The Advocate
FOR INSTITUTIONAL INVESTORS

DETERRENT FACTOR:

Class Actions Promote Honesty and Integrity in Corporate America

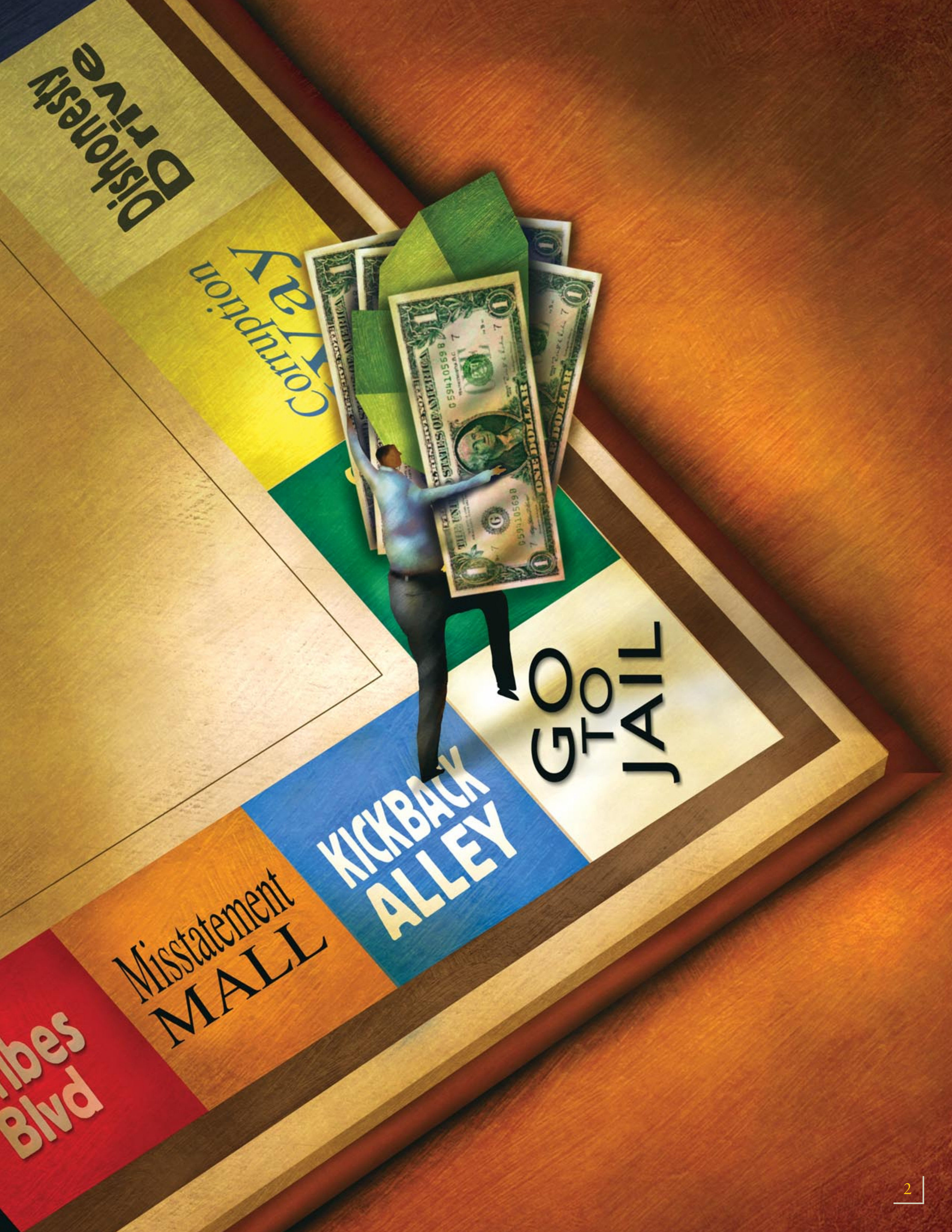
Recent Studies Illustrate the Value of Private Securities Litigation as a Deterrent to Corporate Fraud

By Angus Ni

Academic studies demonstrate what class action practitioners have long believed: Securities class action litigation deters corporate misconduct and improves corporate disclosures.

Over the past year, there has been a steady stream of news about President Trump's and the GOP-led Congress's efforts to erode consumer and investor protections by rolling back regulations and thwarting class actions. For instance, the Summer 2017 edition of The Advocate discussed how the House GOP majority under President Trump has sought to gut class action practice through aggressive legislation. This edition's article entitled "Enforcement, or Appeasement?" (page 8) further discusses several regressive actions by the Trump administration to toss aside important and hard-fought regulatory measures.

In this environment, it is worth taking a renewed look at the proven benefits of class action litigation and, in particular, securities class actions. Several recent academic studies of class action practice have demonstrated what class action practitioners have long believed: Securities class action litigation deters corporate misconduct and improves corporate disclosures. Empirical research by professors at the nation's top universities concludes that private securities litigation has an important disciplining role on companies' disclosure behavior and a deterrent effect that helps stem "contagion" of unlawful practices from one company to another.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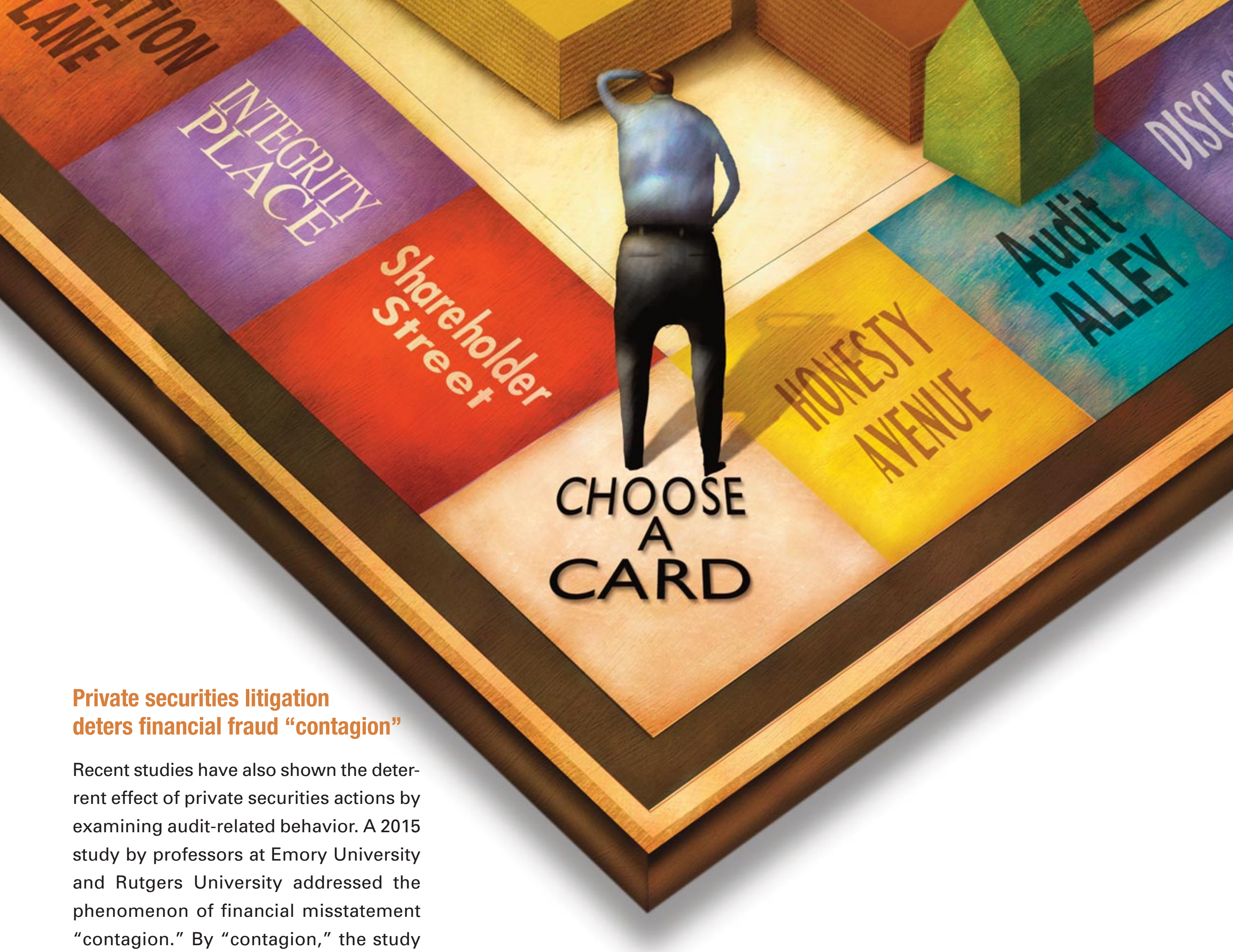
As discussed further below, these researchers have analyzed the measurable impacts of recent changes in legal standards and their findings reinforce the continued importance of class action practice to the integrity of the nation's securities markets.

Private securities litigation induces better corporate disclosures

Several researchers have documented a positive correlation between private securities enforcement litigation and improved corporate disclosures. Two recent studies, conducted in 2016 and 2017, showed the deterrent effect of private securities cases by examining market data before and after the 2010 decision in *Morrison v. National Australia Bank*. In that case, the US Supreme Court determined that certainsecurities claims could no longer be brought in federal courts if the plaintiffs' shares were purchased on foreign exchanges. This decision severely reduced potential litigation costs for certain cross-listed companies, i.e., companies which list their securities for trading on both US and foreign exchanges, with only a small portion of the shares trading on the US exchange.

One of the two studies, a 2017 study by professors at the Kellogg School of Management at Northwestern University, among others, compared the pre- and post-*Morrison* behavior of hundreds of cross-listed companies over a period of years. The study unequivocally concluded that "US private securities litigation has an important disciplining role on cross-listed firms' disclosure behavior" and that there was "consistent evidence that a reduction in litigation costs leads to a reduction in voluntary disclosure" to investors. The availability of private securities litigation leads to more informative corporate disclosures to investors because "there is a positive relation between expected private litigation costs and voluntary disclosure." In sum, after the *Morrison* decision decreased the litigation risk for cross-listed firms, the firms reduced the quality of their disclosures to investors.

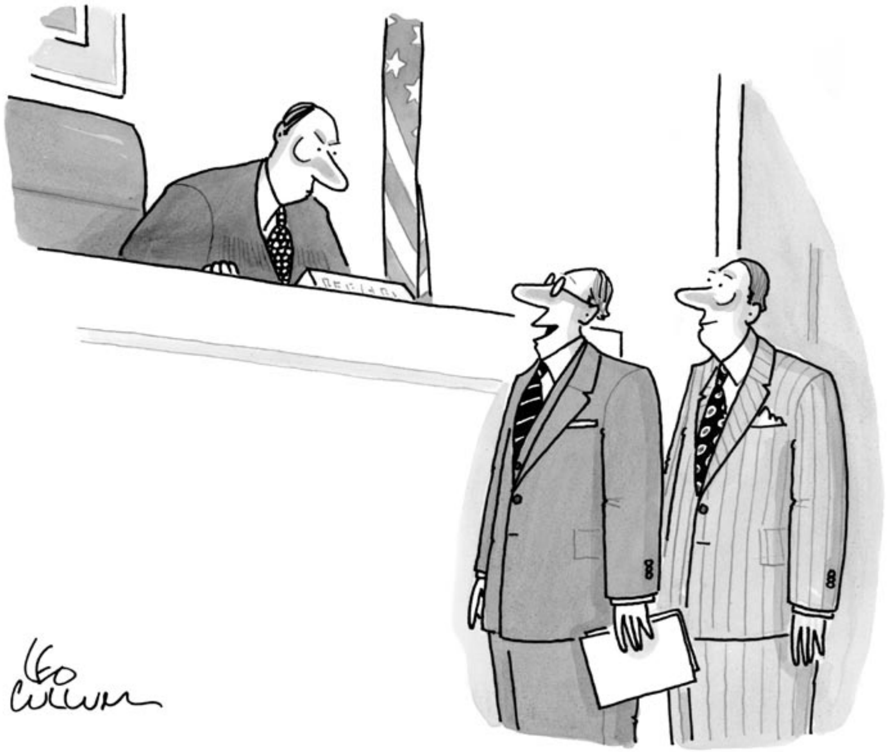
A 2016 study by Professor Sikochi of Harvard Business School similarly addressed the pre- and post-*Morrison* behavior of cross-listed firms. Using somewhat different analytical methodology, the study nonetheless arrived at remarkably similar results, finding evidence that "lower litigation risk reduces the cost [for companies] of withholding bad news" and "lower shareholder litigation risk is associated with deterioration in the information environment," i.e., a deterioration in the quality of the cross-listed company's disclosures. The study noted that there are many ways in which a reduced potential for securities litigation can harm companies' disclosures to investors. For example, in response to a reduction in litigation risks, firms may: (i) "reduce the frequency of management forecasts"; (ii) "reduce the precision of forecasts"; (iii) "omit material information"; (iv) "change disclosure tone"; or (v) "issue misleading statements." The study also noted that "the forecasting accuracy for cross-listed firms decrease[d] relative to US firms." The somber conclusion for investors is that it appears "the information environment is poorer for cross-listed firms relative to US firms in the wake of the Supreme Court ruling" in *Morrison*.



Private securities litigation deters financial fraud "contagion"

Recent studies have also shown the deterrent effect of private securities actions by examining audit-related behavior. A 2015 study by professors at Emory University and Rutgers University addressed the phenomenon of financial misstatement "contagion." By "contagion," the study described the recognized phenomenon whereby one firm in an industry admits to past financial misstatements and restates its financials, then other firms in the same industry commence similar or related accounting misconduct. Examining thousands of restatements between 1997 and 2008, the study found that peer firms chose "to begin misrepresentation after revelation of misconduct." Indeed, the study found that "restatement announcements that are not accompanied by class action litigation are associated with significant contagion." Such contagion, however, generally did not occur where a firm's restatement led to private securities litigation or governmental enforcement actions. The study reported that private securities litigation not only deterred the restating companies' industry peers from making financial misstatements, but also deterred other firms in the same metropolitan areas as the restating firms from committing such misstatements.

A recent study published in late 2017 by professors at Stanford Law School, Columbia Business School, and Harvard Business School, similarly showed a positive correlation between private securities law enforcement by shareholders and increased audit quality by public companies. The study examined changes in the legal standards governing private securities class actions in light of the Supreme Court's 2007 and 2011 rulings in *Tellabs v. Makor* and *Janus v. First Derivative*. Each of the two Supreme Court decisions resolved different splits in legal standards between the federal Courts of Appeals, so each decision changed the legal standards in different ways from one federal Court of Appeals to the next. Some jurisdictions became more friendly to private securities class actions, while others became less friendly. The authors note, for example, that by reducing liability for secondary actors such as auditors, "*Janus* most benefitted those auditors likely to be sued in the Fourth and Ninth Circuits." The study tracked these developments in detail, examining financial restatements, litigation events, and audit quality in the wake of the *Tellabs* and *Janus* decisions. The authors concluded that after both *Tellabs* and *Janus*, "audit



"My client would like to do his community service in the financial community."

quality…decreased in the [jurisdictions] where it became more difficult to bring Section 10(b) claims" for securities fraud. By contrast, "audit quality increased in the [jurisdictions] where it became easier to bring [the] Section 10(b) claims."

Securities litigation's proven deterrence of unlawful conduct is a boon to capital markets

For decades, investors have relied on the important protections of federal securities class actions to vindicate their rights and recover damages when victimized by fraud. While the financial benefits of such litigation have been obvious to investors over the years, the related deterrent effects have often been less visible or harder to quantify. In showing yet again the ability of securities class actions to deter misconduct and improve the integrity of the nation's financial markets, independent empirical analyses such as those discussed above should be welcome news for institutional investors who remain vigilant in protecting and enforcing their valuable shareholder rights. And for those who seek to restrict such class actions in the Trump era, these studies should provide ample warning of how weakening private enforcement of the securities laws would undermine our nation's securities markets and invite securities fraud.

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