BLB&G

Bernstein
Litowitz
Berger &
Grossmann LLP

INSTITUTIONAL INVESTOR

Advocate

A Securities Fraud and Corporate Governance Quarterly

First Quarter 2007

Fewer Securities Class Actions Filed in 2006

Permanent Decline, Part of a Cycle, or Random Variation?

By David Stickney

Investors filed fewer securities class actions in 2006 than in past years. Indeed, according to industry consultants, fewer new cases were filed last year than were filed during any year since the year Congress enacted the Private Securities Litigation Reform Act. The recent decline has been a hot topic as analysts and commentators offer myriad possible explanations for the dip and also speculate whether it is permanent, part of a cycle or a random variation.

The exact reason for the decline in new cases is far from conclusive. Several reasons or combination of reasons might explain the drop-off, such as more cautious corporate behavior in the wake of high-profile recoveries from individuals like in *Worldcom*, the reforms of the Sarbanes-Oxley Act, increased government enforcement of securities fraud or a strong stock market with lower price volatility.

Whatever the reason (or combination of reasons) for the decline in the number of new securities class actions in 2006, investors should not be

Continued on next page.

The SEC Flip-Flops at Supreme Court, Betraying Investors

Tellabs, Inc. v. Makor Issues & Rights Ltd.

By John C. Browne and Jai Chandrasekhar

"The past was erased, the erasure was forgotten, the lie became truth."
Nineteen Eighty-Four, by George Orwell, Chapter VII, p. 78.

In more than a dozen cases litigated during the last eight years, the Securities and Exchange Commission ("SEC") has consistently argued to courts across the country that a key provision of the Private Securities Litigation Reform Act of 1995 (the "PSLRA") should be interpreted in favor of investors. Unfortunately for the victimized investors that the SEC is supposed to protect, in an important case currently pending before the Supreme Court, the agency has sided with corporate interest groups and asked the Supreme Court to adopt a radically different — and far more stringent — interpretation of the PSLRA. If accepted by the Supreme Court, the SEC's position would significantly limit the ability of defrauded investors to pursue private securities litigation and, simply put, would allow serious frauds to go unaddressed.

The case before the Supreme Court is *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, and arises out of an appeal from the Seventh Circuit Court of Appeals. At issue in *Tellabs* is the interpretation of a provision of the PSLRA that requires investors asserting fraud claims under the securities laws to plead facts "giving rise to a ***strong inference*** that the defendant acted with the

Continued on page 8.

Note: The recent "open letters" from BLB&G Partner Max Berger in response to the Paulson Committee's Interim Report and the more recent McKinsey report commissioned by Sen. Schumer and Mayor Bloomberg are available on the BLB&G website at *http://www.blbglaw.com/html/securities_publications.html.*

FEWER SECURITIES CLASS ACTIONS

Continued from page 1.

lulled into a false sense of security. Fewer new cases does not mean that there is less corporate greed and fraud or that the decline is permanent. Such practices often remain hidden in the market for a period of time. Moreover, most of the reasons put forward to explain the decrease in filings during 2006 are not permanent factors, suggesting that the decline is either part of a cycle or a random occurrence.

In this respect, the relative calm in securities litigation is reminiscent of 1996, when the number of reported new cases fell from 213 filed during 1995 to 130 in 1996, before increasing again to 240 new cases in 1998. Now, as Yogi Berra said, "It's déjà vu all over again" in 2006.

Investors should not be lulled into a false sense of security. Fewer new cases does not mean that there is less corporate greed and fraud or that the decline is permanent.

Behind The Numbers

Each year, the National Economic Research Associates ("NERA") and Cornerstone Research (together with the Stanford Law School Securities Class Action Clearinghouse) issue reports with their findings related to securities litigation during the year. The reports include various statistics and the authors' observations concerning, for example, the number of complaints filed, the location of such lawsuits, the industries involved and the relative size of lawsuits as measured by the loss of market capitalization.

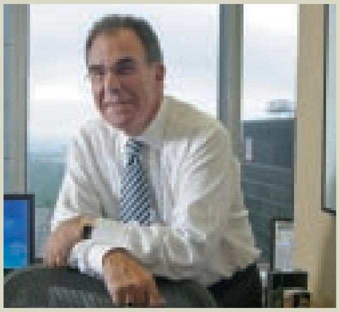
In January 2007, both NERA and Cornerstone reported that the number of

Inside Look

This quarter, the *Advocate*, and its two enclosures, focus on three issues of vital importance to investors — the *Tellabs* case currently pending before the United States Supreme Court, a response to recent developments calling for sweeping changes in private rights of action under the securities laws, and an analysis of the 2006 studies reporting on the decrease in securities class action filings.

In "Fewer Securities Class Actions Filed In 2006: Permanent Decline, Part of a Cycle or Random Variation?," firm partner David Stickney analyzes the myriad possible explanations for the recent decline in new securities class action filings. As David concludes, whatever the reason (or combination of reasons) for the decline, investors should not be lulled into a false sense of security. The decrease in new cases in 2006 does not mean there is less hidden fraud in the market or that the landscape has permanently changed.

In "The SEC Flip-Flops at the Supreme Court, Betraying Investors: *Tellabs, Inc. v. Makor Issues & Rights Ltd.*," firm partner John Browne and associate Jai Chandrasekhar summarize the *Tellabs* case currently pending before the U.S. Supreme Court and the *amicus* brief submitted by the SEC. At issue in *Tellabs* is the interpretation of a provision of the PSLRA that requires investors asserting fraud claims under the securities laws to plead facts giving rise to a "strong inference" that the defendant acted with scienter. John and Jai adeptly challenge the SEC's advocacy for a new higher standard that would significantly limit the ability of defrauded investors to pursue private securities litigation. The SEC's new position conflicts with the standard the SEC has repeatedly argued should be adopted by courts throughout the country on this same issue. This stunning reversal raises serious concerns about whether the SEC is acting in the best interests of the investors it is supposed to protect. For your convenience, we have enclosed a copy of the *amicus* brief to the U.S. Supreme Court in the *Tellabs* case we submitted on behalf of a consortium of major public pension funds.



Max Berger

Also enclosed with this issue is a copy of my letter in direct response to the "McKinsey Report" and other recent developments calling for sweeping changes in private rights of action under the securities laws.

Apart from the articles and enclosures, I direct your attention to the regular "Eye on the Issues" column. Benjamin Galdston has again provided an insightful compilation of this quarter's most significant legal and regulatory developments for your reference.

We hope that you find issue of the *Advocate* to be informative and helpful. As always, we strive to bring you current news and information affecting the securities laws and we welcome the many comments, questions and input we receive from our readers.

Max W. Berger

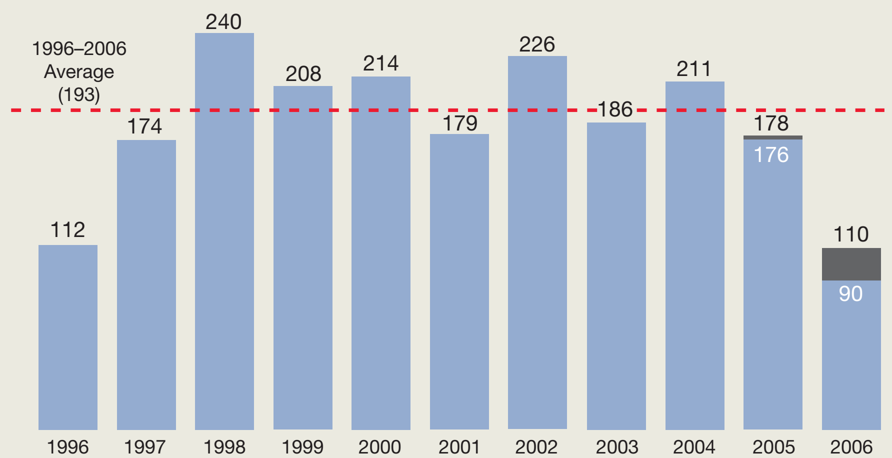
new class actions filed in 2006 fell to the lowest total since 1996. While the specific number of filings differs in the two reports — NERA identified 129 cases; Cornerstone, 110 — the emphasis of the two reports is the same. They both report that 2006 saw the lowest annual total since 1995. As you can see from the graph reproduced at right, Cornerstone reported that new class actions fell by 38 percent since 2005, from 178 filings to just 110 filings. Likewise, NERA reported that filings declined by 36 percent from 2005, from 211 to 129 new cases.

Cornerstone, to underscore its point that "[c]lass action lawsuits plunged to a record low in 2006," isolated class actions related specifically to the practice of options backdating. Cornerstone identified 22 securities class action lawsuits containing backdating allegations, of which 20 were filed in 2006. Excluding such backdating cases because, according to Cornerstone, such cases are "unlikely to be repeated," Cornerstone arrives at a "core litigation rate" of 90 companies sued in 2006.

Both Cornerstone and NERA are correct that the decline in new securities class actions coincided with the public exposure of the widespread options-backdating scandal. *See* Noam Mandel, "Mirror, Mirror On the Wall, Give Me the Lowest Price of All (Corporate Greed Redux)," *Institutional Investor Advocate* (Second Quarter, 2006). Notably, however, the number of reported class actions relating to such practices understates the amount of litigation. Investors seeking redress for options backdating practices frequently file derivative actions on behalf of the corporation and its shareholders, rather than file a class action. Because reporting services do not report derivative actions at the state level in the same way as securities class actions in federal court, the extent of such litigation focused on options-backdating practices is not fully reflected in NERA's and Cornerstone's reports on securities litigation in 2006. According to media reports, over 150 companies are under investigation, and there are believed to be more than 350 derivative lawsuits arising from the backdating scandal.

Class Action Filing Index

Number of Class Action Filings 1996–2006



Note: 2005 and 2006 figures include options backdating cases (represented by shaded areas).

Source: Cornerstone Research, 2007.

There are obvious problems with the simplistic notion that corporate America "got religion" due to stepped-up federal enforcement of the securities laws. While the previous wave of corporate fraud may have inspired a period of increased federal enforcement, we have experienced a backlash and a major lobbying effort to roll back investor protections.

In short, both NERA and Cornerstone focus primarily on the cold statistics. They reach no particular conclusions concerning the level of hidden fraud or misconduct in the market. This limitation is significant because fraud often remains concealed for years before detection. For instance, while the number of new securities class actions declined between 1995 and 1996, ongoing fraud unquestionably existed in the market but remained concealed until the widespread corporate scandals at the start of the millennium. At HealthSouth Corporation, for example, executives cooked the books for over ten years until the fraud was revealed in 2003. Since then, five former chief financial officers have pleaded guilty to crimes related to financial fraud.

Cornerstone, NERA and others commenting on the 2006 studies suggest a number of explanations for the decrease in filings during 2006. The possible reasons offered for the decrease include stronger federal enforcement by the Securities Exchange Commission ("SEC") and the Department of Justice, improved corporate governance due to the reforms of Sarbanes-Oxley, and less price volatility in the market with fewer sharp price declines.

Continued on page 4.

FEWER SECURITIES CLASS ACTIONS

Continued from page 3.

Has Federal Enforcement Eliminated Corporate Greed and Fraud?

Certain commentators say outright (and others certainly imply) that there is a link between the 36 percent decline in new securities class actions in 2006 and a sustainable decline in the actual level of fraud in the market. Remarkably, in a *Wall Street Journal* piece, a professor of law and business at Stanford Law School, Joseph Grundfest, wrote that "[p]erhaps fewer companies are being sued for fraud because there is less fraud." There is less fraud, Professor Grundfest says, "because there is a new, tougher and superior enforcement mechanism in place." Under this theory, "the government's aggressive criminal and civil enforcement strategy following the Enron and WorldCom frauds has caused corporate boards and management to 'get religion' when it comes to complying with the securities laws."

There are obvious problems with the simplistic notion that corporate America "got religion" due to stepped-up federal enforcement of the securities laws. Leaving human nature aside, the reality is that business groups continue to vigorously resist SEC enforcement programs and lobby against the reforms put in place in 2002 after the wave of corporate scandals. While the previous wave of corporate fraud may have inspired a period of increased federal enforcement, we have experienced a backlash and a major lobbying effort to roll back investor protections. In fact, SEC enforcement actions have declined for three years in a row. According to media reports, the SEC attributed the decline to shrinking staff levels due to a hiring freeze and turnover of senior positions. The SEC reportedly brought just 574 enforcement actions in fiscal 2006, 10% fewer than the prior year, marking a three-year decline from a record high in fiscal 2003. Of these cases, the SEC brought the greatest number against delinquent filers. Notably, for fiscal 2007, the SEC actually cut its requested budget for the staffing of the SEC enforcement division. This, of course, leaves enforcing the securities laws up to investors and their legal representatives, as it has been for decades.

Moreover, the SEC has recently taken steps on two fronts to limit the ability of investors to seek redress for corporate wrongdoing. On February 9, 2007, the SEC filed a brief with the United States Supreme Court in *Tellabs Inc. v. Makor Issues and Rights Ltd*, siding against investors and urging the adoption of a legal standard that will make it even harder for investors to have their day in court. (*See "SEC Flip-Flops at the Supreme Court," in this issue.*) At the same time, SEC Chairman Christopher Cox and the agency's chief accountant stated that they were also considering ways to limit the ability of investors to pursue redress against accounting firms. The need for such added protection is difficult to understand: According to the Securities Class Action Clearinghouse, only one suit was filed against an auditor defendant in 2006, and only five such lawsuits were filed in 2005.

Ironically, prior to its enactment, business groups opposing Sarbanes-Oxley predicted that the reforms actually would spur an increase in securities litigation. It now appears that the opposite is true.

At about the same time the SEC was filing its brief urging the Supreme Court to raise the pleading standards for defrauded investors, the results were released of a comprehensive independent study into the effectiveness of the SEC and auditors in the detection of corporate fraud. (Luigi Zingales, I.J. Alexander Dick and Adair Morse, *Who Blows the Whistle on Corporate Fraud.*) The authors gathered data on a broad sample of corporate frauds in the United States between 1996 and 2004 at companies with over $750 million in assets. Based on their analysis, the SEC is not particularly effective at revealing corporate fraud. The SEC detected only 6% of the frauds in the study. Interpreting the results, the authors concluded that appointing an official investigator like the SEC is "extremely costly" and "so ineffective"

Quarterly Quote...

"Government should not decide the compensation for America's corporate executives, but the salaries and bonuses of CEOs should be based on their success at improving their companies and bringing value to their shareholders.... [corporate directors] need to pay attention to the executive compensation packages that you approve."

President George W. Bush, in a January 31, 2007 speech to a large gathering of business executives on Wall Street. ***In advocating the unremarkable proposition that CEO compensation should be tied to performance, the President received no applause. Hmmm.***

because looking for fraud is like "looking for a needle in the proverbial haystack."

Nonetheless, Professor Grundfest suggests that investors should rely on the SEC because the agency has authority to collect funds that can be distributed to shareholders. Real-world experience, however, shows that SEC action is just not as effective as private litigation at compensating victims of fraud. In *Worldcom*, for example, the SEC recovered $750 million for investors. By contrast, the New York State Common Retirement Fund, as the lead plaintiff in the securities class action, recovered $6.156 billion.

Against this backdrop, stepped up enforcement by federal regulators seems an unlikely explanation for the decline in new class actions during 2006, and in any event, certainly not a permanent one.

"I was at a high-powered investment firm for seven years and a high-powered penal institution for a year and a half."

The Sarbanes-Oxley Effect

Congress enacted the Sarbanes-Oxley Act of 2002 in the wake of high-profile corporate scandals at Enron, Worldcom and other companies. The reforms enhanced corporate governance, produced more reliable corporate financial statements and has had a positive effect on investor protections. While Sarbanes-Oxley probably cannot fully explain the reduced level of new filings in 2006, it has undoubtedly impacted the litigation environment.

Sarbanes-Oxley increased the awareness and sensitivity of officers and directors to corporate governance, disclosure requirements and financial reporting. Among other changes, Sarbanes-Oxley requires the chief executive officer and the chief financial officer to certify the annual and period reports filed with the SEC. Further, commencing after November 15, 2004, annual reports on Form 10-K must include management's assessment of the effectiveness of its internal control over financial reporting. Such changes have forced officers, directors and auditors to take their responsibilities seriously.

Ironically, prior to its enactment, business groups opposing Sarbanes-Oxley predicted that the reforms actually would spur an increase in securities litigation. *See* Richard B. Schmitt, Michael Schroeder and Shailagh Murray, "Corporate-Oversight Bill Passes, Smoothing Way for New Lawsuits," *The Wall Street Journal,* July 26, 2002. It now appears that the opposite is true.

To the extent that Sarbanes-Oxley may be a contributing factor to the decline in new class actions in 2006, however, the Sarbanes-Oxley effect may not be a permanent factor. Unfortunately for investors, Congress and regulators are considering rolling back the reforms of Sarbanes-Oxley. Business groups have complained loudly that the requirements of Sarbanes-Oxley add millions of dollars in compliance costs and make life difficult for corporate directors. Along these lines, the Committee on Capital Markets Regulation (a.k.a. the Paulson Committee), advocates that the

Continued on page 11.

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.

BLB&G

Eye on the Issues

LEGISLATIVE/REGULATORY UPDATES AND RECENT DECISIONS OF INTEREST

By Benjamin Galdston

Most Restatements Caused By Basic Accounting Errors, Not Complex Rules

The number of public-reporting companies that restated historical financial results has soared since implementation of stricter reporting rules under the Sarbanes-Oxley Act of 2002. Between 2001 and 2005, the number of companies restating historical results more than quadrupled from 270 to 1,195, according to research by Glass Lewis. Indeed, in the first three quarters of 2006, 1,070 companies had restated and the SEC predicted that the total would top 1,300 by year-end. But the SEC has found that the increase in restatements is not due to more complex accounting rules or stricter oversight by accountants and regulators. Instead, a study by the SEC's Office of the Chief Accountant found that most restatements were due to simple misapplication of the rules and basic mistakes with "nuts-and-bolts" accounting. *The Wall Street Journal, Nov. 20, 2006.*

Public Accountancy Oversight Board Inspections Find Big Four Audits Deficient

The Public Company Accounting Oversight Board ("PCAOB"), the non-profit organization charged with overseeing the auditors of public companies, recently concluded its annual inspections of the "Big Four" accounting firms for 2005 and found deficiencies in audits performed by each of the firms. For example, Deloitte & Touche LLP was cited for 17 audits where the firm failed to identify or appropriately address errors in the issuer's application of Generally Accepted Accounting Principles, or instances where Deloitte failed to perform, or to perform sufficiently, certain necessary audit procedures. Similarly, KPMG LLP, Ernst & Young LLP and PricewaterhouseCoopers LLP ("PwC") were cited for 11, 10 and 9 deficient audits, respectively. In one instance, PwC failed to test the fair value of warrants and stock-based compensation issued by a company in 2004. The company, which is not identified in the PCAOB report, later was forced to restate its financial statements because of its options backdating practices and accounting errors. The PCAOB reviews a sampling of audits performed by the "Big Four" firms to assess compliance with the Sarbanes-Oxley Act of 2002, SEC rules and professional accounting standards. The PCAOB reports are available to the public at www.pcaobus.org

Morgan Stanley Hid Emails From Regulators & Clients For More Than 3 Years

The National Association of Securities Dealers ("NASD") has filed a disciplinary complaint against Morgan Stanley, charging the financial services company with routinely failing to provide emails to claimants in arbitration proceedings, as well as to regulators. According to the complaint, Morgan Stanley, which manages nearly $700 billion in assets, also falsely claimed that millions of email messages it possessed had been lost in the Sept. 11, 2001 terrorist attacks on the World Trade Center in New York, where its email servers were located. In truth, the company had restored millions of email messages shortly after September 11 using back-up tapes. Other emails were available from individual users' desktop computers, yet Morgan Stanley failed to search those computers and make the emails available. Morgan Stanley also failed to preserve relevant messages or permitted back-up tapes to be overwritten, thereby destroying important evidence. Morgan Stanley was previously sanctioned by a Florida court for withholding or destroying email evidence in a case brought by financier Ron Perelman related to Perelman's 1998 sale of his Coleman camping gear company to Sunbeam Corp. In 2005, the jury awarded Perelman $1.57 billion in damages against Morgan Stanley. In February 2006, Morgan Stanley agreed to pay $15 million to settle a separate SEC investigation into deficient email preservation, the largest fine ever paid for that type of violation. The latest NASD complaint potentially impacts hundreds of arbitration and court proceedings during the past four years. *Bloomberg News, Dec. 19, 2006.*

New Study Finds Even Outside Directors Complicit In Stock Options Backdating

Previously, most regulatory inquiries focused on how companies manipulated stock option grant dates to benefit their top executives. Now, a new study has found that an alarming number of outside directors — the very people who are supposed to add a measure of independence and control to the boards of directors — received preferential options grants. The finding may help explain why the practices were so pervasive and continued for so long. The study was conducted by academics from Harvard Law School, the University of Chicago, and Cornell University's Johnson School of Management. The same group previously analyzed historical options grants to executives between 1996 and 2005, and found that 12% of the companies studied engaged in manipulative practices resulting in at least 1,150 improper grants. The previous study also found that manipulated grants were less likely when the company did not have a majority of independent directors on the board. However, the new study of grants during the same period found that approximately 460 companies and 1,400 outside directors were associated with opportunistically-timed grants. The study found that 9% of the grants were timed to days when the stock price was equal to a monthly low. More than 130 companies are currently under investigation by U.S. authorities for manipulating stock option grants. *The Wall Street Journal, Dec. 18, 2006.*

Investment Banks And Auditor Agree To Settlement For Their Role In Adelphia Fraud

Adelphia's auditor, Deloitte & Touche LLP, and 39 investment banks have agreed to pay $455 million to settle a shareholder securities fraud class action related to bankrupt cable company Adelphia Communications Corp. Under the terms of the settlement, Deloitte will pay $210 million in the Court-approved settlement. The investment banks, which include the three largest U.S. banks — Bank of America, JP Morgan Chase & Co., and Wachovia Corp. — will pay $245 million collectively. Adelphia also is suing Deloitte in a Pennsylvania state court over the adequacy of Deloitte's auditing services and its alleged role in the fraud. In April 2005, Deloitte agreed to pay $50 million to the SEC to settle charges stemming from Deloitte's audit of Adelphia's 2000 financial statements. Following revelations of the fraud at Adelphia, the company sold its cable properties to Comcast Corp. and Time Warner Inc. in July 2006 for $16.7 billion. Adelphia is currently undergoing reorganization under court supervision. The company was controlled by the Rigas family and gained notoriety for the lavish expenditures it allowed its founder, John Rigas, and his son, Timothy, who was the company chief financial officer. In total, the Rigas family stole more than $100 million from Adelphia. John Rigas was sentenced to 15 years in prison, while his son received a 20-year sentence. *Bloomberg News, Dec. 8, 2006.*

Deferred Prosecution Agreements On The Rise

Increasingly, companies facing regulatory investigations or criminal prosecutions have been taking the lead in negotiating deferred prosecution or no-prosecution agreements with the U.S. Dept. of Justice and other agencies. The rise of such agreements since 2003 represents a marked shift in strategies for companies that formerly embarked on scorched-earth defenses, sparing no cost to fend off public and private actions. Under deferred or no-prosecution agreements, the company usually agrees to cooperate with an investigation, undertake reforms, pay restitution, submit to greater government oversight, and, in some cases, even admit to wrong-doing. In exchange, the company avoids criminal prosecution or a conviction, which might spell the demise of the entire company. *New York Law Journal, Dec. 11, 2006.*

SEC Agrees To Address Shareholder Access To Director Election Process

For years, shareholder activist groups have been fighting for better access to the director election process. Recently, a group of shareholders of the insurance giant American International Group ("AIG") won an important victory when the Second Circuit Court of Appeals upheld their right to access the company's proxy statement and publish the names of shareholder-nominated director candidates together with any candidates nominated by AIG's board. After years of conflicting decisions and statements on the issue, on January 22, 2007, the SEC announced that it would not support Hewlett-Packard Co.'s attempt to block a shareholder resolution relating to director elections. The dispute stems from a September 2006 proposal by four pension plans that collectively own about $700 million worth of HP securities. The proposed resolution would have allowed shareholder-nominated candidates to run for seats on HP's board of directors and marked the first such proposal after the Second Circuit's AIG decision. In response, HP filed a no-action letter with the SEC asking for SEC support for its decision to reject the shareholder resolution, which would have been considered at the company's March 2007 shareholder meeting. The SEC declined to support HP's efforts to block the proposal. In addition, the SEC scheduled consideration of shareholder access for later in January 2007. *Bloomberg News, Jan. 26, 2007.*

Most Corporate Fraud Uncovered By Whistleblowers, Not Regulators

During the last 9 years, approximately 65% of the cases of corporate fraud came to light because of whistleblowers and media analysts, according to a recent study by the University of Chicago Graduate School of Business. Remarkably, the entities charged with overseeing corporate compliance — the SEC, outside auditors and industry regulators — discovered only 35% of the cases of fraud. The study suggests that those responsible for protecting the U.S. capital markets are ineffective at detecting and prosecuting fraud. Meanwhile, industry participants, such as commercial banks, underwriters and even stock exchange regulators, made no appreciable contribution to fraud detection. As a group, employees were responsible for the largest percentage of reported fraud, although the percentage declined since passage of Sarbanes-Oxley despite that Act's monetary reward for whistleblowers. "Who Blows The Whistle On Corporate Fraud?" *Portfolio Media, Feb. 9, 2007.*

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.

SEC BETRAYS INVESTORS

Continued from page 1.

required state of mind [commonly referred to as 'scienter']." The plaintiffs in *Tellabs*, a class of investors who purchased the common stock of Tellabs, Inc., allege that the company's chief executive officer repeatedly made false statements about sales of the company's most important product. When Tellabs corrected these false statements, the price of the company's stock declined significantly, causing hundreds of millions of dollars in investor losses. After a lower court dismissed the complaint for failure to adequately plead scienter, the Seventh Circuit reinstated the complaint and allowed investors to proceed with their lawsuit. The Supreme Court agreed to hear the case in order to determine the correct standard to be applied to the PSLRA's pleading requirements for securities lawsuits.

On February 9, 2007, the SEC filed with the Supreme Court an *amicus curiae* (friend of the court) brief in support of the *Tellabs* defendants. In that brief, the SEC argues that the Seventh Circuit should be reversed and the investors' complaint dismissed with prejudice using reasoning which goes against longstanding SEC policy.

For the first time, the SEC now contends that private securities fraud lawsuits should be dismissed at the pleading stage—before investors get discovery—unless the investor can plead particularized facts demonstrating a "high likelihood" that a defendant acted with scienter. This is a major departure from longstanding SEC policy.

For the first time, the SEC now contends that private securities fraud lawsuits should be dismissed at the pleading stage—before investors get discovery—unless the investor can plead particularized facts demonstrating a ***high likelihood*** that a defendant acted with scienter. This new standard is significantly higher than the one adopted by the Seventh Circuit in *Tellabs*, and also higher than the standard that the majority of federal courts have applied since the PSLRA was enacted in 1995.

Most troubling, as touched on before, the standard proposed by the SEC in *Tellabs* is significantly higher than the standard that the SEC has repeatedly argued should be adopted by courts throughout the country on this same issue. For instance, in an *amicus curiae* brief that the SEC filed in 1999 with the Second Circuit Court of Appeals in *Novak v. Kasaks, 216 F.3d 300 (2d Cir. 2000)*, the SEC argued that the interpretation of the PSLRA's pleading standard "will have a significant impact on the [PSLRA's] effectiveness and on the federal securities laws' protection of investors." Over the next several years, the SEC repeated this argument in twelve separate *amicus curiae* briefs that it filed in courts across the country. In its *Novak* brief, the SEC explained that the Second Circuit's standard, which allowed "recklessness" to be the basis for alleging a "strong inference" of scienter, is critical to the proper functioning of the securities laws:

> The Commission…believes that elimination of the recklessness liability would encourage corporate directors and officers to put their heads in the sand and would have enormously counterproductive effects on the integrity of corporate disclosure and the quality of corporate governance.

In its *Tellabs* brief, by contrast, the SEC barely acknowledges the role of the securities laws to protect investors, and instead emphasizes purported concerns about the "costs on companies" that private securities litigation entails. This change in focus from the investors it is supposed to protect to a concern about the supposed "costs" on companies that are accused of securities fraud is worrying. Additionally, it is mind boggling that

By The Numbers…

Over a dozen:

The number of times the SEC has argued to courts across the country that the PSLRA should be interpreted in favor of investors.

One:

The number of times the SEC has argued to courts across the country that the PSLRA should be interpreted to further insulate corporate insiders from prosecution.

Six:

The percentage of frauds detected by the SEC between 1996 and 2004.

In its* Tellabs *brief, the SEC barely acknowledges the role of the securities laws to protect investors, and instead emphasizes purported concerns about the "costs on companies" that private securities litigation entails. This change in focus — from protecting investors to protecting companies — is worrying.

the SEC would seek to further insulate corporate insiders from prosecution in the wake of outrageous frauds like Enron and Worldcom.

Prior to *Tellabs*, in keeping with its mission to protect investors and ensure honest corporate disclosure, the SEC argued—forcefully and successfully—that, "[i]n using the term 'strong inference' Congress adopted the Second Circuit standard" for pleading scienter under the PSLRA. The Second Circuit standard allows investors to plead scienter by alleging facts sufficient to show that the defendants:

(1) benefited in a concrete and personal way from the purported fraud;

(2) engaged in deliberately illegal behavior;

(3) knew facts or had access to information suggesting that their public statements were not accurate, or;

(4) failed to check information they had a duty to monitor.

This balanced and pragmatic standard allows courts the necessary flexibility to assess the merits of investors' complaints in the wide range of facts and circumstances in which securities fraud can arise.

In *Novak* and many other cases, the SEC argued that:

> This [Second Circuit] test is proven, sound, widely used, and consistent with the Reform Act's purposes. Nothing in the language or history of the Act shows that the Act deviates from this established means of pleading a "strong inference."
>
> ---
>
> [T]he Reform Act uses the "strong inference" language, which the Second Circuit developed as a pleading standard in a long line of securities cases. It may be presumed, absent contrary evidence, that Congress intended to adopt the judicial definition of that pleading standard.

Based on this view, the SEC urged the court to "adopt the Second Circuit's dominant and correct interpretation of the Reform Act."

The SEC also argued that the legislative history of the PSLRA conclusively demonstrates Congress' intent to adopt the Second Circuit's standard for pleading scienter. For instance, in *Novak*, the SEC reviewed the legislative history and stated:

> In the floor debate, Senator Domenici, one of the Conference Committee Managers, stated that "the conference report adopts the pleading standard utilized by the second circuit court of appeals." …Senator Dodd, another of the managers, agreed that the Conference Committee had "adopt[ed] the Second Circuit Court of Appeals standard,"…as did Senate managers D'Amato and Gramm.

The SEC further explained that, following President Clinton's veto of the PSLRA on the basis that certain language in the legislative history could be interpreted as departing from the Second Circuit standard, Congressional efforts to override the veto confirmed Congress' intent to adopt the Second Circuit standard:

> Senator Dodd reported that the Conference Committee had omitted [an] amendment because it "did not really follow the guidance of the Second Circuit."…[H]e stated that the pleading provision…"met [the Second Circuit] standard"…Senator Domenici reiterated that the [PSLRA's] pleading standard "is the Second Circuit's pleading standard" and was a codification of the Second Circuit Rule."

Any doubt that Congress intended for the PSLRA to adopt the Second Circuit's pleading standard was eliminated with the passage of the related Securities Litigation Uniform Standards Act ("SLUSA") in 1998. SLUSA provides that specified types of securities class actions may be brought only in federal court. The Statement of Managers for SLUSA, reacting to certain district courts that had interpreted the PSLRA as imposing a higher standard than the Second Circuit, leaves no doubt as to Congressional intent behind the PSLRA:

> The [PSLRA] established a heightened uniform Federal standard on pleading requirements based upon the pleading standard applied by the Second Circuit Court of Appeals. Indeed, the express language of the [PSLRA] itself carefully provides that plaintiffs must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."

Clearly, the SEC previously cited a wealth of evidence to courts as overwhelming support for the conclusion that the PSLRA "adopted" the Second Circuit's standard. In *Tellabs,* the SEC retreats from this position and argues that Congress "built upon the Second Circuit's 'strong inference' terminology and added various other pleading requirements, resulting in a statute that

Continued on page 10.

SEC FLIP-FLOPS AT SUPREME COURT

Continued from page 9.

Rather than discuss protecting investors, the SEC has largely abandoned the pro-investor arguments that it consistently made in the years after the passage of the PSLRA. Do not forget that this twelve year period has seen the largest and most destructive frauds in history, not to mention significant subsequent legislation to repair lost confidence in our capital markets due to those frauds.

was intended to strengthen existing pleading requirements." Thus, the SEC is asking the Supreme Court to impose additional hurdles—beyond those that the PSLRA intended or the Second Circuit has recognized—on the ability of victimized investors to bring private securities litigation. Notably absent from the SEC's arguments to the Supreme Court are references to the "proven, sound [and] widely used" Second Circuit test. Nor are there any references to this "dominant and correct" interpretation of the PSLRA, or the legislative history showing that the PSLRA "was a codification of the Second Circuit rule."

In short, the SEC has largely abandoned the pro-investor arguments that it consistently made in the years after the passage of the PSLRA. Rather than discuss the important role that private securities litigation plays in protecting investors, the SEC is now disingenuously suggesting to the Supreme Court that Congress' sole intent behind the PSLRA was to curb "abusive and meritless suits," which "had become rampant in recent years." Certainly Congress enacted the PSLRA in 1995 in part to ensure that only meritorious suits against culpable defendants are filed and pursued and, over the ensuing twelve years, the PSLRA has plainly achieved this objective. The empirical evidence shows that securities class action filings are at an all-time low, with 43 percent fewer class-actions filed in 2006 than the ten year historical average. But do not forget that this twelve year period has seen the largest and most destructive frauds in history, not to mention significant subsequent legislation to repair lost confidence in our capital markets due to those frauds.

Based on this, it strains credulity for the SEC to ask the Supreme Court to erect additional barriers in the path of aggrieved investors — indeed, imposing more barriers would have the effect of barring legitimate, meritorious investor lawsuits and preventing victims of fraud from obtaining any recovery from wrongdoers. The SEC lacks the funding and resources to pursue every instance of corporate fraud or to undertake the massive litigation efforts necessary to secure consistently meaningful recoveries for defrauded investors. *See* chart, below, comparing SEC and class action recoveries. The agency previously acknowledged these points by encouraging courts across the country to interpret the PSLRA in a way that would permit meritorious private investor lawsuits to proceed past the pleading stage. The SEC's stunning reversal in *Tellabs* is a troubling development for anyone concerned with the efficient operation of our capital markets, and raises serious concerns that the SEC is no longer acting in the best interests of the investors it is supposed to protect.

John C. Browne is a partner in BLB&G's New York office. He can be reached at johnb@blbglaw.com. Jai Chandrasekhar is an associate in the New York Office. He can be reached at jai@blbglaw.com.

NO WONDER the Committee wants to abolish class actions and put the SEC in charge!

Company	Securities Class Action Recovery	SEC Recovery
Enron	$7.161 Billion	$424.84 Million
WorldCom	$6.156 Billion	$750 Million
AOL Time Warner	$2.65 Billion	$308 Million
Lucent	$667 Million	$25 Million
Bristol-Myers Squibb	$574 Million	$150 Million

Sources: Institutional Shareholder Services; Stanford Securities Class Action Clearinghouse

FEWER SECURITIES CLASS ACTIONS

Continued from page 5.

SEC consider rolling back the provision of Sarbanes-Oxley requiring certification of internal controls for some companies, curtail liability of auditors and outside directors involved in corporate fraud, and permit companies to adopt bylaws preventing shareholders from pursuing class litigation.

Responding to the Paulson Committee, the Council of Institutional Investors, representing 140 pension funds with more than $3 trillion in assets, issued a statement strongly disagreeing with the Paulson Committee's recommendations. "We believe many of the panel's recommendations, if adopted, would undermine the effectiveness of market watchdogs and weaken critical investor protections."

The Market Cycle

Cornerstone and other commentators have observed a statistical correlation between the number of new class actions and the overall volatility of the markets. Put simply, increased stock price volatility typically results in more securities class actions.

Intuitively, this makes sense because disclosure of hidden information often results in large and sudden stock price declines. Such corrective disclosures and ensuing stock-price declines are often evidence of fraud. During 1999 through 2002, for example, the volatility in the market for U.S. stocks was relatively high due to the bursting of the internet bubble and the wave of corporate scandals. During that period, the number of new cases ranged from 208 new cases in 1999 to 226 in 2002, according to NERA. Since mid-2003, however, the stock-price volatility for U.S. stocks has been relatively low. Thus, while NERA reported the filing of 211 new cases in 2004, the number fell to 178 in 2005 and then to 110 in 2006.

During 2006, our financial markets delivered a strong performance, and the Dow Jones Industrial Average approached an all-time high. Relatively low market volatility during the year likely was a contributing factor to the reduced level of filings. The overall market was strong and stable (although investors in particular companies experienced substantial losses due to dramatic price movements when previously-hidden information was revealed, such as what occurred at UnitedHealth Group, Inc.; Safenet, Inc.; and Scottish Re Group Ltd.). While the strength and stability of the market during 2006 likely was a contributing factor to the total number of new cases, historical experience shows that volatility in the market undoubtedly will increase.

Conclusion

Historically, the markets have experienced waves of scandal followed by a period of relative tranquility. While commentators have given a number of reasons to explain the decrease in new cases in 2006, our system is fundamentally unchanged. It continues to provide the same motives for corporate fraud and the same opportunities to carry out such fraud. It is a mistake, therefore, to assume that the relative calm in 2006 means less hidden fraud in the market or that the landscape has permanently changed. History, after all, has a strange habit of repeating itself.

David Stickney is a partner in BLB&G's San Diego office. He can be reached at davids@blbglaw.com.

"Hold it! We almost forgot your backdated stock options."

Contact Us

We welcome input from our readers.
If you have comments or suggestions,
please contact Editor Timothy DeLange,
in our California office,
at 888-924-1888
or timothyd@blbglaw.com.

If you would like more information about our firm, please visit our website at

www.blbglaw.com

Editor: Timothy DeLange
Marketing Director: Alexander Coxe
"Eye" Editor: Benjamin Galdston
Contributors: Max Berger,
John Browne, Jai Chandrasekhar
and David Stickney

BLB&G
BERNSTEIN LITOWITZ BERGER & GROSSMANN LLP

800-380-8496
E-mail: blbg@blbglaw.com

New York
1285 Avenue of the Americas
New York, New York 10019
Tel: 212-554-1400

California
12481 High Bluff Drive
San Diego, CA 92130
Tel: 858-793-0070

Louisiana
2727 Prytania Street, Suite 14
New Orleans, LA 70130
Tel: 504-899-2339

New Jersey
220 St. Paul Street
Westfield, NJ 07090
Tel: 908-928-1700

iiforum2007

THE 13TH INSTITUTIONAL INVESTOR FORUM

Join us in New York City for our 13th Institutional Investor Forum

Recovering Investor Assets

How Institutional Investors Can Fight Back Against Securities Fraud in the U.S. Markets

October 11-12, 2007 • Waldorf-Astoria Hotel, New York City

Save the date for the next Institutional Investor Forum, an educational conference sponsored by BLB&G for the benefit of the worldwide institutional investor community. The Forum features many industry experts as guest speakers. For more information, visit us at www.iiforum.org or contact:

Tony Gelderman (U.S.)
+1 504 899 2339 tony@blbglaw.com

Abbe Cherkaoui (Europe)
+33 6 8942 4306 abbe@blbglaw.com

www.iiforum.org