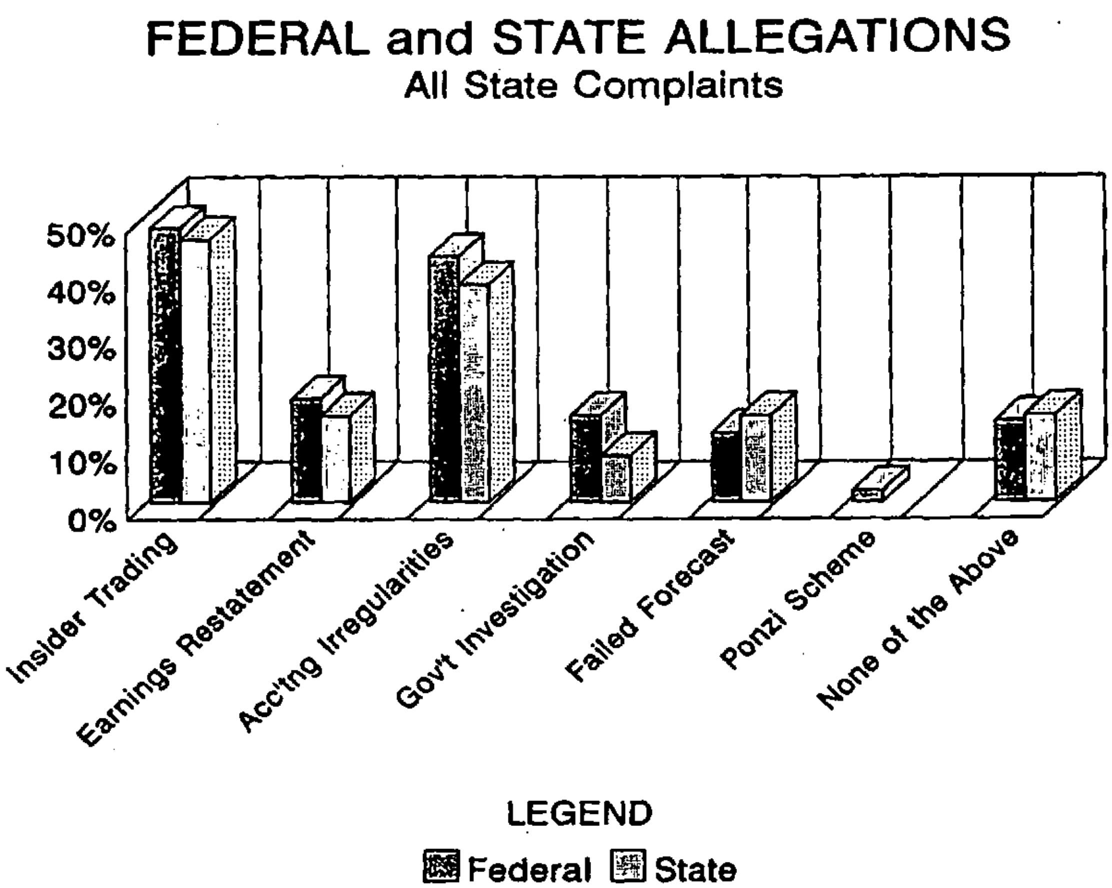
- 38% contain allegations of accounting irregularities (as compared to 43% at the federal level);

- 15% contain allegations of a restatement of the financials (as compared to 18% at the federal level);

- 8% contain allegations of a concurrent government investigation (as compared to 15% at the federal level); and

- 15% contain none of the above allegations (as compared to 14% at the federal level).

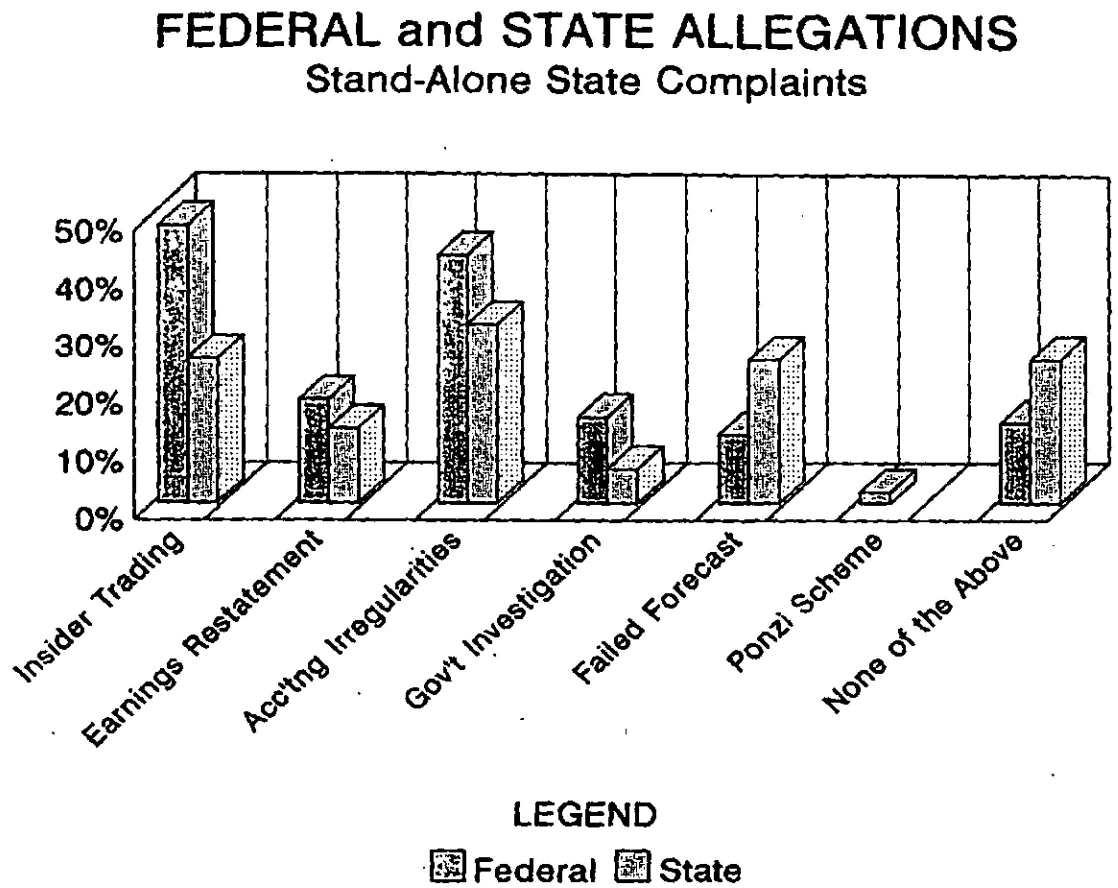
The following graph presents these results.



Although these numbers suggest that the allegations in state court complaints are substantially the same as federal complaints, further analysis casts a slightly different light. While the parallel state court complaints should be nearly identical in their factual allegations to their federal court counterparts, the stand-alone complaints, which are not subject to the heightened federal pleading standards, contain a somewhat different mix of allegations. In the 16 stand-alone state complaints that we reviewed, the numbers are as follows:

- 25% of these complaints are based solely on failed forecasts (as compared to 12% at the federal level);
- 25% contain insider trading allegations (as compared to 48% at the federal level);
- 31% contain allegations of accounting irregularities (as compared to 43% at the federal level);
- 13% contain allegations of a restatement of the financials (as compared to 18% at the federal level);
- 6% contain allegations of a concurrent government investigation (as compared to 15% at the federal level); and
- 25% contain none of the above allegations (as compared to 14% at the federal level).

The following graph presents these results.




While the small sample size does not allow for a definitive assessment of the stand-alone state complaints, we note that the percentage of failed forecast cases is double the federal percentage, while the percentage of insider trading cases is approximately half that of the federal complaints.

C. State Obstacles.

Class action plaintiffs may also find obstacles in state court. First, a discovery stay may -- or may not -- be available. Of the four cases that have addressed the issue, two have granted the stay and two have denied it. Second, institutions may seek to intervene, but there is no equivalent notice and presumptive lead plaintiff provision as there is under the Reform Act. Third, state securities actions raise difficult constitutional issues when plaintiffs seek to certify a national class. Thus, the long term viability of the state court securities class action remains to be determined.

1. State Discovery Stay Cases.

a. *Cases Imposing a Discovery Stay.*

In *Milano v. Auhll*,[263] plaintiff filed a complaint in California state court alleging violations of both state and federal securities laws.[264] The defendants demurred and moved for a discovery stay pursuant to the Reform Act. Milano responded that the Reform Act's discovery stay does not apply to cases pending in state courts. Milano's primary argument rested on the Act's plain language. First, under the Reform Act, a "motion to dismiss" triggers the discovery stay, and Milano contended that this term is unknown to California civil procedure, which instead uses the term "demurrer." Second, the Act states, "[t]he provisions of this subsection shall apply to each private action arising under this title that is brought as a plaintiff class action pursuant to the *Federal Rules of Civil Procedure*." Milano argued that the reference to the Federal Rules meant that the Act's provisions were not meant to apply in state court actions.

The court rejected these arguments and imposed the discovery stay. The court reasoned that Section 27(b), which contains the discovery stay provision, applies by its terms to "any private action arising under this title." The court concluded that "title" referred to the Securities Act. The court accordingly held that the discovery stay applies "if at least one cause of action is within [the Reform Act amendments]." Because Milano had alleged a violation of Section 11 of the Securities Act, his complaint was controlled by the Reform Act.

263. No. SB 213 476 (Oct. 2, 1996); 1 SEC. REF. ACT LITIG. REP. 870 (August & Sept. 1996).

264. Milano's state court claim for violations of federal securities laws is authorized by Section 22 of the Securities Act which provides state courts with concurrent jurisdiction to enforce any liability or duty created by that Act. 15 U.S.C. § 77v(a). Section 22 further provides that cases brought in state court may not be removed to federal district courts. *Id.* *Compare* Section 27 of the Exchange Act, 15 U.S.C. § 78aa (providing federal courts with exclusive jurisdiction to enforce any liability or duty created by the Exchange Act).

In response to *Milano*, state class action complaints may omit Securities Act Section 11 claims, and instead rely exclusively on state law claims.[265] This strategy, however, may not allow plaintiffs to avoid the discovery stay. In a class action filed against Brooktree Corporation in California,[266] a discovery stay was imposed, despite the fact that plaintiffs had alleged no federal securities claims. Notwithstanding the exclusively state claims, the court granted Brooktree's motion to stay all discovery, including third-party discovery. While no opinion accompanied the court's order, the oral argument transcript discloses that the court was "looking at the spirit of the new federal legislation ... in the nature of guidance" and that imposing a stay was "a function of judicial discretion."

b. *Cases Denying a Discovery Stay.*

In two state class actions, *Nutrition for Life* and *IMP, Inc.* (both parallel to federal actions), state courts have denied the discovery stay.[267] While the *Nutrition for Life* court does not explain its ruling, the *IMP* court, in allowing discovery and denying a motion to stay the proceedings in favor of the federal action, held:

> The motion to stay the consolidated state actions is denied. This action was filed after the related federal actions. California law affords plaintiffs broader and more effective relief on their state law claims than on their federal claims, which involve different issues. Under the circumstances, this court can best determine the rights of the parties. There are no "unseemly conflicts" if this case proceeds. And this action is not harassing, vexatious or oppressive.[268]

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265. This is not to say that a Securities Act Section 11 claim may not be added in an amended complaint after discovery is had. *See* Alpern v. UtiliCorp United, Inc., 84 F.3d 1525 (8th Cir. 1996) (holding that a Section 11 claim added to an amended complaint relates back to the date the original complaint was filed for purposes of the statute of limitations and calculation of damages, if based on the same transactions, occurrences, and conduct alleged in the original complaint).

266. Sperber v. Bixby, Case No. 699812 (Cal. Super. Ct., San Diego Cty., Oct. 18, 1996).

267. David S. Gilfand, Ltd. Profit Sharing Plan v. Nutrition for Life Int'l, Inc., (Harris Cty., Tex. Dec. 11, 1996); Lee v. IMP, Inc., CV 760793 (Cal. Super. Ct. Santa Clara Cty. Dec. 11, 1996).

268. Lee v. IMP, Inc., CV 760793 (Cal. Super. Ct. Santa Clara Cty. Dec. 11, 1996).

Thus, state courts are in conflict on the question of whether plaintiffs who seek to elude the federal discovery stay in state court will be granted discovery.

### 2. Institutional Intervention in State Court.

Filing suit in state court does not necessarily preclude institutional involvement. A recent New York state court decision, not involving the Reform Act, raises issues of control similar to those being litigated under the lead plaintiff provision of the Act. On September 3, 1996, a New York State Supreme Court trial judge granted a motion made by the California Public Employees Retirement System ("CALPERS") to become co-lead counsel during settlement talks in a shareholder action against W.R. Grace & Co.[269] The suit centered on the departure of Grace's CEO, J.P. Bolduc, who received severance pay in excess of $20 million. CALPERS, one of W.R. Grace & Co.'s largest shareholders, was displeased with a previously proposed settlement that would have required the company to change certain policies, but not return any funds to shareholders. If institutions continue to intervene in this manner, the influence of the Reform Act will be felt at the state level as well, although the Act does nothing to encourage institutional involvement in state court.

### 3. National Certification.

For the state court actions for which there is no parallel federal action, certification of a national class is critical. If a national class cannot be certified, potential recovery is greatly diminished. In order to apply its law to defendant companies not incorporated or headquartered within the state, a state must satisfy both the Due Process Clause of the Fourteenth Amendment and the Full Faith and Credit Clause of Article IV. As those provisions have been construed by the United States Supreme Court, the state "must have a 'significant contact or significant aggregation of contacts' to the claims asserted by each member of the plaintiff class, contacts 'creating state interest,' in order to ensure that the choice of state law is not arbitrary or unfair."[270] State law will likely apply to the entire class if the defendant is



269. Weiser v. Grace, Index No. 106285/95 (N.Y. Sup. Ct., N.Y. Cty. Sept. 3, 1996); 1 SEC. REF. ACT LITIG. REP. 940 (Aug. & Sept. 1996).

270. Phillips Petroleum Co. v. Shutts, 472 U.S. 797, 821-22 (1985) (citation omitted).

incorporated or maintains its principal place of business in that state.[271] A state also has a "significant contact" if the plaintiff resides in that state or the alleged fraudulent conduct occurred in that state.[272]

Many issues remain to be decided at the state court level.[273] These decisions will determine whether the increase in state court filings will be sustained.

### D. Proposition 211.

Lawyers and consumer groups that had opposed enactment of the Reform Act unsuccessfully sought to rewrite the California securities laws through a ballot measure known as Proposition 211, officially known as the "Attorney-Client Fee Arrangements, Securities Fraud, Initiative Statute." The measure would have, among other things, created an Exchange Act Section 10(b) type action at the state level expressly allowing: private rights of action, aiding and abetting, punitive damages, the fraud-on-the-market theory, no indemnification of officers and directors, joint and several liability for all defendants, and no caps on attorneys' fees. Proponents of Proposition 211 argued that the Reform Act left investors in need of better protection from fraud. After opposition by, among others, President Clinton and Chairman Levitt, California voters defeated the measure in November, 1996 by a vote of 3 to 1. In voicing his opposition, Chairman Levitt stated Proposition 211 "may skew [the] balance" between investor protection and capital formation and that "the Litigation Reform Act should be given a chance to work before other measures are taken." In response to the threat of greater exposure at the state level, issuers and other

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271. Havlicek v. Coast-to-Coast Analytical Serv., 39 Cal. App. 4th 1844, 1855 (Cal. Ct. App. 1995) (principal place of business is a "significant contact."). *But see*, In re Victor Tech Sec. Litig., 102 F.R.D. 53, 60 (1984) (certifying national class where the misstatement "emanated" from the forum state), aff'd, 792 F.2d 862 (9th Cir. 1986).

272. *Phillips Petroleum*, 472 U.S. at 819.

273. For example, a Petition for Review has recently been filed with the California Supreme Court to address whether the California Corporate Securities Law applies to stock transactions outside of California. Pass v. Diamond Multimedia Sys., Inc., Case No. CV-758927 (Santa Clara Cty. Sup. Ct.) (petition filed Jan. 27, 1997).

traditional defendants have begun a push for federal preemption of state securities class actions.[274]

## VIII. CONCLUSION.

In his letter to Chairman Levitt, President Clinton expressed his concern that the Reform Act "may reduce the ability of investors to seek redress for damages resulting from arguably fraudulent activities." The President said it was important for the agency to "monitor the implementation and impact of this legislation carefully -- and increase enforcement and rulemaking activities if necessary." The staff of the Office of the General Counsel has been following private securities class action cases very closely since the Reform Act was enacted.

While the number of cases filed in federal court has dropped on an annual basis compared to prior years, it is not clear whether this decrease is the result of a temporary drop in cases immediately following the enactment of the Reform Act or whether it means that the weaker cases are no longer being brought in federal court. It is also possible that the drop is a reflection of the strength of the market. A market downturn could result in an increased number of lawsuits. It appears that the number of suits naming accountants and other third party defendants has dropped sharply. This may be the result of the Supreme Court decision in the *Central Bank* case, as well as the Reform Act.

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274. On November 9, 1996, at their annual industry convention, top Wall Street officials, including NYSE Chairman Richard Grasso, announced they would push for federal legislation during this upcoming Congressional session to preempt state blue sky laws. *See* Jill Dutt, *Brokers Pledge to Fight Anti-Securities Initiatives*, WASH. POST, Nov. 10, 1996, at A7. Further, Silicon Valley executives have formed the California Technology Alliance, with passage of preemption legislation one of its top priorities. *See* CORP. FIN. WEEK, Dec. 16, 1996 at 13. As expected, opposition to preemption is beginning to form. *See* Rachel Witmer, *Industry Groups Seek New Legislation to Preserve Securities Litigation Reform*, Sec. Reg. & L. Rep. (BNA) Vol. 29, No. 6, at 152-153 (Feb. 7, 1997) (listing Public Citizen, Government Finance Officers Association, and Consumer Federation of America as potential opponents).

Legislators in California have taken action which may also affect the future of the state securities class action. *See* Legislative Briefs, State News Briefs, Sec. Reg. & L. Rep. (BNA) Vol. 28, No. 48, at 1523 (Dec. 13, 1996) (reporting that California State Senators John Vasconcellos and Jim Brulte introduced SB No. 35, which would incorporate the Reform Act into California state law).

We have found that the cases are moving slowly through the courts. The courts appear to be proceeding in a cautious and deliberate manner, carefully considering the sufficiency of the cases under the strict new pleading standards imposed by the Act. Our review suggests that plaintiffs' lawyers are not filing "cookie-cutter" complaints and that the race to the courthouse has slowed somewhat.

It appears that more securities class action cases are being brought in the state courts. In some cases, this may be an attempt to overcome the discovery stay imposed by the Reform Act. In other cases, it may reflect a migration of weaker cases to state court. We are continuing to monitor the situation.

The quality and quantity of forward-looking disclosure has not significantly improved following enactment of the safe harbor for forward-looking statements. Companies have been reluctant to provide significantly more forward-looking disclosure beyond what they provided prior to enactment of the safe harbor. Companies are primarily concerned about the lack of judicial guidance as to the sufficiency of the required "meaningful" cautionary language and about potential liability under state law, where the statements may not be protected by the federal safe harbor. Concerns also have been raised about the quality of the cautionary language provided by some issuers. The staff intends to continue to study the safe harbor and to consider what steps might be necessary to encourage companies to provide forward-looking information and to improve the quality of the accompanying cautionary language.

In addition to requesting this Report, the President also expressed his hope that, if there were indications that the Act was having a negative impact on the integrity of our markets, the Commission would recommend amendments. Based on our review of the actions that have been filed and the judicial decisions that have been rendered, as well as on discussions with various interested parties, the staff believes that it is too soon to draw any firm conclusions about the effect of the Reform Act on frivolous securities litigation, or, for that matter, on meritorious litigation. Accordingly, the staff does not recommend any legislative changes at this time.

There are still many uncertainties about the effects of the Reform Act. The staff expects to continue carefully monitoring the cases, offering our views to the courts through the filing of friend of the court briefs, studying issuer use of the safe harbor, and reporting back to the Commission if we find that modifications are necessary.