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Advocate

A Securities Fraud and Corporate
Governance Quarterly

*First Quarter
2006*

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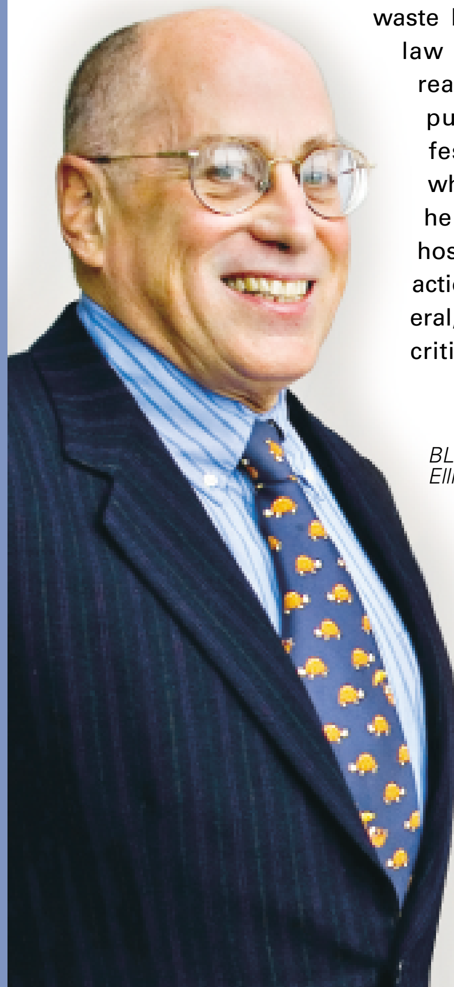
From Academia to the Private Sector: A Discussion With Professor Elliott Weiss

An interview by Bruce Carton
Vice President, Institutional Shareholder Services' Securities Class Action Services

In late December, leading plaintiffs' securities class action law firm Bernstein Litowitz Berger & Grossmann LLP announced that Elliott Weiss, a prominent professor and securities law expert, had left academia to join BLB&G. This announcement intrigued and somewhat puzzled many lawyers and others in the industry, who viewed Professor Weiss as a harsh, long-time critic of class action abuse and waste by plaintiffs' law firms. This reaction in turn puzzled Professor Weiss, who states that he is not at all hostile to class actions in general, and that his criticisms have been "directed at suits that have no merit and lawyers who exploit the process, neither of which advance investors' interests."



BLB&G's Elliott Weiss

> ***"I have always believed that the plaintiffs' bar can, and often does, play a very important, constructive role in our capital markets."***

I interviewed Professor Weiss about his move from academia to private practice, as well as several other subjects.

Carton: Your 1995 article, "Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions" {104 Yale L.J. 2053 (1995)}, proposed reforms for the organization of securities class actions, and was the basis of the lead plaintiff provisions of the Private Securities Litigation Reform Act (PSLRA) of 1995. You have been a long-time critic of class action abuse and certain practices of the plaintiffs' bar. What led you to join a plaintiffs' law firm and, specifically, BLB&G?

Weiss: After I retired from the faculty of the Rogers College of Law at the University of Arizona, I decided that I would like to remain active professionally. I also was interested in developing an ongoing relationship with a law firm. I had had several good experiences working with BLB&G in the past, including, most recently, working on the brief on defendants' Rule 23(f) appeal to the Fifth Circuit of the class certification decision in the EDS litigation. The BLB&G lawyers impressed me

Continued on page 2.

A DISCUSSION WITH PROFESSOR WEISS

Continued from page 1.

with their professionalism and their commitment to effectively representing their clients. I also was impressed by the results they had achieved in cases such as *Baptist Foundation, Cendant and WorldCom,* among others. We began discussing a possible relationship and things worked out.

Carton: Have the PSLRA's lead plaintiff provisions worked the way you envisioned?

Weiss: Not exactly. When we wrote our article, the Internet was in its infancy. We anticipated that most communications between law firms and investors would be face-to-face. The explosive growth of the Internet created a very different dynamic. However, especially in big cases where major institutional investors have served as lead plaintiffs, they have worked pretty much as we hoped they would. Recoveries are in a whole different league than was the case before the PSLRA was adopted and are much more reflective of the merits of the claims being litigated. Attorneys' fees are a much lower percentage of recoveries and reflect real bargaining between institutions and their lawyers. And, in at least a few cases, institutional investors have pushed for and obtained recoveries payable out of the pockets of corporate officers and directors, which has a potential major deterrent effect, but was not anything plaintiffs' lawyers were inclined to seek before institutional investors entered the picture.

Carton: What role will you serve with BLB&G? Do you expect to actively litigate cases? To serve as an expert behind the scenes? Something else?

Weiss: My role at BLB&G is still evolving. The relationship is very much a part-time one. I expect to be — and already have been — involved in cases that the firm is actively litigating, but I do not anticipate assuming a lead counsel role. My guess is that I'll be more like an in-house consultant.

Inside Look

This quarter, the *Advocate* is proud to welcome Elliott J. Weiss, one of America's most highly respected experts in securities and corporate law, to the firm. In "Academia to the Private Sector: A Discussion With Professor Elliott Weiss," Professor Weiss's remarkable career teaching, writing and lecturing is profiled, along with his decision to join the firm as Counsel. It is with great pleasure that we welcome the esteemed Professor Weiss to BLB&G.

In "Making Sure the Dice Aren't Loaded: Market Efficiency and the Fraud-on-the-Market Theory in Securities Class Actions," firm associate Jai Chandrasekhar provides a fascinating look into the fraud-on-the-market theory. Since its endorsement by the United States Supreme Court in *Basic, Inc. v Levinson* in 1988, the rebuttable presumption of reliance upon the integrity of the market has become a key factor for plaintiffs in securities class actions. To receive the benefit of this presumption, plaintiffs must simply show that the market for the particular security was efficient — that is, the market rapidly incorporated all publicly available information. As Jai details, however, defendants have recently began an assault on the efficient market hypothesis, arguing that even securities traded on the New York Stock Exchange or NASDAQ did not trade in an efficient market. The applicability of the fraud-on-the-market theory has become a hotbed of debate and we are pleased to bring you Jai's insight on the topic.

In analyzing the SEC's Proposed Rule On Executive Compensation, firm partner Doug McKeige and associate Jeff Spinazzola examine the problem of excessive executive compensation and the SEC's decision to take notice and propose rules governing executive compensation. As Doug and Jeff explain, the SEC's proposed rule would not only require more detailed disclosures of executive compensation, but would require that such details be provided in plain English which will describe the process by which executive compensation is determined. In short, the proposed rule should be seen as a victory for shareholders, albeit a modest one.

Max Berger

Again this quarter, firm associate Ben Galdston, our "Eye on the Issues" specialist, offers an insightful compilation of the most significant developments in the field for your reference. As a quick perusal reveals, we could fill the entire *Advocate* with news reports affecting securities and corporate law.

As a reminder, mark your calendars for the 12th Institutional Investor Forum, which will be held in New York City on October 5-6, 2006. Please see page 12 or visit www.iiforum.org for more information.

Finally, we are very excited to unveil our "new look" — more colors, more graphics and more features! We hope that you will find this issue of the *Advocate* informative and enjoyable to read. As always, we welcome your feedback.

Max W. Berger

"Recoveries are in a whole different league than was the case before the PSLRA was adopted and are much more reflective of the merits of the claims being litigated. Attorneys' fees are a much lower percentage of recoveries and reflect real bargaining between institutions and their lawyers."

Carton: In May 2000, you filed a declaration in the *Cendant* case opposing the BLB&G fee request to the extent it short-cut the "Lead Plaintiff's rightful participation in the process of formulating a request for attorneys' fees." What were the circumstances that led you to do so, and what are the lessons that can be taken from the *Cendant* case with respect to attorneys' fees?

Weiss: In *Cendant,* I filed a declaration as an expert retained by the New York City Pension Funds, which were one of three lead plaintiffs. The thrust of my declaration was that the district court should have deferred to the fee arrangement negotiated by lead plaintiffs, rather than taking over the fee-setting process. The fee agreement required lead counsel to obtain the approval of lead plaintiffs before submitting their fee request. I argued that the district court should require them to seek that approval before passing on counsel's fee request. That's almost exactly how the Third Circuit eventually ordered the district court to proceed. The lessons from that case seem self-evident.

Carton: What changes, reforms, or other shifts do you foresee in the securities class action process in the next five years? Ten years?

Weiss: I'm not sure my crystal ball is any better than that of anyone else. My impression is that courts have gotten more comfortable and more sophisticated when dealing with the lead plaintiff appointment process. For example, they're no longer appointing large "groups" of unrelated investors to serve as lead plaintiffs, which was a process that pretty much left control of the case in the hands of the lawyers who assembled those groups. I think we will see a steady evolution in that area. I also think courts will get better at using the pleading provisions of the PSLRA to winnow out those complaints that should be dismissed and to sustain those that address real instances of fraud.

Carton: What are you most excited about with respect to your new position in private practice?

Weiss: The opportunity to work with a group of smart, committed lawyers and the opportunity to seek meaningful remedies for investors who have been injured by fraud. I have always believed that the plaintiffs' bar can, and often does, play a very important, constructive role in our capital markets. In fact, in our article proposing the lead plaintiff process, we pointed out the flaws in work by Janet Cooper Alexander and others who suggested that the merits never matter in securities class action litigation. My goal as an academic was always to suggest ways to improve the manner in which the plaintiffs' bar can protect investors' interests. I'm excited to have the opportunity to become a more direct part of that process. ■

The preceding interview appeared in the February 2006 SCAS Alert.

When you secure the most significant recoveries in history ...people notice.

BLB&G partners honored by *Lawdragon* and *Superlawyers* Magazines

The Advocate is delighted to announce that *LawDragon Magazine* has named BLB&G partners **Max Berger, Sean Coffey, Alan Schulman and Darnley Stewart** to its list of the Top 500 Leading Litigators In America. To have four partners from a firm this size selected to such an elite list is a tremendous and unique achievement. Congratulations to our Lawdragons!

In its inaugural issue, *New York Superlawyers Magazine* selected nine BLB&G partners to its list of "superlawyers" — outstanding attorneys who have attained a high degree of peer recognition and professional achievement. Congratulations **Max Berger, Sean Coffey, Edward Grossmann, Chad Johnson, Douglas McKeige, Erik Sandstedt, Gerald Silk, Steven Singer, and Darnley Stewart** on being selected to the the top 5 percent of Manhattan lawyers!

When Less is More, and When It's Not

The SEC Proposed Rule on Executive Compensation

*By Douglas M. McKeige
and Jeffrey T. Spinazzola*

Issues of executive compensation are again making headlines. Recently, reports indicated that the chief executive officer of North Fork Bancorporation, John A. Kanas, will receive a $135 million payout if Capital One's acquisition of the company is completed. More troubling than the largess of the payout is the fact that the compensation adviser behind the estimated $135 million payout also received fees for other services from the bank in recent years. As *The New York Times* rightly noted, this raises significant questions about which "master the consultant is serving." The planned payout to Mr. Kanas represents the latest summit in an ongoing trend toward excess as "compensation paid to the top five executives at all public companies in the three years ending in 2003 reached 10 percent of those companies' earnings." Behind Every Underachiever, an Overpaid Board?, *The New York Times,* Gretchen Morgenson, January 22, 2006. More recently, according to a study by compensation consultant Pearl Meyer & Partners, in 2004, the average CEO of a major company received $9.84 million in total compensation, a 12 percent increase in CEO pay over 2003. In contrast, as reported by the AFL-CIO, the average non-supervisory worker's pay increased just 2.2 percent to $27,485 in 2004."

The executive compensation problem is not just a matter of inequity between CEOs and employees, as overpaying executives also results in smaller net profits for shareholders. For example, executive pay consumed 6 percent of total corporate profits between 1993 and 1997 and 10 percent of aggregate corporate profits from 1998 to 2002. No wonder the media has spotlighted villains and heroes to dramatize the national problem. A few high profile examples include New York Stock Exchange CEO Richard Grasso, who was forced to resign following disclosure of his $140 million pay package, and Michael Eisner, CEO of the Walt Disney Company, who received a vote of "no confidence" from 45 percent of Disney shareholders. On the other end of the spectrum, Whole Foods Market has limited CEO John Mackey's salary to no more than 14 times the pay of the average frontline employee.

The executive compensation problem is not just a matter of inequity between CEOs and employees, as overpaying executives also results in smaller net profits for shareholders.

Despite these troubling headlines and statistics, shareholders have little recourse in holding corporate directors (and the board's compensation committees) accountable for their irrational largess. Compensation committees handle the basic work for the board of directors to oversee and determine executive compensation programs. And securities laws and stock market rules require that compensation committee members meet independence and outside director requirements. How then to explain the vast increases in executive compensation?

One explanation is that these committees routinely work with outside consulting firms that provide the basic parameters of these programs and, yet, as with the North Fork Bank example, these firms are incentivized to make sure their advice leads to generous packages. These firms want to be hired for many other functions by corporate management. Many of them are engaged in executive search functions and similar activities such as recommendations for compensation for members of the board of directors. Perhaps there is a phenomenon occurring similar to what was witnessed with audit firms that compromised on their audit work in favor of side-by-side consulting businesses with far greater revenues and margins.

Shareholders have faced equally daunting obstacles to tackling the executive compensation issue in the courtroom where, under Delaware law, even an inspection of a company's books and records places a substantial burden on a shareholder to present credible evidence from which the court can infer that waste or mismanagement has occurred. Thus, where a shareholder argues that executives are receiving compensation that is both undeserved and far above their contracted minimums, courts will not grant him the right to inspect the company's books and records to prove waste absent facts to support his argument, including facts related to the "process by which these compensation decisions were made." See, e.g., *Seinfeld v. Verizon Communications, Inc.,* No. Civ.A. 1100-N, 2005 WL 3272365, at *2 (Del. Ch. Nov. 23, 2005). Marshalling the facts, however, is easier said than done because the pay packages themselves are so complex that even compensation specialists have a hard time figuring them out. Indeed determining a total price tag means assigning a number to every benefit and sorting out what portion of a stock option grant belongs in which year's paycheck.

Further, any attempts by shareholders to control executive compensation via the

election of a truly independent board of directors have also been thwarted. In most cases, shareholders have no real ability to nominate or appoint members to the board of directors. Though shareholders may, in theory, stage expensive battles to nominate board candidates via proxy fights, these uphill battles seldom end in a shareholder-nominated candidate. Moreover, while shareholders technically vote on appointees to the board of directors, management almost always gets its choices filled as the slate of nominees generally only includes enough candidates to fill the available seats, and nominees who receive a plurality, not a majority, vote are appointed. Finally, the Securities & Exchange Commission ("the Commission") recently disappointed institutional investors by failing to enact rules that would have made it easier for large shareholders to propose nominees for the board of directors.

Though executive compensation remains a hot issue for shareholders, because attempts to limit or review executive compensation have largely been defeated, the focus has shifted to the transparency of compensation disclosures themselves so that, in theory, shareholders will have the ability to decide, *ex ante,* whether to invest in a company that is overly generous with its executives. Moreover, this time, shareholders are finding support from the Commission, which has an interest not only in protecting shareholders, but in encouraging investment and liquidity in capital markets. Given several years of shareholder activism on this front, the Commission has apparently taken notice. Specifically, the Commission "is proposing revisions to … rules governing disclosure of executive compensation, director compensation, related party transactions, director independence and other corporate governance matters and current reporting regarding compensation arrangements." Securities and Exchange Commission, Executive Compensation and Related Party Disclosure Proposed Rule ("Proposed Rule"). Moreover, the "proposed revisions to the compensation disclosure rules are intended to provide investors with a clearer and more complete picture of compensation to principal executive officers, principal financial officers, [and] the other highest paid executive officers and directors."

Whether the Proposed Rule will result in sufficient transparency to satisfy shareholders remains to be seen, but the stakes for the Proposed Rule may never have been higher as executive compensation issues continue to make the headlines. Given the timeliness of the Proposed Rule, the following provides a brief summary of some of its key features.

Generally, the Proposed Rule is designed to require executive compensation disclosures that are both more transparent and more complete. The changes, however, do not end with clarity as to what executives are earning, but instead extend to how they earn it. Namely, while changes to executive disclosure rules adopted in 1992 favored tables that allowed for easier year-to-year and company-to-company comparisons, the Proposed Rule would require more complete tables, including the disclosure of all elements of compensation, as well as narrative disclosures designed to provide "material qualitative information regarding the manner and context in which compensation is awarded and earned."

Under the Proposed Rule, compensation disclosures would begin with a narrative overview that "would call for a discussion and analysis of the material factors underlying compensation policies and

Continued on page 11.

By The Numbers…

When is Enough, ENOUGH?

$398 million:
The value in cash and stock of retirement package of ExxonMobil's former chairman.

8 percent:
Average yearly return to ExxonMobil shareholders 2001–2005 (just about industry average).

90 percent:
Institutional investors who think that corporate executives are overpaid.

The New York Times, April 13, 2006; Watson Wyatt Worldwide survey

Executive pay consumed 6 percent of total corporate profits between 1993 and 1997 and 10 percent of aggregate corporate profits from 1998 to 2002. No wonder the media has spotlighted villains and heroes to dramatize the national problem.

Eye on the Issues

LEGISLATIVE/REGULATORY UPDATES AND RECENT DECISIONS OF INTEREST

By Benjamin Galdston

The Big Board Goes Public

On March 7, 2006, the New York Stock Exchange merged with Archipelago Holdings, Inc., an electronic exchange, transforming the 213-year old NYSE into a for-profit company. The NYSE, already the world's largest stock exchanges, now has new, high-tech trading capabilities and an estimated 49 percent of the market in stock trading. The combined company is called NYSE Group, Inc. and trades on the Big Board as "NYX." Shares of NYX soared to $80 per share on its first day of trading, up 19 percent from the opening price of $67 per share, giving NYSE Group a market value of $12.6 billion. The NYSE describes itself as the world's largest and most liquid equities market, where customers can choose between the floor-based auction market and sub-second electronic trading. On an average day, over 1.8 billion shares valued at more than $69 billion are traded. The total global market capitalization for companies listed on the NYSE is $22.5 trillion. In the past several years, the venerable exchange came under fire for allegedly widespread trade-timing violations by trading firms at the NYSE, along with public chagrin over the $188 million pay package received by its former chairman, Richard Grasso. Many believed the scandals called into question the long-established system of self-regulation at securities exchanges. In order to win approval from regulators, the NYSE instituted a number of changes, among them: a majority of members of the exchange's board has to be independent of management, and the board's committees — including those that set compensation for exchange officials — has to be fully comprised of independent members. *New York Times, March 8, 2006.*

2005 In Review: Number Of Securities Fraud Lawsuits Filed Down; Settlements Up

The number of class action securities fraud cases filed in 2005 decreased more than 17 percent compared to 2004 levels, according to a recent study, from 213 filings to 176. The 2005 filing rate is nearly 10 percent below the historic average for the past 9 years. The study also found that investor losses claimed in the lawsuits also decreased in 2005. The immediate market impact of the lawsuits was $99 billion, down 33 percent from $147 billion in 2004. The impact is measured by calculating how much the total market capitalization of a defendant company declined from the day before a lawsuit was disclosed to the public. Interestingly, a different study conducted by the same group found that securities class action settlements reached unprecedented levels in 2005. Even excluding the multi-billion dollar settlements in the *WorldCom* and *Enron* litigations, the total value of cases settled during 2005 grew to an all-time high of $3.5 billion, surpassing the $2.9 billion high reached in 2004 by nearly 17 percent. In 2005, the median settlement value was nearly 20% higher than in 2004. *"Securities Class Action Filings. 2005: A Year In Review," Class Action Clearinghouse; "Post-Reform Act Securities Settlements. 2005 Review And Analysis," Cornerstone Research.*

Nortel Agrees To Pay $2.5 Billion To Settle Accounting Fraud Case, Then Restates For A Third Time On Newly Discovered Accounting Errors

Canadian telecommunications giant Nortel Networks, Inc. agreed to pay $2.5 billion in cash and stock to settle two shareholder lawsuits. Nortel, the largest North American telephone-equipment maker, will pay $575 million in cash and stock equivalent to 14.5 percent of the company. Under the terms of the settlement, the Company must also turn over a portion of any amounts it recovers from former executives, who the Company contends must forfeit bonuses and other compensation they received during the time Nortel's earnings were inflated by the alleged accounting fraud. In addition, Nortel must implement important governance changes. The settlement is the fifth largest class action securities fraud settlement on record to date. The lawsuits stem from a $3.2 billion accounting fraud that relied on boosting sales by accelerating the booking of fiber-optic equipment contracts. The company's CEO, Frank Dunn, was fired after Nortel was forced to restate its financial results for the five-year period between 1999 and 2003. Within one month of announcing the historic settlement, Nortel announced that it will further restate financial results for 2003, 2004 and the first nine months of 2005 due to revenue incorrectly recognized in those periods that should have been deferred to future periods. According to a company press release, Nortel's internal and outside auditors have not undertaken an investigation as to whether any improper conduct may be associated with this latest restatement. Instead, the company claims the restatement relates to an ongoing contract review, which it has undertaken to ensure compliance with the accounting rules for certain complex contracts. *Bloomberg, Feb. 8, 2006.*

Anti-Tax Group Challenges Sarbanes-Oxley

The Free Enterprise Fund ("FEF"), an anti-tax group that promotes limiting government regulation, is challenging the constitutionality of the Sarbanes-Oxley Act of 2002. The group has hired a team of A-list lawyers to try to overturn the law that has reshaped the accounting industry and increased penalties for securities fraud. The legal team heading up the challenge includes Kenneth Starr, who is best known as the special prosecutor in the Monica Lewinsky investigation. The attack focuses

on the Public Company Accounting Oversight Board ("PCAOB"), which Sarbanes-Oxley created to oversee the accounting industry. The FEF argues that the PCAOB violates the Constitution's mandated separation of powers among the three branches of government. According to the FEF, the PCAOB violates the Appointments Clause of the Constitution because the board is composed of officers appointed by the President, rather than the SEC. A lawsuit was filed in Washington against the PCAOB in February 2006. The FEF claims that Sarbanes-Oxley has reduced the stock value of American companies by $1.4 trillion dollars and creates unnecessary barriers to needed liquidity, while "discouraging entrepreneurship and innovation." The FEF argues that the high cost of compliance disproportionately affects smaller public companies and will have long-term negative implications for the U.S. economy. *Business Week, Feb. 8, 2006.*

AIG To Pay $1.6 Billion To Settle Civil Enforcement Actions

Insurance giant American International Group, Inc. ("AIG") agreed to pay more than $1.6 billion to settle the SEC and New York State Attorney General's charges related to improper accounting, bid rigging and practices involving workers' compensation funds. It is the largest regulatory settlement by a single company in U.S. history. As part of the settlement, AIG has agreed to replace some of its top management and acknowledge that it misled investors and regulators. The company must also adopt a series of reforms designed to prevent further abuses. The actions stem from a series of allegedly fraudulent transactions between AIG and its subsidiary General Re beginning in 2000 that were designed to inflate AIG's books by $500 million. The settlements do not resolve the government's pending case against AIG's former chairman and CEO, Maurice "Hank" Greenberg, and its former CFO, Howard Smith. *CNN/Money, Feb. 9, 2006.*

Legg Mason Reluctant To File Proof Of Claims

Many institutional investors, including public pension funds, have responded to the call of Congress and taken the lead in prosecuting private actions under the federal securities laws. However, one investment manager, Legg Mason Capital Management, Inc., is reluctant to even file proofs of claims to receive settlement proceeds. The Baltimore, Maryland-based financial firm believes it should focus on making money for its clients and not interfere in the compliance role filled by regulators and others. At a Washington industry seminar, a Legg Mason representative stated that deciding whether or not to file a proof of claim in a class action is a legal question. Therefore, Legg Mason contends, filing proofs of claim could amount to practicing law without a law license. Legg Mason says it does automatically file proofs of claim in securities class actions on behalf of clients that request them to do so, without trying to make any legal determination as to whether it is in the client's best interest. *Wall Street Journal, March 6, 2006.*

Institutional Investors Continue To Focus On Corporate Governance

A recent Institutional Shareholder Services study of 300 institutional investors confirms that corporate governance remains a growing concern of large investors, such as pension funds, mutual funds, and hedge funds. The study found that 63% of these institutional investors expect corporate governance to receive even more attention over the next three years. Since the scandals at WorldCom and Enron rocked the investing world, large fund managers have sought an increasingly active role in corporate decisions and policy. Most recently, investors have focused on executive pay, seeking greater disclosure and accountability. The California State Teachers' Retirement Board has involved itself in the legislative process by sponsoring State Senate Bill 1207 and officially supporting the provisions in Congressional Bill H.R. 4291. State Senate Bill 1207 would bolster corporate governance at the board level by strengthening shareholders' voting rights in publicly traded corporations. Congressional Bill H.R. 4291 would require company disclosure of executive compensation plans in annual reports and proxy statements. Other funds let companies know how important corporate governance is by investing only in businesses that have instituted internal reforms. Clearly, the corporate governance and reform issue is here to stay. *Wall Street Journal, April 12, 2006.*

Wendy's Board Yields To Large Investor

Recently, funds and other shareholders have become increasingly vocal about how companies are run or should be run in an effort to make companies more accountable to their investors. In response, many companies are making it easier for investors to vote out directors who displease them. As of early February, about 120 major U.S. companies had instituted "majority vote" measures that require a company's directors be approved by a majority of investors rather than just a plurality. Casual dining chain Wendy's International recently announced that it would give three seats on its board to a hedge fund that controls a large block of Wendy's shares. Trian Fund Management, the hedge fund controlled by billionaire investor Nelson Peltz and his longtime partner Peter W. May, nominated three new board members, thereby increasing the board from 12 to 15 members. Mr. Peltz has been one of Wendy's most vocal critics, having previously urged the company to sell all of its operations except for its core Wendy's chain and to concentrate on making it more competitive. In response to this criticism, Wendy's spun off its Tim Horton's chain, a thriving coffee and doughnut subsidiary. *New York Times, March 3, 2006.*

Benjamin Galdston is an associate in the California office of BLB&G. He prosecutes securities actions on behalf of the firm's institutional investor clients and can be reached at beng@blbglaw.com.

Making Sure the Dice Aren't Loaded:

Market Efficiency and the Fraud-on-the-Market Theory in Securities Class Actions

By Jai Chandrasekhar

"Fraud-on-the-market." "An efficient market." These terms are used frequently throughout the course of securities litigation. But what do they mean? What significance do they carry in securities litigation? Claims under the federal securities laws require the plaintiff investor to have relied on the alleged false statement or omission by the corporate defendants. In a traditional fraud case, this means that the investor must have read or heard the misstatements and made his investment on the basis of the false information. In 1988, the United States Supreme Court, in *Basic, Inc. v. Levinson,* adopted the fraud-on-the-market theory, which benefited plaintiffs in securities class actions by establishing a presumption of reliance on the integrity of the market. To receive the benefit of this presumption, plaintiffs must show that the market for the security was efficient. Once established, plaintiffs are entitled to a rebuttable presumption that they relied upon the integrity of the market when purchasing or acquiring the securities. Recently, however, the securities defense bar has been launching attacks on the fraud-on-the-market theory and the efficient markets hypothesis, arguing that even securities traded on the New York Stock Exchange or NASDAQ did not trade in an efficient market.

By way of background, modern economic studies confirm that the prices of securities that are traded in active, liquid markets rapidly reflect all publicly available information about a company. This efficient markets hypothesis underlies the modern United States system of securities regulation, including the Securities and Exchange Commission's rules governing corporate disclosures and securities offerings, as well as the laws governing investors' remedies when companies disclose false and misleading information to the market or fail to report facts that should have been disclosed.

The hypothesis gained widespread acceptance among economists in the early 1970s and, under Rule 10b-5, federal courts began to permit class actions based on this presumption of reliance. Finally, in 1988, the Supreme Court endorsed the efficient markets presumption of reliance in *Basic, Inc. v. Levinson.* "It is hard to imagine that there ever is a buyer or seller who does not rely on market integrity," wrote Justice Harry Blackmun for the Court. "Who would knowingly roll the dice in a crooked crap game?" The presumption of reliance remains a central tenet in securities fraud class actions seeking to keep Wall Street from loading the dice to cheat investors.

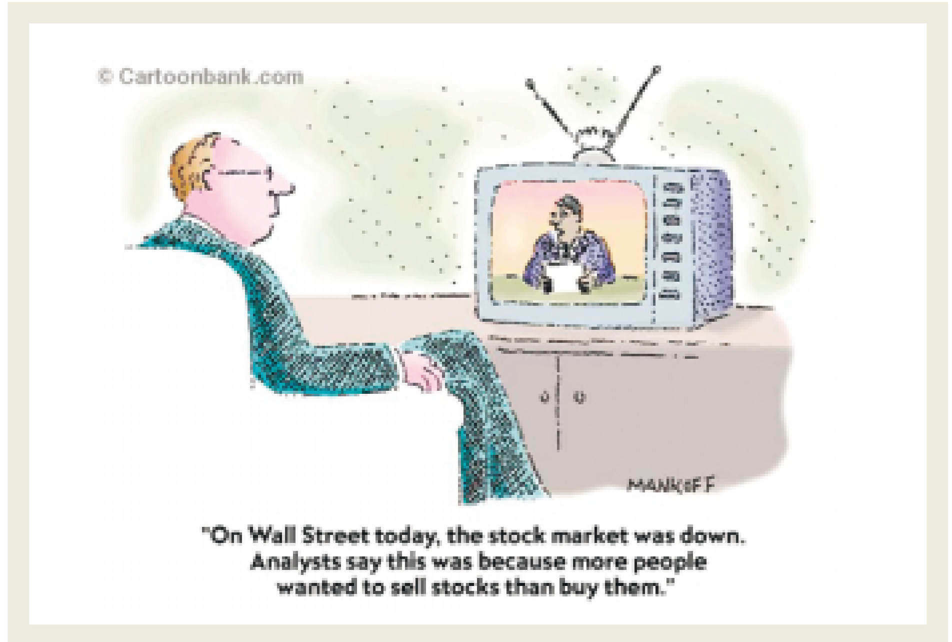
In 1988, the Supreme Court endorsed the efficient markets presumption of reliance in* Basic, Inc. v. Levinson. *"It is hard to imagine that there ever is a buyer or seller who does not rely on market integrity," wrote Justice Harry Blackmun for the Court. "Who would knowingly roll the dice in a crooked crap game?"

The efficient markets hypothesis does not hold that actively traded securities' prices reflect *all* information about the issuers. It only holds that the prices reflect *all publicly available* information. Nor does it hold that the prices necessarily reflect the publicly available information accurately, in the sense that the prices reflect the "true value" of the securities. Rather, the theory only holds that market prices reflect all publicly available information so quickly that it is impossible for traders to make trading profits on the basis of new information.

The reliance requirement under the federal securities laws poses two challenges to protecting investors from fraud in modern securities markets. First, many investors do not actually read or hear the corporate disclosures that later turn out to have been false or incomplete. Instead, they simply rely on the integrity of the market prices — for example, by buying a portfolio of many stocks based on a market index — or they employ investment advisers who make their securities purchases for them. Thus, the investors cannot claim that they themselves actually relied on the false disclosures.

Second, many securities fraud claims are brought as class actions, because most investors' losses from any particular fraud are too small for individual lawsuits to be economical. To maintain a lawsuit as a class action, the plaintiffs must establish, among other things, that legal and factual issues that are shared by all members of the class predominate over legal and factual issues that are different for different members of

From its adoption by the lower federal courts in the 1970s until the last few years, the efficient markets hypothesis made certification of securities fraud cases as class actions almost routine. Recently, however, defendants have begun to resist class certification as vigorously as they press their motions for dismissal or summary judgment.



"On Wall Street today, the stock market was down. Analysts say this was because more people wanted to sell stocks than buy them."

the class. Many courts have held that each purported class member must prove that they individually relied on issuers' false statements, and rule that the class action is not permissible — though these class members were all clearly damaged by the fraud.

The efficient markets hypothesis provides a solution for both of these challenges. First, the theory provides a sound basis for presuming that investors who buy securities in reliance on the integrity of the market price are indirectly relying on the accuracy of the issuer's public disclosures, regardless of whether they actually read or heard those disclosures, because the market price reflects all publicly available information about the company. Second, by eliminating the need to prove that every member of a plaintiff class read or heard the statements, the efficient markets hypothesis makes the presumption of reliance into an issue that is common to all members of the class, so that shared issues predominate and a class action may be maintained.

From its adoption by the lower federal courts in the 1970s until the last few years, the efficient markets hypothesis made certification of securities fraud cases as class actions almost routine. Instead, the pre-trial battles in securities cases occurred when defendants asked the courts to dismiss the cases for failure to plead legally adequate claims, or after fact discovery, when defendants later sought summary judgment. Recently, however, defendants have begun to resist class certification as vigorously as they press their motions for dismissal or summary judgment.

Defendants' increased resistance to class certification follows a 1998 amendment to the Federal Rules of Civil Procedure that permits immediate appeals of trial court certification decisions. Before this rule change, these decisions generally could not be appealed. As a result, cases that were certified as class actions were usually settled, because defendants

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The Institutional Investor Advocate

is published quarterly by Bernstein Litowitz Berger & Grossmann LLP, 1285 Avenue of the Americas, New York, NY 10019, 212-554-1400 or 800-380-8496. The materials in this newsletter have been prepared for information purposes only and are not intended to be, and should not be taken as, legal advice. Bernstein Litowitz Berger & Grossmann LLP prosecutes class and private actions, nationwide, on behalf of institutions and individuals. Founded in 1983, the firm's practice concentrates in the litigation of securities fraud; corporate governance; antitrust; employment discrimination; and consumer fraud actions. The firm also handles, on behalf of major institutional clients and lenders, more general complex commercial litigation. The firm's client base in securities fraud and corporate governance litigation includes large public pension funds and other institutional investors.

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MAKING SURE THE DICE AREN'T LOADED

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could not afford the risk of trial, and classes that were denied certification were generally abandoned by plaintiffs. The increased litigation over class certification also reflects a shift by the courts, which in earlier years determined certification of the class by relying largely on plaintiff's allegations in the complaint. Now courts typically permit defendants to introduce extensive evidence in opposition to class certification. Both plaintiffs and defendants present financial expert reports and other evidence on class certification in the trial court, and pursue appeals if they lose.

There are two primary battlegrounds in the class certification struggle. First, the fraud-on-the-market presumption of reliance under *Basic Inc. v. Levinson* may be rebutted if defendants are able to present evidence that the named plaintiff in fact did not rely on the integrity of the market price. Defendants therefore seek documents and testimony from the court-appointed lead plaintiff, attempting to establish that the lead plaintiff did not rely on the market. Courts have generally rejected arguments by defendants that institutional investors who rely on investment advisers cannot establish reliance on the market. On the other hand, plaintiffs who are short sellers, betting that the stock price will decline, or who testify that they believed the issuer's disclosures were false, or that the market for its securities did not reflect the publicly available information about it, have been found by some courts not to have relied on the market, defeating class certification.

The second major battleground is whether the market for the particular securities at issue in the case is efficient. Stocks that are actively traded on the New York Stock Exchange, NASDAQ National Market System, or American Stock Exchange are typically found to trade in an efficient market. Smaller stocks, stocks of companies that have only recently gone public, preferred securities, bonds, and unregistered securities that trade only in the Rule 144A institutional market are often the subject of heated litigation over whether their markets promptly reflect all publicly available information such that the presumption of reliance should apply.

The courts' adoption of the efficient market hypothesis uses sophisticated economic theory to protect investors and maintain the honesty and integrity of the United States capital markets. By allowing defrauded investors to benefit from the presumption that they relied on the issuer's public statements, the fraud-on-the-market theory enables investors to maintain class actions to recover their losses.

Plaintiffs may try to establish that the market for a security is efficient by presenting evidence about its trading activity. A variety of analyses help to demonstrate that publicly available information rapidly instructs behavior, such as: the average weekly trading volume as a percentage of total outstanding shares; the number of securities analysts following and reporting on the securities; the extent of market maker and arbitrager trading in the securities; the company's eligibility to register securities with the SEC on the short-form registration statement on Form S-3 (which is available only to larger issuers that have filed periodic reports with the SEC for 12 months); the company's market capitalization; the bid-ask spread for the securities; and the company's float (publicly held shares not owned by insiders).

Most importantly, plaintiffs must establish that the securities price responds promptly to unexpected corporate news, because courts and economists recognize this as the heart of the efficient market hypothesis. There is no legal requirement that plaintiffs present expert testimony at the class certification stage, but the likelihood that defendants will present expert testimony claiming the market is not efficient means that in close cases, plaintiffs today are well advised to put forward their own economic expert report. Typically, the experts on both sides present statistical "event studies," in which they analyze the particular security's volatility relative to market indices, calculate how much of the security's price change on particular days is attributable to changes in the overall market index and how much is unique to the particular security, and seek to show that the price did — or did not — change to a statistically significant extent in response to company-specific news.

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WHEN LESS IS MORE

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decisions reflected in the data presented in the tables." Following the narrative overview, the Proposed Rule would require detailed disclosure of executive compensation in three categories: a) "compensation with respect to the last fiscal year (and the two preceding fiscal years)," including options, restricted stock and similar grants as well as compensation consisting of current earnings or awards; b) "holdings of equity-related interests that relate to compensation or are potential sources of future gains, with a focus on compensation-related equity interests that were awarded in prior years" and any "recent realization of these interests, such as through vesting of restricted stock;" and c) "retirement and other post-employment benefits."

In addition to requiring narrative supplements necessary to understand the information provided as to each of these three categories, the Proposed Rule would require a "new disclosure requirement of the total compensation and job description of up to an additional three most highly compensated employees who are not executive officers or directors but who earn more than the highest paid executive officers."

In light of "the increasing focus on corporate governance and director independence," the Proposed Rule also includes "amendments to update, clarify and slightly expand the related party transaction disclosure requirements." Further, the Proposed Rule would require "a narrative explanation of the independence status of directors under a company's director and independence policies, consistent with recent significant changes to the listing standards of the nation's principal securities trading markets." Further, the Proposed Rule would "consolidate this and other corporate governance disclosure requirements regarding director independence and board committees into a single expanded disclosure item."

Finally, in order to ensure that the new the Proposed Rule results in disclosures that are "clear, concise and understandable," the Proposed Rule also requires that most disclosures be made in plain English. *(See box at left for more information on specific guidelines.)*

The Proposed Rule, in many respects, should be seen as a victory for shareholders. After several years of fighting for limits to and clearer transparency of executive compensation, the Commission is considering awarding investors with amendments to executive compensation disclosures that, for the most part, would require not only more detailed disclosures for a greater number of executives, but that these disclosures be more clearly written in general. Perhaps most importantly, the Proposed Rule is also designed to explain to shareholders the process by which compensation is determined. The fight, however, is not over as the Proposed Rule is still under consideration, and the Commission has invited comments to the proposed changes. Furthermore, certain changes and requests for commentary seek ways of curtailing currently required disclosures.

At least when it comes to the transparent disclosure of executive compensation, however, shareholders have already made their decision: less is not more. ■

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Proposed Rule "Plain English" Guidelines

Specifically, among other guidelines, the plain English requirement requires that disclosures:

a) present information in clear, concise sections, paragraphs and sentences;

b) use short sentences;

c) use definite concrete everyday words;

d) use the active voice;

e) avoid multiple negatives;

f) use descriptive headings and subheadings; and

g) avoid legal jargon and highly technical business and other terminology.

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