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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 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 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

SEC BETRAYS INVESTORS

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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 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."

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.

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 long-standing SEC policy.

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 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

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.

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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.

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.

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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