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SECURITIES LAW

Study Confirms: Institutional Investors Promote Purpose of Securities Laws

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Special to the Legal

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This has been an unusual year for securities litigators. While the economic crisis has led to new case filings in the first six months of 2009, the cases are largely focused on the financial sector and address subjects related to the lost value of assets backed by subprime and other debt. In addition, a significant number of the cases stem from the Madoff scandal. According to Kevin LaCroix, writing for the blog "D&O Diary, with many filings this year involving different classes of related securities and with various overlapping suits in the Madoff litigation, the process of identifying distinct cases "was extraordinarily complicated." The number of more traditional securities fraud cases involving allegations of accounting fraud dropped off during the first half of the year. While this column does not make any predictions, based on early third-quarter filings, LaCroix predicts traditional securities cases outside the financial sector, including accounting fraud cases, will be filed in greater numbers during the remainder of the year.

But this recent "lull" in traditional securities fraud filings gives rise to an opportunity to reflect on the purpose of the federal securities laws in order to focus on the values that they were enacted to protect and promote. When enacting the Securities Exchange Act of 1934, Congress intended to legislate values of honesty and integrity because those values were deemed essential to the proper functioning of the U.S. capital markets. This column contends that institutional investors seeking to serve as lead plaintiffs in securities class actions are best suited to, and do, effectuate the values inherent in the federal securities laws.

In House Report No. 73-1383, dated April 27, 1934, Congress discussed the Securities Exchange Bill of 1934, and the intent for enacting it.

"No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value. There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the marketplace thrive upon mystery and secrecy. The disclosure of information materially important to investors may not instantaneously be reflected in market value, but, despite the intricacies of security values, truth does find relatively quick acceptance on the market. That is why in many cases it is so carefully guarded. Delayed, inaccurate and misleading reports are the tools of the unconscionable market operator and the recreant corporate official who speculate on inside information. Despite the tug of conflicting interests and the influence of powerful groups, responsible officials of the leading exchanges have unqualifiedly recognized in theory at least the vital importance of true and accurate corporate reporting as an essential cog in the proper functioning of the public exchanges."

While discussing an amendment to the Securities Exchange Act of 1934, in House Report No. 90-1711, dated July 12, 1968, Congress further commented on the intent of the law: "The competence and integrity of a company's management, and of the persons who seek management positions, are of vital importance to stockholders. Secrecy in this area is inconsistent with the expectations of the people who invest in the securities of publicly held corporations and impairs public confidence in securities as a medium of investment."

> *The shareholder litigation study found that lawsuits with an institutional lead plaintiff are less likely to be dismissed and have significantly larger settlements than cases with an individual lead plaintiff.*

Discussing another amendment to the 1934 Act, in Senate Report No. 94-75, dated April 14, 1975, Congress further noted: "The basic goals of the Exchange Act remain salutary and unchallenged: to provide fair and honest mechanisms for the pricing of securities, to assure that dealing in securities is fair and without undue preferences or advantages among investors, to ensure that securities can be purchased and sold at economically efficient transaction costs, and to provide, to the maximum degree practicable, markets that are open and orderly."

These statements by Congress over the years, considered together with the language of the Exchange Act and its application in federal courts, demonstrate that the federal securities laws were enacted to hold corporate liars and cheaters — "the unconscionable market operators and the recreant corporate officials" — accountable for the losses suffered by investors as a result of fraudulent conduct adversely affecting stock prices.

The Private Securities Litigation Reform Act, or PSLRA, of 1995 directed federal district courts, in overseeing class actions brought under the Securities Act of 1933 and the Securities Exchange Act of 1934, to appoint a lead plaintiff based on the size of a plaintiff's stake in a lawsuit. The PSLRA was intended to encourage institutional owners to lead securities class actions based on the assumption at the time that the largest stakeholders — likely institutional investors — are more capable of seeking better case outcomes for investors. The data since the passage of the PSLRA shows that Congress got that point right.

A 2009 academic study titled "Institutional Monitoring through Shareholder Litigation" was conducted by C.S. Agnes Cheng of Louisiana State University, Henry He Huang of Prairie View A&M University, Yinghua Li of Purdue University and Gerald Lobo of C.T. Bauer College of Business. The shareholder litigation study investigates the use of securities class actions by institutional investors to monitor defendant corporations, discipline management and deter the commission of future wrongdoings. The authors note that when large public institutional investors, like state pension systems, serve as lead plaintiff seeking damages on behalf of similarly situated investors, they also seek corporate governance reforms through securities litigation.

Starting with a sample of 1,811 securities class actions filed between 1996 and 2005 for their statistical analysis, the authors found that: "[W]hen the likelihood of winning is high, the potential damage is large, and the defendant firm is important to the institutional owners, institutional owners are more likely to step forward to serve as the lead plaintiff. Specifically, we find that institutional investors are more likely to serve as the lead plaintiff when the lawsuit involves an accounting-related allegation, has an accounting firm as the co-defendant, has a longer class period, has a larger negative market reaction to the revelation event, and has a larger potential investor loss. The probability of having an institutional lead plaintiff is also higher when the defendant firm has a larger market capitalization, has a higher level of institutional holdings, and is operating in a high-tech industry."

The shareholder litigation study found that lawsuits with an institutional lead plaintiff are less likely to be dismissed and have significantly larger settlements than cases with an individual lead plaintiff. The study further found that within three years of filing the suit, corporate defendants in securities cases led by institutional plaintiffs also experience greater improvement in director independence than corporate defendants in cases led by individuals. The results of the study demonstrate that "institutional investors can effectively monitor defendant firms through litigation."

The shareholder litigation study posits that institutional investors tend to "step forward to lead the lawsuits when the punishment of the defendant firms can promote positive changes in the overall market." Institutional investors are more likely to seek the lead plaintiff role when the case has higher merit and larger potential damages. The statistical results of the Shareholder Litigation study indicate that "having an institutional investor as the lead plaintiff improves the lawsuit's chance of surviving the motion to dismiss."

Notably, the study also "suggests that securities litigation does not automatically lead to governance improvement. Rather, it is the institutional [investor] involvement that drives, either directly or indirectly, governance changes." For example, corporate defendants in securities class actions led by institutional investors experience a significantly higher increase in audit committee independence than corporate defendants in suits led by individual lead plaintiffs. The study's authors also note that corporations tend to "respond to serious accounting accusations by improving board independence, and having an institutional lead plaintiff further pushes the defendant firms to take such an action." Simply put, the shareholder litigation study found that "institutional lead plaintiffs are associated with greater subsequent corporate governance reform."

The shareholder litigation study confirms that institutional investor involvement in securities litigation since the passage of the PSLRA "enhances not only investors' success in seeking financial recovery, but also the quality of the defendant firms' corporate governance. In light of the ineffectiveness of traditional institutional monitoring channels (e.g., private communication, etc.) and the increasing number of securities [cases], institutional investors could use litigation as a mechanism to discipline management and to secure the long-term health" of defendant corporations. By pursuing leadership roles in securities class actions, institutional investors promote the philosophy of full and fair disclosure that has been the continuing purpose of the federal securities laws for 75 years, and enhance transparency in corporate reporting for all participants in the capital markets. •

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