Mapping the American Shareholder Litigation Experience

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Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Law

by

JAMES D. COX* and RANDALL S. THOMAS**

In this paper, we provide an overview of the most significant empirical research that has been conducted in recent years on the public and private enforcement of the U.S. federal securities laws. The evidence reviewed shows that the PSLRA’s provisions have largely achieved their intended purposes. For example, many more private suits are headed by an institutional lead plaintiff, such plaintiffs appear to fulfill the desired role of monitoring the suit’s prosecution and their presence is associated with suits yielding better settlements and lower attorneys’ fees awards. SEC enforcement efforts, while significant, have tended to focus on weaker targets, suggesting that the big fish get away.

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I. Introduction

As this symposium documents, class actions, and particularly securities class actions, are at the forefront of a worldwide debate on the desirability of enhancing the private enforcement of legal norms through the procedural device that allows large numbers of claims to be aggregated into a single suit. While this is a recent topic in most countries, the United States has forty years of extensive experience with securities class actions and therefore is a promising focal point for studying its operation and, more importantly, the effects of class actions.\(^1\)

There has long been recognition in the United States that private suits, and particularly class actions, are a desirable and necessary complement to government enforcement. The U.S. Supreme Court has endorsed this idea explicitly:

Private enforcement of the proxy rules provides a necessary supplement to Commission action. As in treble damage litigation, the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements.\(^2\)

As the above quote reflects, there is both private and public enforcement of the U.S. securities laws. In the U.S., an independent regulatory agency, the Securities and Exchange Commission (the "SEC") enjoys both broad regulatory and enforcement authority over securities transactions. The SEC promulgates guidelines for mandatory disclosures that must be met for public

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1 In 1968 the Federal Rules of Civil Procedure were amended to liberalize the availability of class actions in federal courts. This development, mimicked by state procedures, provided an important impetus for class actions. But there are equally important features of American law that nurture the developments of class actions. The "American Rule" provides that the loser in the litigation is not required to pay his opponents litigation costs. And, the fuel that drives the suit is the contingency fee arrangements that permits the plaintiff to pursue on behalf of an aggrieved class a claim without having to bear any of the litigation's cost because the class' counsel agrees to be paid only if the suit is successfully prosecuted and the court awards counsel fees and expenses.

2 While in this paper we focus solely on federal securities fraud class actions, we note that state court class actions and derivative suits are other important forms of representative shareholder litigation in the U.S. To get a sense of the relative magnitudes of these alternative forms of actions, see generally Robert B. Thompson & Randall S. Thomas, The Public and Private Faces of Derivative Lawsuits, 57 Vand. L. Rev. 1745 (2004) (including statistics on all class action and derivative lawsuits filed in Delaware during the two year period 1999–2000).

offerings as well as periodically by publicly traded firms. Its enforcement authority is not limited to public companies but reaches any violation committed in interstate commerce, an extremely broad concept in the U.S. In bringing enforcement actions, the SEC has a range of sanctions it might consider: a light reprimand, a cease-and-desist order it may issue without court approval, obtaining an injunction from a federal court, substantial fines, disgorgement orders, suspending trading in a public company’s securities, and barring individuals from serving as officers and directors of public companies. The SEC is not the only public prosecutor. The Department of Justice also has authority to prosecute violations criminally when the conduct involves a knowing violation and it believes pursuing the case is an appropriate use of its prosecutorial discretion. And, in our federal system, there is also public enforcement by the states, generally through the offices of their respective state attorney general. But, as the preceding quote reflects, there is substantial private enforcement by investors, frequently, but not always, through the medium of a class action.

Each enforcer has its strengths and weaknesses. On the government side of the equation, some might view public officials at the SEC as civic minded policymakers that seek to deter wrongdoing through a judicious mix of criminal, monetary and reputational penalties. An alternative perspective is that the SEC is comprised of bumbling bureaucrats, who are poorly informed about market conditions, under-incentivized to bring needed enforcement actions, and “captured” by the firms that they claim to regulate. Which prism is used to view the SEC’s enforcement efforts will crucially affect the future of securities enforcement efforts.

That class actions pose an agency problem on the plaintiffs’ side of the equation has long been recognized. To be sure, private class action attorneys

5 Gretchen Morgenson, Following Clues the SEC Didn’t, New York Times, Sunday Business, Feb. 1, 2009, at 1 (discussing the SEC’s failure to investigate both Bernard Madoff’s long running $50 billion fraud and a second fraud at Allied Capital, despite numerous tips concerning both frauds). These failures bring to mind a similar SEC failure to uncover massive fraud in the 1980s at Equity Funding. There the fraud was eventually revealed by an analyst, who the SEC subsequently filed insider trading charges against for his efforts, although their case was ultimately thrown out the U.S. Supreme Court. Dirks v. Securities and Exchange Commission, 463 U.S. 646 (1983).
6 Oddly, the two important problems that create agency costs of litigation on the defense side of these class actions have been largely ignored. The first problem relates to the corporation’s control over the defense counsel in these actions. As Baker and Griffith’s studies of D&O insurance carriers have highlighted, there are serious agency cost
that file securities fraud cases have strong incentives to ferret out fraud, punish
the wrongdoers and compensate injured investors. If they are successful in
doing so, these lawyers garner significant fees as well as increase their recovery
of their out-of-pocket expenses. However, the class action inherently has been
a poor vehicle to curb the attorney's natural tendency to maximize her utility
rather than the class generally. This may result in the attorney initiating suits
with little merit, settling strong suits for too little, and structuring the
settlement so that the costs are not borne by the actual wrongdoers. To see
how this occurs, we begin by understanding the overall structure of the
American class action.

The sine qua non of the class action is that common questions of law and fact
must predominate. This reflects the view that claims should be aggregated
when it is consistent with the efficient operation of the judicial system. The
presiding judge determines whether the criteria for class certification have
been met and, upon so finding, notice is given to all class members that they
will be bound by the results of the litigation unless they pursue the procedure
for "opting out" of the class. Many members of a securities class action are
small retail investors and have an insufficient stake in the suit's outcome to
engage in close monitoring of their attorneys' actions. The class action device
thus raises concerns that either the unmonitored representatives of the class,

J. 1795 (2007). The crux of the problem is that while the D&O carrier is in the real party in
interest in most securities fraud class action settlements, it is the corporate defendant in
these cases that retains legal counsel to defend the action and also controls the defense.
Whenever there is a divergence of interests between the D&O carrier and the corporate
defendant, the corporate defendant and defense counsel will advance the interests of the
Corporate defendant. This conflict is most pronounced in the negotiations over the
settlement of these cases, where the corporation and defense counsel will press hard to
settle cases because it is in the best interests of the corporate defendant even at the expense
of the interests of the insurance carrier. Id. at 1815 ("as long as the settlements are within
the D&O policy limits, corporations pressure D&O insurers to settle claims sooner and
at greater expense than an insurer in full control of defense and settlement would
allow.").

A second problem is the nature of defense counsel's fee arrangements with its corporate
client. Defense side lawyers bill the D&O carriers on an hourly basis. This creates
incentives for the attorneys to drag cases out unnecessarily, which is unchecked by the
company because the costs are all charged to the D&O policy. The D&O carrier is
powerless to control these billings. Id. at 1814–1815 ("D&O insurers are unable to
control the costs of defending claims..."). The excessive costs incurred because of this
problem cannot be estimated because the defendants' counsel fees are not disclosed
publicly so that researchers can study them.

Securities class actions occur in the federal court system where the procedural
requirements are set forth by Federal Rule of Civil Procedure 23.
and/or the class' counsel, will not pursue their own self-interest, rather than act in the interests of the class. 8

Concern generally over the incentives of class action attorneys arises because it is class' counsel, and not the class representative, that is the engine that drives the lawsuit. Historically, the class representative in securities litigation was a small, retail investor whose potential recovery in the case was miniscule compared to the imputed cost of any reasonable monitoring of the class' attorney's conduct of the suit. Indeed, because the class' counsel customarily invests substantial out-of-pocket costs to prosecute the suit, and incurs even more substantial opportunity costs by devoting time to the suit rather than to other suits, we can justifiably understand that it was usually the attorney, and not the class representative, that had the largest interest in the suit. This was generally believed to deflect the attorney's interest from that of the class to questions such as when to settle and for what amount. Indeed, because the attorney can manage risk of non success by maintaining a portfolio of suits, we can see that the attorney may be much more risk preferring than shareholders on questions of initiating suits. Hence, the possibility exists that class action attorneys may initiate suits that have low chances of recovery. At the same time, the class' counsel may be the strongest advocate for an early, and low, settlement, not viewing the marginal benefits of pursuing a larger settlement as worth expending the additional time and costs necessary to obtain the uncertain benefits of doing pushing the case further. And, the assured payment from an existing insurance policy or even the corporation's treasury may be much more promising to the contingent fee counsel than continuing the case against the defendant firm's officers, the likely alleged perpetrators of any fraud. These defendants can be expected to be much more resistant to a settlement that extracts sums from their personal assets as opposed to a settlement that leaves them whole at the expense of their corporation or its insurer.

The potential negative implications of the plaintiffs' side agency costs that surround securities class actions were very much in many legislators' minds when the Republican leaders of the U.S. Congress passed the Private Securities Litigation Reform Act of 1995, overriding a Presidential veto along the way. Despite the haste with which it was put together and passed, the statute contained a surprising number of useful innovations. Foremost among them was the "lead plaintiff" provision, whereby once a class action suit is filed the presiding court imparts nationwide notice inviting petitions by class members

8 See John C. Coffee, Jr., Understanding the Plaintiffs' Attorney: The Implications of Economic Theory for Private Enforcement Through Class and Derivative Actions, 86 Colum. L. Rev. 669 (1986)(reviewing the weak incentives for both the class' representative and class counsel to represent the broader interests of the class).
to seek the position as the pending suit’s lead plaintiff. When there are competing petitioners, the party with the most substantial losses to be recovered is presumptively the most adequate plaintiff.  

Another important provision of the PSLRA bars discovery by the suits’ plaintiff until the resolution of all pretrial motions lodged by the plaintiff. Discovery abuses were believed to occur in the pre-PSLRA era by plaintiffs filing suits setting forth bald allegations of a violation, thereby gaining access to the defendants’ records through discovery, and if those records revealed wrongdoing, amending the earlier complaint to detail the nature of the violation that was learned only through discovery.  

The PSLRA put an end to such a fishing expedition. The bar to discovery is coupled with the PSLRA requiring not only that the complaint must allege with particularity facts setting forth a violation, but that it do so in a way that establishes a “strong inference” that the violation was committed with either knowledge of falsity, or recklessness indifference of the truth. In 2007, the U.S. Supreme Court interpreted this standard to mean that to survive a defendant’s motion to dismiss the pleadings of both the plaintiff and the defendant when read together must set forth a “cogent and compelling” inference that it is at least equally as likely that a knowing or reckless misrepresentation was committed as not. With the adoption of the heightened pleading standard and the bar to discovery before testing all the defendants’ motions to dismiss, dismissal rates in securities class actions doubled in the wake of the heightened pleading standard being adopted in 1995.

9 As Cox and Thomas have shown in an earlier empirical analysis, institutional investors have been favored by courts in these “beauty” contests, winning the vast majority of disputed lead plaintiff positions. James D. Cox and Randall S. Thomas, Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions, 106 Columbia Law Review 1587, 1618-19 (2006).

10 One of the authors argued in favor of allowing such discovery to proceed in a tightly focused state court proceeding, much in the manner that the Delaware Supreme Court has suggested that derivative suit plaintiffs proceed in their efforts to obtain pre-filing discovery in derivative suits. Randall S. Thomas & Kenneth J. Martin, Using State Inspection Statutes for Discovery in Federal Securities Fraud Actions, 77 Boston University Law Review 69 (1997). However, this position has not been accepted in the courts as yet. See, e.g., Beiser v. PMC-Sierra Inc., 2009 Del. Ch. LEXIS 36 (Feb. 26, 2009).


12 See Elaine Buckberg, et. al., NERA Econ. Consulting, Recent Trends in Shareholder Class Action Litigation: Are WorldCom and Enron the New Standard? 3 (2005) (Before 1995, dismissal rates in securities class actions was 20.3%) and Ronald I. Miller, NERA Econ. Consulting, Recent Trends in Shareholder Class Action Litigation:
The hearings leading up to the passage of the PSLRA did attract some empirical support for reform efforts, but the empiricism was at best uneven. For example, one study based on a sample of six companies claimed to establish conclusively that the size settlements in securities fraud class actions bore no relationship to the intrinsic merits of the case. Subsequent work has demonstrated time and time again that this was an overly hasty conclusion that is unsupported by any existing large sample study of securities fraud class action settlements. Perhaps in response to our inadequate understanding of the various empirical effects of these actions, in the post-PSLRA period there has been an explosion of research on the provisions of the PSLRA and securities fraud class actions more generally. Much of this work focuses on the key question of whether the conduct of securities class actions improved after the enactment of the PSLRA.

In this paper, we provide an overview of the most significant empirical research that has been conducted in recent years on the public and private enforcement of the federal securities laws. We have tried to be comprehensive in our review of the newest scholarship, but more selective in reviewing articles that study events pre-dating the passage of the PSLRA, or that rely solely on data from the pre-PSLRA period, as the latter two types of study are often less relevant to the key issues in the field today. Moreover, our focus is on studies that are primarily empirical in nature, and therefore we omit a large number of more theoretical papers that explore important issues relating to many of the topics covered here. Finally, we note that this is a very dynamic area of research and new studies are appearing all the time. While we have done our best to locate the most recent work publicly available as of October of 2008, we apologize to any authors that we have failed to include in this review.

II. SEC Enforcement Actions

To understand the relative importance of public enforcement actions, we need to examine both the level of resources available to the SEC as well as how frequently they deploy their enforcement resources. This section first provides a brief overview of the SEC and its operations, then discusses what

Beyond the Mega-Settlements, Is Stabilization Ahead? 4 (2006) (during 1998–2003 dismissal rate in securities class actions was 40.3%).


In fact, as we discuss in section below, these later studies show that there are numerous merits related factors that affect settlement size.

For an earlier review that analyzes many of these early studies, as well as some later ones that we discuss, see Stephen J. Choi, The Evidence on Securities Class Actions, 57 Vanderbilt Law Review 1465 (2004).
we know about its funding and resource levels, and concludes with an analysis of its enforcement efforts. While we provide some background information, our main focus is on summarizing the empirical studies that have been conducted.

The SEC harkens back to Franklin D. Roosevelt's New Deal, being one of the independent regulatory agencies created to address the multiple forces that were believed to have led to the Great Depression. Its five commissioners are appointed by the President with the approval of the U.S. Senate. One of them is the agency's chairman and charged with the responsibility of overseeing its operations that are carried out through multiple divisions and bureaus. For the purposes of this paper, the most important of these is the Division of Enforcement.

A. Resources

One potential measure of the strength of public enforcement efforts is the budgetary resources and staffing levels for the public enforcer. The U.S. spends more on public enforcement activities than any other country in the world, although it falls well below Canada and Australia once these amounts are adjusted for the size of its stock markets. Better public enforcement should result from higher funding because "[h]igher budgets and greater staffing allow the regulator to examine allegations of wrongdoing, to write its rules carefully, to conduct market surveillance and review filings, and to act more often to remedy, prevent and punish wrongdoing." Not all of these actions fall within the scope of this survey, but intuitively, there should be a strong correlation, at least in the U.S. system, between bigger regulatory budgets and more enforcement activity.

Cox and Thomas examine the SEC's funding levels and enforcement for the period 1997–2002. They find that looking at all forms of enforcement actions, the SEC filed a total of between 500 and 600 proceedings annually over these six years. Only about one half of these actions are of the type that could possibly give rise to class action suits, since many actions the SEC

prosecutes involve broker-dealer violations and other regulated-party violations that do not lend themselves to suits by large numbers of aggrieved investors. Furthermore, Cox and Thomas document that severe resource limitations at the SEC have resulted in declining rates of review of mandatory company filings, high staff turnover, and greater numbers of departures of more experienced personnel.¹⁹

**B. SEC Enforcement Actions: Targeting and Size of Sanctions**

Cox and Thomas also examine the overlap of private class actions and public enforcement actions brought by the SEC. They seek to determine if private securities fraud class actions are a necessary supplement to SEC enforcement actions. First, they find that the total volume of SEC enforcement actions is relatively modest compared to the number of complaints that it receives and that only one-half of the enforcement actions it files could have parallel securities class actions. Even with its expanded powers to seek recoveries on behalf of investors under the Fair Funds Act, they find it unlikely that the SEC’s recoveries will displace those obtained in private actions. They go on to compile a sample of 248 private class actions filed from 1990 to 2001 and investigate how many of these cases overlap with SEC enforcement actions targeting the same firm. The overlap between public and private plaintiffs arises in only about 15% of the cases. Cox and Thomas show that private recoveries are larger and class actions settle faster at firms that are also targeted by SEC enforcement actions. Dissecting the characteristics of the SEC enforcement cases, however, they find during this time period that the SEC targeted firms that were mostly smaller firms suffering from financial distress. Interestingly, the SEC did not seem to select its targets for enforcement actions based on investors’ losses.

In a subsequent paper, Cox and Thomas examine SEC enforcement action characteristics using a sample of cases that includes a substantial number of post-2001 actions in an effort to see if the financial scandals that came to light in the wake of Enron’s collapse in late 2001 changed the SEC’s targeting parameters.²⁰ Their data set includes 389 class action settlements including 89 settlements in which the defendant company was also the object of a parallel SEC enforcement action. They find that SEC targeting patterns have shifted over time so that in the post-2000 time period, it was selecting targets based on

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¹⁹ Id. at 757–758.
investor losses, although still with a bias toward smaller targets. We can speculate that the differences noted in the post 2001 time period could be due to any one of multiple factors. This was the Enron-era of securities enforcement cases where multiple large market capitalization firms were found to have engaged in false financial reporting. Following Enron’s collapse, there was substantial public outcry regarding the number of reporting abuses by public companies which may have energized David to venture toward a field of giants. And, there was change in directors for the Division of Enforcement near the beginning of this observation period that may have contributed to the change.\textsuperscript{21}

An important related topic is the size of the sanction that is levied upon wrongdoers in an SEC enforcement action. In his classic work, Nobel laureate Gary Becker shows us that the frequency of anti-social behavior is a function, in part, of the probability of conviction per offense and the punishment per offense.\textsuperscript{22} Under this view, the sanctions incurred by fraudsters impart not only a message to those who might consider following their crooked path but should discourage some or many, depending on the actual experience with sanctions, from deceiving investors. Thus, the frequency and magnitude of sanctions are important in the deterrence of deceptive financial reporting. At the same time, we should be concerned that sanctions are proportional to the harm caused by the violation, otherwise enforcement may take on a random, overly harsh, appearance and thereby erode deterrence and lead to wasteful precautionary action.

Karpoff, et.al. in their study of 697 government securities law enforcement actions filed during the time period of 1978–2004 found that regulatory monetary sanctions imposed by the SEC increased with investor losses and decreased with the complexity of the fraudulent enterprise.\textsuperscript{23} They also found


\textsuperscript{23} Jonathan M. Karpoff, D. Scott Lee & Gerald S. Martin, The Legal Penalties for Misrepresentation (Univ. of Wash. Working Paper, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=933333 (included in their assessment of penalties were monetary and non-monetary sanctions imposed by the SEC and/or
that non-monetary regulatory sanctions increased with the number of violations of federal law, the number of regulatory proceedings and the number of defendants in the enforcement action, but were unrelated to investor losses. They conclude that regulators shift out of monetary penalties and into non-monetary penalties as the violations become more complex, perhaps because certain non-monetary penalties, such as jail time, are necessary for the perpetrators to internalize the very large costs of complex violations. Furthermore, they determine that private awards of damages increase with both complexity of the fraud and investor losses. Importantly, their study found the magnitude of sanctions is in step with legislative developments: in the period following the enactment of the Sarbanes-Oxley Act of 2002, sanctions increased just as they increased earlier after the sentencing guidelines for business organizations were established.

Not surprisingly, the announcement of an SEC enforcement action adversely and immediately impacts the value of the firm that is targeted. However, Muradoglu and Huskey find important differences in the size of the market response including larger negative reactions for more significant violations, whereas they observe smaller reactions for firms that communicated with the market about any pending action. These results are consistent with the claim that the market wants to be fully informed about the facts surrounding these actions, that it will punish uncertainty about these facts, and that once it is informed, it correctly assesses the severity of the violation.

There are also very large reputational penalties for firm’s targeted by SEC enforcement actions. Karpoff et al. studied a group of 585 firms that were subjected to SEC enforcement actions for financial misrepresentations from 1978–2002. On average, these firms lost 41% of their market value when the

Department of Justice as well as awards recovered by investors through class action suits).


25 Jonathan M. Karpoff, D. Scott Lee and Gerald S. Martin, The Cost to Firms of Cooking the Books, forthcoming Journal of Financial and Quantitative Analysis (2008). This is a very rich paper that contains a wealth of interesting results. The authors (i) measure the total legal penalties, including state-level sanctions, (ii) provide measures of the inflation effect, and (iii) show that the total market cap loss dwarfs the sum of the legal penalties and inflation readjustment effect (implying large reputational penalties). The paper also
market became aware of their misconduct. Karpoff et al. break this drop in value into components and show that while the SEC assessed an average of $23.5 million in penalties on these firms, the reputation penalty was 7.5 times the total of all penalties faced by the firm from all legal (SEC, DOJ and private securities fraud class action settlements) sources. While they conclude that firms that are caught cooking their books face very serious sanctions, they acknowledge that without better knowledge about the apprehension rate it is difficult to extrapolate their results to all firms.\(^2\)

To summarize, SEC enforcement historically is uneven, and the vast majority of private suits occur without there being a parallel SEC enforcement action. However, the market reacts negatively to news of an SEC enforcement action being initiated against a public company which is consistent with the claim that SEC enforcement actions, although occurring infrequently vis-à-vis private suits, may impact the degree of compliance with the securities laws. How strong this effect is, however, depends crucially on a missing variable—the likelihood of the SEC detecting the fraud. Recent events surrounding the Madoff scandal have cast some doubt on the SEC’s abilities to ferret out fraud,\(^2\) even when they are given ample notice of its likely existence, suggesting that the SEC may be underenforcing the securities laws.

One important unexplored research question is the impact of the political party of the SEC’s chairman, or the U.S. president, on its enforcement efforts. While the SEC is an independent agency, there may be significant ramifications arising out of the which political party picks its chairman.

### III. Private Class Actions

Securities fraud class actions are not a favored species in many quarters of America. In this regard, they are no doubt tainted by the company they keep, namely the general negative perception of class actions in American society today. With respect to securities class actions, complaints abound that they yield small, if any, real gains to investors with the true economic benefits going to the class' counsel, that the ultimate cost of the suit is borne not by the wrongdoers but by the corporation directly, or indirectly by its D&O insurance company, and that settlements systematically give the real wrongdoers, for example, the firm’s chief financial officer, a free pass by not requiring those that knowingly prepared and published the false report to

explores the determinants of reputational penalties and apprehension rates, although these parts of the paper largely suggestive.

26 Id. at 3.
27 See note 5 supra.
contribute to any settlement. And, perhaps the most damning complaint is that any class members who are diversified, such as institutional investors, do not benefit if they continue to hold stock in the defendant company after the suit. This so-called circularity problem of securities class action settlements argues that, because settlements paid largely by the defendant corporation come at the expense of its continuing owners, they yield no net gain to a class member who continues to own shares in the defendant after the settlement, or to diversified investors that hold stock in a large number of firms. Indeed, the payment of both plaintiffs’ and defendants’ counsel will lead to an overall net loss to these shareholders. There are also the excessive precautionary or over-compliance costs that the threats of private litigation stimulate. The argument flows from the belief that the more likely a company will be subject to non-trivial litigation expenses, the greater will be its efforts to prevent this occurrence so that its compliance costs will grow ever larger over time.

The counterarguments are equally compelling. First, the flip side of the over-compliance concerns is that private suits, to the extent they generally stimulate greater compliance, are themselves producing a social benefit. Corporate officers and directors are deterred from engaging in securities fraud, corporate governance structures at all firms are strengthened to avoid wrongdoing that could lead to such an action, and the SEC’s beleaguered enforcers are able to be more selective in their efforts, secure in the knowledge that the private attorneys will pick up the slack. As seen earlier, in the securities field, private suits, and particularly class actions, are welcomed in some quarters because they reflect the private enforcement of public laws.

Second, the circularity claim can be rebutted on several levels. First, not all investors are diversified or continue to own shares in the defendant company; hence, these shareholders may suffer uncompensated losses. Individual investors, employees purchasing company stock for their 401(k) plans, or in company sponsored employee stock ownership plans (ESOPs), and even undiversified institutional investors, such as hedge funds who often hold large

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28 Sadly the employees of many companies destroyed by securities fraud, such as Enron, lose both their jobs and their retirement funds when they are betrayed by their firm’s management. See Rick Bragg, Enron’s Collapse: Workers; Workers Feel Pain of Layoffs and Added Sting of Betrayal, N.Y. Times, Jan. 20, 2002, at 1 (“[The Enron scandal] . . . was a betrayal by executives who hid the corporation’s crumbling finances and fattened their bank accounts while their employees’ jobs and retirement funds—built from Enron stock—disappeared”).

29 Often portrayed as ways to encourage employees to feel more like owners of their businesses, ESOPs generally have the unfortunate feature that they result in an over-concentration of employee retirement funds in their employer’s stock.
positions in only a handful of companies,\textsuperscript{30} may fall into these categories. Furthermore, indexed investors, often touted as the holders of most equities in the U.S., actually hold a surprisingly small amount of the market suggesting that commentators have overestimated their potential importance.\textsuperscript{31} Second, we might well view all commercial litigation having such a circularity problem. For example, well diversified investors may own both Cisco and Northern Telecom. If there was a patent infringement judgment won by Cisco against Northern Telecom, this might be seen as yielding no net benefit to such a diversified shareholder. More generally, if all investors are diversified investors, then no type of intra-firm litigation will increase their overall welfare, and once attorneys' fees are deducted will show an overall loss of value. Nevertheless, we still recognize the benefits of the suit in part because of the social desirability of affirming an important principle that underlies the right vindicated, for example, that patent holders should be protected. Similarly, we should recognize there is a benefit to society from affirming the value of ensuring compliance with the disclosure requirements of the U.S. securities laws. Concerns about over-deterrence are better addressed by more precise formulations of the underlying securities laws, such as, tighter definitions of concepts like materiality that underpin many of the legal obligations faced by firms.\textsuperscript{32}

And finally, a broad response to criticism of securities class actions is that the alleged ills affecting them were largely corrected by the PSLRA. If plaintiffs' side agency litigation costs afflicted these cases because attorneys were pursuing their own interests at the expense of the class, then the lead plaintiff provision arguably has addressed them.\textsuperscript{33} If too many weak cases were permitted to move forward into discovery, then the PSLRA's stay on discovery until after a resolution of the defendants' motion to dismiss, and the statutory higher pleading standards for fraud, have addressed this problem as

\textsuperscript{30} One of the authors recently completed an extensive empirical investigation into hedge fund shareholder activism that involved examining publicly disclosed information about the investment portfolios of a large number of these activists. Many of these funds manage hundreds of millions of dollars in investment funds, yet hold only a tiny number of different stocks.


\textsuperscript{33} Unfortunately, the PSLRA did nothing to address the litigation agency cost problems on the defense side of these cases. See note 6 infra for further discussion of the nature of these costs.
well. In the remainder of this section, we seek to bring this debate into sharper focus by reviewing the empirical data for securities class actions.

A. Compensation and Deterrence

Litigation is almost never a value increasing activity, given the high costs to both the defendants and the plaintiffs of their respective attorneys’ fees. Securities fraud litigation is no different from other forms of litigation in this regard, although its costs are often dwarfed by the costs to the firm of committing the underlying fraud. A large number of studies have examined the stock price effects of the various events leading up to, and including, the filing of a securities fraud class action. A consistent finding is that the disclosure of a financial fraud yields a large negative market reaction to the bad news. Interestingly, stock analysts for the adversely affected firms do not generally downgrade the firm prior to the issuance of any corrective disclosures, but seem only to react after the announcement of the adverse tidings. However, informed parties, such as insiders and short sellers, become very active in trading the company’s stock in the months preceding the announcement of the corrective disclosures and higher net insider selling is correlated with higher analyst forecast error. This suggests that insiders are not fooled by the company’s false statements, but that outsiders, including analysts, small investors, and plaintiffs’ lawyers, are left in the dark until after the company makes corrective disclosures. Correspondingly, one can infer

34 Along these lines, Karpoff and Lott’s study of reputational harm to corporate defendants in criminal proceedings finds that firms suffer significant harm from committing fraud against corporate customers and suppliers. Jonathan M. Karpoff and John R. Lott, Jr., The Reputational Penalty Firms Bear from Committing Criminal Fraud, 36 Journal of Law and Economics 757 (1993). Similarly, Michael Block finds that firms suffer significant negative stock price effects when they commit fraud. Michael K. Block, Optimal Penalties, Criminal Law and the Control of Corporate Behavior, 71 Boston University Law Review 395 (1991).


37 Id. To the extent that such selling violates the insider trading prohibitions of the securities laws, or establishes that insiders had knowledge of the fraud prior to its public disclosure, this suggests that allegations that the company was acting with scienter when it failed to disclose the fraudulent activities are very credible.
that the losses from securities frauds impact outside investors more heavily than the well-compensated officers and other insiders.

The filing of a securities fraud lawsuit arising out of the same events that led to the fraudulent conduct, or corrective disclosures, leads to a separate and statistically significant decline in the company's stock price.\textsuperscript{38} There is some evidence that at the time of the filing of the case, the stock market efficiently estimates the strength of the plaintiff's case.\textsuperscript{39} This is consistent with findings in other studies that settlement values are related to the seriousness of the claims in the case, the length of the class period which measures the period of time over which shareholders were misled, and the degree of over-optimism in the firm's disclosures during the class period.\textsuperscript{40}

1. \textit{Circularity}

As discussed briefly above, a more broadly based challenge to the efficacy of securities class actions is premised upon the argument of circularity. This argument traces its roots back to the early law and economic writings that focused on the remedial wonders of portfolio theory for efficiently diversified investors. In a classic work, Professors Frank Easterbrook and Daniel Fischel advance the view that management misbehavior that affects a specific firm should not necessarily cause a loss to investors if investors held diversified portfolios because the randomness of firm-specific gains or losses would inevitably sum to zero.\textsuperscript{41} While, as noted above, such an argument can be made about all forms of intra-firm litigation where the firm's shares are held by diversified investors, in the context of securities class actions, the circularity argument claims that money resulting from settlements merely flows out of

\textsuperscript{38} See, e. g., Ferris & Pritchard, Stock Price Reaction, supra note 35.
\textsuperscript{40} James D. Beck and Sanjai Bhagat, Shareholder Litigation: Share Price Movements, News Releases and Settlement Amounts, 18 Managerial and Decision Economics 563, 564 (1997) (noting that these findings are limited to a sample of settled cases); James D. Cox and Randall S. Thomas, Does The Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions, 106 Columbia L. Rev. 1587 (2006) (also using a sample of settled cases).
one pocket of the institutional holder and into the other pocket of that same institution. Indeed, the circularity scenario is socially wasteful because the lawyers prosecuting and defending the suits impose non-trivial transaction costs that ultimately reduce the wealth of the institutional holders.

The one study of the circularity thesis concludes that before considering recoveries through litigation, large institutions generally break even from their investments in common stocks impacted by fraud allegations.\(^4\) Indeed, the study even finds such institutions are overcompensated as a result of the litigation. The latter insight offers some support for the plaintiff's attorney, i.e., they are not the deadweight loss their critics claim they are if their actions succeed in compensation being paid to their clients. Indeed, as our earlier discussion of Gary Becker's work showed, if a substantial number of frauds go unpunished, then overcompensation of investors in cases that do lead to a recovery will help to bolster compensation more in the direction of optimal deterrence. Moreover, major qualifications to this finding exist for the non-diversified institutional holder, such as a hedge fund whose holdings are concentrated in a few companies, or when the fraudulent reporting was in connection with a new issuance of securities such as occurs in acquisition transactions.

There is some evidence to the contrary. A recent working paper by Evans, using observational data and simulated trading data, finds not only that undiversified individual investors are likely to suffer net losses from securities fraud, but that large numbers of diversified institutional investors may also be harmed.\(^4\) She interprets these findings as inconsistent with claims that diversified investors suffer little or no harm from securities fraud.

No studies have sought to extend the circularity argument to other forms of litigation. Intuitively, it seems clear that all litigation between publicly traded firms will suffer from the circularity problem just as severely if all shareholders are diversified. If we accept the premise that the only shareholders that matter are diversified holders, then this suggests that boards of directors that are truly acting to maximize shareholder value should avoid filing suit against

\(^4\) Anjan V. Thakor, Jeffrey S. Nielsen & David A. Gulley, The Economic Reality of Securities Class Action Litigation, Navigant Consulting, prepared for U.S. Chamber of Commerce Institute for Legal Reform, Oct. 26, 2005. While these findings are quite intriguing, their generality is impossible to verify given the authors' unwillingness to disclose even the names of the companies in their sample. It also bears mentioning the funding source for this study is an organization that has publicly spearheaded a campaign to eliminate the private enforcement of the federal securities laws.

other firms, even in circumstances where they can enforce the firm’s legal claims, unless they can do so costlessly. For boards to do otherwise will decrease their shareholders’ overall wealth. Yet, we do not see this in the marketplace, nor do we hear it being seriously proposed in legislatures. Finally, we do not find such an injunction to be either practicable or desirable because it fails to take into account the value society gains by enforcing its laws, including the federal securities laws.

2. Claims Filing in Securities Fraud Class Actions

If the circularity argument and evidence in support of it was not enough to tarnish the image of securities class actions, its image is further dulled by the claims filing history of institutions in securities class actions. In two papers, Cox and Thomas examined a sample of securities class action settlements to assess whether institutional investors that held shares during the class period in those actions were filing claims with the settlement administrators to collect their portion of the settlement proceeds.44 In their first paper, using a group of 53 class action settlements, Cox and Thomas matched institutional investors’ Form 13F filings with the class periods for those cases to determine which institutions actively traded during the class period.45 They then mapped the names of those institutions against the beneficial ownership data for each claimant in the individual settlements to calculate what percentage of the institutions that could have made claims actually did make such claims. They found that only approximately one third of eligible institutions filed claims to recover from the settlement. They used a similar methodology in their second paper to analyze 118 securities fraud class action settlements and found that only about 28% of institutions filed claims in those cases. In combination the studies indict the diligence of institutions in pursuing their fair share of settled securities class actions.

It may well be the institutions’ poor record in submitting claims in settled securities class actions in part documents the correctness of the circularity perspective, i.e., having suffered no losses, they are ambivalent about seeking to recover easily available funds. An alternative hypothesis is that the amounts of money recovered in securities fraud class action settlements are insignificantly


45 Cox and Thomas, Leaving Money, supra note 44.
small to most institutional investors, given the vast sums of money that they manage for their beneficiaries. The logic of this argument depends in large part on the metric used for the comparison: if we compare recoveries to assets under management and calculate the amounts paid to institutions in comparison to them, then the recoveries are trivial on a percentage basis. However, if the average public pension fund recovers $6.75 million per year, and they can continue to recover that amount every year for the foreseeable future, then this is equivalent to an annuity worth $135 million. If we could compare this amount to the operating budget of an average size public pension fund, one suspects that the trustees of the fund would think it quite significant. Also, we believe it equally appropriate for funds to compare the benefits they garner by filing claims against the rather small cost they would incur by doing so. We believe this calculation would show far superior rates of return on their costs of submitting claims vis-à-vis what they derive through their investment activities. Our suppositions are supported by Choi and Fisch whose recent investigation finds that public pension funds have apparently responded to the earlier Cox and Thomas studies. Their data show that in their sample of self-selected respondents, public pension funds now file all of their claims in securities fraud class actions. One could infer that institutions are manifesting their support for securities fraud class actions by these changes in their behavior.

3. Deterrence

Compensation and deterrence frequently are joined together in debates over the social value of securities class actions. Much of the empirical research reviewed here bears directly on the former, but as seen here there is very little on the latter. To be sure, studies profile the differences between class actions with a parallel SEC action versus the larger number of suits where there is no parallel securities class actions, studies recount that officers who cook their

49 Choi and Fisch, supra note 47.
50 See James D. Cox, Compensation, Deterrence, And The Market As Boundaries For Derivative Suit Procedures, 52 Geo. Wash. L. Rev. 745 (1984)(examining the disconnection between courts’ overwhelming embrace that shareholder suits should be compensatory even though this seems improbable for multiple reasons examined in the article).
51 Cox and Thomas, SEC Enforcement Heuristics, supra note 18.
firm’s books are dismissed,\textsuperscript{52} and companies that are found to have cooked their books suffer reputational loss that is captured in their stock prices.\textsuperscript{53} But by far the greater part of empirical work bears more directly on compensation than deterrence.

This no doubt is because measuring the deterrence value of private suits is problematic. The costs of suits are visible: fees awarded to plaintiff’s counsel are usually matters of public record, the defendants and their insurers in such suits are painfully aware of the (publicly undisclosed) significant fees garnered by the defense side lawyers, and settlements and related insurance premiums are also observable. But what we don’t know is the level of precautionary measures to discourage and detect fraudulent reporting that would not be there but for the present looming threat of the securities class action. Business organizations employ financial reporting safe guards as part of their governance mechanisms for monitoring the stewardship of management. Just how much additional protection is embraced out of fear of the securities class action is at best speculative and indeterminate and, hence, beyond the empiricists’ reach.

Even if we could isolate the incremental precautionary efforts attributable to the threat of the securities class action, a complete inquiry would also necessitate that there be within this calculus measurement of the benefits flowing from these additional precautionary efforts. This portion of the inquiry is certain to be even more problematic than measuring the incremental precautionary efforts attributable to the risk of shareholder suits. We therefore are left with an incomplete analysis of the value of securities class action suits since data bearing on the compensatory functions of the suits is accessible but inputs relative to measuring deterrence are not. This is an extremely important area for future research.

\textbf{B. Settlement Size, Attorneys’ Fees, and the Lead Plaintiff Provision}

Enacted in late 1995, the PSLRA creates a rebuttable presumption that the shareholder with the largest financial interest in the firm should be named the lead plaintiff in a federal securities class action law suit. Congress intended this provision to harness the power of institutional investors, especially public pension funds, to act as monitors of plaintiffs’ attorneys in these cases. After a slow start, institutional investors began appearing more frequently as lead plaintiffs so that by 2007 institutional investors appeared in roughly 60% of

\textsuperscript{52} See Karpoff, et. al., The Cost to Firms of Cooking the Books, supra note 25.

\textsuperscript{53} Karpoff, et al., The Cost to Firms of Cooking the Books, supra note 25.
all securities class action settlements. Have institutional lead plaintiffs been effective in filling the role of litigation agency cost monitors?

One measure of effectiveness is whether these institutional lead plaintiffs have been able to increase the size of the settlements in their cases. Several studies have examined this question, using different samples of settlements drawn from different post-PSLRA time periods. All the studies have consistently found a strong correlation between the appearance of a public pension fund as a lead plaintiff and higher settlements. The earliest academic work is Choi, Fisch and Pritchard’s study using 122 post-PSLRA settlements from 1996–2000. They find that the presence of a public pension fund acting as a lead plaintiff is correlated with higher settlements for investors. They claim, however, that their model may be misspecified by failing to include control variables for the presence of an accounting restatement or of an SEC investigation. As a result, they cautiously opine they can not reject the possibility that institutional investors “cherry pick” the highest valued cases in which to appear. More recent papers control for these variables, yet still find strong linkages between the presence of public pension fund lead plaintiffs and higher settlement values, pointing in favor of finding a causal linkage.

The strong relationship between the presence of an institutional lead plaintiff and higher settlements is documented by several other studies using larger and more recent samples. Cox and Thomas look at the 1995–2002 time period for a sample of 260 post-PSLRA settlements. Controlling for a variety of other factors, including the presence of an SEC investigation, they find a positive and significant relationship between institutional lead plaintiffs and higher settlements. Cox, Thomas and Bai subsequently examined 627 post-PSLRA settlements for the 1996–2004 time period. They establish that institutional

56 Id. at 892.
58 Cox and Thomas, Does The Plaintiff Matter?, supra note 9.
investors are appearing in a larger number of securities class actions over time, and that public pension funds and labor union funds are the most commonly observed participants. Public pension fund lead plaintiffs are associated with the largest positive impact on settlement size, although labor union funds show a similar relationship, albeit the magnitude of their impact is smaller than that of public pension funds.60

In the most thorough study done to date, Perino uses a sample of 501 post-PSLRA cases from 1995–2004 to study the relationship between public pension fund participation as lead plaintiffs and settlement size.61 Controlling for accounting restatements and SEC investigations, as well as numerous other potential influences on settlement size, he concludes that “there is at least some reason to believe that self-selection [i.e. cherry picking] is not a significant problem here.”62 Perino also finds that cases with public pension fund lead plaintiffs show a greater number of docket entries and a higher ratio of settlement value to docket entries. This increased activity he interprets as support for the claim that institutional monitoring may reduce attorney shirking.

Perino’s paper also sheds light on the effect of institutional lead plaintiffs on attorney fee awards in securities fraud class action settlements. He concludes that “attorneys’ fee requests and fee awards are lower in cases with public pension lead plaintiffs, either because public pensions are sophisticated repeat players or as a result of attorney competition to represent these institutions.”63 This evidence is consistent with the claim that public pension funds are acting as effective monitors of class counsel in these actions.

In a related paper, Perino evaluates the effect of competition and the participation of experienced repeat players as lead plaintiffs on the level of attorneys’ fees in securities class actions.64 He finds “a significant negative correlation between public pension fund participation as lead plaintiffs and the size of fee requests and fee awards.”65 He further uncovers negative correlations between fee levels and experienced courts, as well as the correlation of fees to repeat players in securities litigation. These results are

60 Id. at 379.
61 Michael A. Perino, Institutional Activism, supra note 57.
62 Id. at 23. See also, Randall S. Thomas, Public Pension Funds As Shareholder Activists: A Comment on Choi and Fisch, Vanderbilt Law Review En Banc (2008).
63 Perino, Institutional Activism, supra note 57, at 3.
65 Id. at 2.
consistent with the claim that there is stronger plaintiffs' side litigation agency cost monitoring by institutional lead plaintiffs and experienced judges.

In sum, these papers show that the lead plaintiff provision has had many of its intended effects. Institutional lead plaintiffs are appearing in large numbers, raising settlement values and decreasing attorneys’ fees. In essence, institutional lead plaintiffs are proving to be socially useful monitors of securities class action prosecutions. This supports a belief that the PSLRA has been successful in this regard.

C. The Effect of the Other Provisions of the PSLRA

The enactment of the PSLRA in 1995 had several other important effects on private securities fraud class actions. A number of its provisions changed significant parameters for filing and litigating these cases. Recall that one provision in the PSLRA stopped all discovery efforts by the plaintiff once the defendant filed a motion to dismiss. Effectively, this meant that while the plaintiff could rely on public information in drafting their initial complaint, they needed to spend significant amounts of time and money conducting private investigations of the merits of their claims in order to uncover any non-public information about fraudulent activity. Prior to the PSLRA, the plaintiff did not need to do so because they could rely on full blown discovery to uncover evidence of wrongdoing.

In this section, we examine the empirical studies that have focused on the impact of a variety of different aspects of the PSLRA, including its heightened pleading requirement for fraud, its safe harbor for the disclosure of forward looking statements, and its impact on auditor liability. Our focus is on whether the PSLRA has effectively remedied the problems that it was designed to address: too much frivolous litigation and high plaintiffs' side litigation agency costs. While we have already seen that the lead plaintiff provision has succeeded remarkably well, how well has the rest of it worked?

66 An interesting paper by Choi and Thompson reports that some institutional investors appear to have developed repeat relationships with certain plaintiffs’ law firms. Stephen J. Choi and Robert B. Thompson, 106 Columbia Law Review 1489 (2006). While they interpret this finding as potentially indicating an “ongoing dependency of certain institutions on plaintiff law firms for advice and expertise” that may undermine the effects of increased competition among plaintiffs law firms to become lead counsel, id. at 1530, a more benign interpretation might be that those firms have established that they provided quality services to these particular clients in the past and therefore receive repeat business.

1. The Stock Market Reaction to the Enactment of the PSLRA

Several papers have looked at the stock market’s reaction to the passage of the PSLRA. Johnson, Kasznik and Nelson examined 489 high technology firms to observe how their stock prices reacted to the passage of the PSLRA. They found that on average the value of these firms increased with the enactment of the statute, with a more significant increase at firms that faced higher expected likelihoods of being sued. Spiess and Tkac reached similar results with a much larger sample of firms drawn from four high litigation industries – electronics, computers, retailing and pharmaceuticals/biotechnology.

By comparison, using data from the same set of industries as Spiess and Tkac, Ali and Kallapur find that investors in these industries reacted negatively to the passage of the statute. Ali and Kallapur point out numerous confounding events that render ambiguous the interpretation of the stock price changes relied upon by the two earlier studies just discussed. Instead, they conduct additional analyses of several other legislative events, calculating the cumulative abnormal returns to investors over the legislative period and an additional analysis of other events affecting investors’ ability to sue for fraud. They conclude that shareholders lost wealth because of the passage of the PSLRA. These results plainly conflict with the earlier studies, rendering it difficult to conclude whether the enactment of the PSLRA was perceived by the market as a value increasing or decreasing event.

2. PSLRA’s Heightened Pleading Requirements

When the PSLRA was enacted, one important question was how courts would interpret its provisions that related to pleading scienter in a securities fraud class action. The statute itself was quite ambiguous and the various circuit courts’ issued different rules that applied in different areas of the country. The Ninth Circuit, which contains Silicon Valley and many of the high technology firms, issued an important early decision in a case called, In Re Silicon

Graphics Inc. Securities Litigation. It adopted a very stringent pleading standard for alleging fraud, which is the subject of a paper by Johnson, Nelson and Pritchard. Using the event study methodology, those authors investigated the effect of the announcement of this decision upon the stock prices of 277 high technology companies both in the Ninth Circuit and elsewhere. They found a statistically significant positive stock price reaction for the sample firms, with a greater increase for the firms located in the Ninth Circuit. They explain the observed difference in returns as supporting their hypothesis that the higher pleading standard increased shareholder wealth by decreasing the likelihood of these firms being sued successfully.

Pritchard and Sale have also studied the effect of different circuit courts' interpretation of the PSLRA's requirements on the outcome of motions to dismiss. Using cases decided by the Second and Ninth Circuit, they find that the more stringent Silicon Graphics fraud pleading standard in the Ninth Circuit is correlated with a higher dismissal rate for securities fraud class actions. They also uncover several significant differences in how the two circuits react to allegations of accounting principle violations, claims of false forward looking statements, and allegations of violations of the 1933 Securities Act.

Although this research supports claims that the higher fraud pleading standards have had their intended consequences of raising dismissal rates for securities fraud class actions, the U.S. Supreme Court's recent decision in the Tellabs case muddies the waters by creating new doubts about what standard will be applied by the circuit courts in the future. Cox, Thomas and Bai analyze the effects of this decision and conclude that it keeps alive the federal appellate courts' disparate standards. They do find empirically, however, that these differences do not appear to lead to forum shopping.

71 In re Silicon Graphics Inc. Securities Litigation, 183 F.3d 970 (9th Cir. 1999). A recent Ninth Circuit decision appears to overrule, or at least back away from, the strict pleading standard in Silicon Graphics. See South Ferry LP #2 v. Killinger, F3d (9th Cir. 2008).
75 Id.

Before the PSLRA, there was a good deal of litigation focused on allegedly false forward looking statements regarding the firm’s, or its products’, likely performance. Generally, the targets of such suits were technology firms residing in Silicon Valley, near the gun sights of the legendary plaintiffs’ class action lawyer, Bill Lerach. One central provision of the PSLRA was a safe harbor provision for companies making such forward looking statements.

Professors Johnson, Nelson and Pritchard, using a data base comprised exclusively of suits filed during 1991–2000 against computer hardware and software firms, find a decided shift away from such litigation following the enactment of the PSLRA. Post-PSLRA, they show that securities class actions increasingly target accounting fraud (rising from 31 percent of the cases in the pre-PSLRA era to 61 percent in the post-PSLRA era), while relatively few post-PSLRA suits focus on forward looking statements. They attribute the latter result to the safe harbor Congress provided for forward looking statements.

Further elaborating on the shift away from forward looking statement allegations, they find firms that announce an accounting restatement are more likely to be sued as are firms whose insiders engage in abnormal stock sales. Each of these considerations may well reflect the impact of the heightened pleading requirement which demands objective evidence to be set forth in the complaint with particularity supporting allegations of fraudulent reporting; courts responding to this approach have, among other things, embraced evidence of the managers’ possible motive for false reporting which is strongly supported by allegations they traded on inside information. Similarly, an accounting restatement, which by itself creates no inference of fraud, does strengthen the inference than can be drawn from other factors set forth in the complaint. Interestingly, restatements are not associated with settlement outcomes in the pre-PSLRA era but are for the post-PSLRA era.

A related question is whether the PSLRA’s safe harbor provisions for the disclosure of forward looking information led companies to increase the amount of this type of information that they provide to the public. Johnson, Kasznik and Nelson using a sample of high technology and pharmaceutical firms’ disclosures from 1994–1996, determine that, controlling for other

77 Id. at 636.
78 Id. at 642.
79 Id. at 646–47.
factors that may affect the disclosure decision, post-PSLRA there have been significant increases in both the frequency of firms issuing forecasts and the mean number of forecasts issued in the first year after the passage of the PSLRA. These authors also find no evidence of any decrease in the quality of the forecasts issued by firms, determining that these forecasts did not appear to be either more optimistic or noisier. A more recent related paper by Brown, Hillegeist and Lo finds that increased litigation risk for a company is associated with forecasts being released earlier and being more precise. They also find that higher litigation risk is “associated with a higher proportion of news being released when firms have bad news.” Summarizing the evidence, here too it appears the PSLRA achieved its objective. Suits for forward-looking statements have declined, the frequency of forecasting has increased, and the relative accuracy of forecasts has not been adversely affected by the protective safe harbor.

4. Auditor Liability

Even though the securities class action has been a robust, some might even say menacing, feature of U.S. capital markets for at least four decades, empirical investigation of its impact on third party defendants, such as auditors, is still relatively undeveloped. While there have long been cries from the industry that unchecked securities class actions will lead to the demise of another major accounting firm, there has been little in the way of objective evidence compiled by disinterested researchers that this is the case. Of course, we are well aware that the Big Five became the Final Four international accounting firms when Arthur Andersen ceased to exist. That firm’s departure, however, was not the result of private liability because of its allegedly faulty audits of such fraud icons as Enron, Arizona Baptist Foundation, etc., but rather stemmed from a decision by the U.S. Department of Justice to indict Arthur Anderson for its complicity in its clients’ frauds.

82 Id. at 1.
83 Indeed, any commentator that tries to lay the prospective blame for future deaths among the Final Four on the plaintiffs bar must address the question why these attorneys, who are repeat players in the game, would want to eliminate such an enticing source of potential future benefits.
Several studies examine the reasons why auditors are named as defendants in securities fraud class actions. An early study by Fuerman, using pre-PSLRA data, examines the risk factors that can increase the likelihood that an auditor is named as a defendant in a private securities fraud class action.\(^8^4\) He finds that, whenever an auditor is charged with wrongdoing (along with the company it was auditing) by the SEC in an Accounting and Auditing Enforcement Release ("AAER"), it is also inevitably named as a defendant in a securities fraud class action. However, if only the company is charged in the AAER by the SEC, and not the auditor, and this is the only risk factor, the auditor is not under these circumstances named in a securities fraud suit as a defendant. Finally, Fuerman determines that the more risk factors that are present, the more likely it is an auditor will be named as a defendant.\(^8^5\)

A second study of why and how frequently auditors are named as defendants in securities fraud class actions is by Gilbertson and Avilla.\(^8^6\) Drawing on settlement data for cases settled from 1990–1993, in other words pre-PSLRA cases, they find that beginning in October of 1989, auditors were named less frequently as co-defendants in securities fraud class actions (26% of the time prior to this time period, but only 16% of the time after it). They also found that auditors are more likely to be named as co-defendants in situations where they were involved with an IPO or a bankrupt company. However, the size of the defendant company, the presence of an SEC enforcement action against the defendant company, and a change of auditors within the two years prior to the class period, did not have significant effects on their likelihood of being co-defendants.

Palmrose and Scholz use pre-PSLRA data to examine lawsuits against auditors that audited firms that were subsequently required to make accounting restatements.\(^8^7\) While prior research had found that accounting restatements are associated with an increased risk of being targeted by a securities fraud class action, they focus more acutely by inquiring into whether the type of restatement matters. They divide their sample into firms making economic accounting restatements and firms making technical accounting restatements. They find that auditors are more likely to be sued

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85 The risk factors he identifies are the AAER, bankruptcy, above average length of class period, and accounting restatements. Id. at 79.
over economic restatements rather than technical restatements, and that revenue restatements are the driving force for this result.88

One post-PSLRA study uses D&O insurance premiums as a measure of business, corporate governance and disclosure risks. It finds that accounting risk is priced in D&O insurance policies by the carriers as part of their assessment of an insured company’s litigation risk, but that there does not appear to be any significant change in litigation risk in the post-PSLRA period.89

Among the missing facts that need to be gathered is a crisp assessment of the true risk faced by Big Four, so-called second-tier accounting firms, and all other accounting firms. The risk referred to here is their respective abilities to withstand liability, and most particularly, just what level of liability can they sustain. Among the questions that come to mind are: relative free cash flow, net worth, and profitability of the accounting firm (historically comparing such inputs with time-matched litigation and settlement expenditures would further sharpen the analysis for going forward). It is also important to have a better understanding of the availability and related limitations on reinsurance for the liability accounting firms face and currently self-insure. It is our understanding that this information is not publicly available in the U.S.90

The most recent theoretical study using a mix of data and self-constructed estimates to model the chances that accounting firms face catastrophic liability concludes that these risks are significant over a five year period.91 Even this conclusion is qualified since much guesswork underlies the variables imputed into the calculations to reach this conclusion.92 In contrast, a study of U.K. based accounting firms examined the limited financial information public accounting firms are required to disclose. The study concluded that the case

88 Id. at 26.
90 See e.g., D. L. Green, Litigation Risk for Auditors and Society, 10 Critical Perspectives on Accounting 339 (1999)(lamenting the absence of data about accounting firms prevents an evaluation of the seriousness of the risk accounting firms face).
92 For example, given the fact that on average five years elapse between the filing of a securities fraud case and any possible settlement, should such an analysis include the likelihood that accounting firms will raise their prices for their services to reflect future anticipated securities fraud liabilities? Given the strong market power of the Final Four accounting firms, it seems at least plausible to think that they could do so relatively easily, but by how much and over what period of time?
for limiting their liability was not supported by the data at hand. To the extent that any consideration is to be given to imposing a ceiling on accountants' liability (whether expressed in absolute amount or determinable via an algorithm), or for that matter any other approach to insulating accounting firms from liability shocks, public disclosure of data bearing on their financial position and performance seems absolutely essential.

To be sure, another factor to consider is the relative risk of suit against the accounting firm. There is limited data on this point but it shows an extremely small number of suits and settlements against accounting firms in the post-PSLRA period. On the other hand, these numbers go to the probability portion of the exposure equation. Those engaged in risky activity assess their overall exposure by the combination of the probability of an adverse outcome and the magnitude of that outcome. It is the latter factor, the magnitude of an adverse outcome that assumes significance in the current debate. Even with a low probability of a cataclysmic liability event occurring, the event nonetheless achieves significance due to its size relative to net worth (or presumably so, since we do not have data on this we can only surmise this is the case). Hence, the fear is that failure to detect accounting fraud of a large capitalization audit client exposes the auditing firm to the prospect of crushing liability since we can expect losses suffered by investors to increase as the relative market capitalization of the audit client increases. It is the magnitude, and not solely the probability, component of the risk-exposure-calculation that no doubt drives the accounting profession's quest for meaningful limitations on their exposure.

Thus, the threat that securities class actions pose to the sustainability of large accounting firms is of great concern but remains difficult to assess because of the absence of data bearing on the relative financial frailty of individual firms.

93 See D. R. Gwilliam, Changes In The Legal Environment in Current Issues in Auditing (M. Sherer & S. Turley eds., 3d Ed. 2004).
5. Do the Merits Matter More or Less?

Alexander's early study of a small sample of securities fraud class action settlements in cases involving IPOs raised the question of whether the merits mattered in terms of the size of settlements in these cases.\(^9\) She claimed that these settlements were not based on the strength of the plaintiffs' case, but rather all settled at roughly 25% of potential damages. Although this study was widely cited by critics of securities fraud class actions during the Congressional consideration of the PSLRA, subsequent research appears to discredit it by identifying a large number of factors related to the strength of the plaintiffs' claims that are correlated with higher settlement values.

For example, Cox and Thomas find that settlement size is highly and positively correlated with the presence of an SEC enforcement action, the length of the class period, the size of the defendant corporation, the presence of an institutional lead plaintiff and the amount of the estimated losses for the class.\(^6\) Perino reports similar results, finding that the presence of a public pension fund, longer class periods, greater total assets of the defendant firm, SEC enforcement actions, accounting restatements, the presence of an underwriter defendant and estimated damages are all positively and significantly related to settlement size, while bankruptcy filing by the defendant firm is negatively and significantly related to settlement size.\(^7\) Simmons and Ryan (from the defense side consulting firm Cornerstone Research) also discover that a large number of variables are correlated with settlement size, including the defendant firm's total assets, restatements, the presence of an SEC enforcement action, accountant or underwriter defendants, public pension fund lead plaintiff, and estimated losses of the shareholder class.\(^8\) All of these studies are consistent with the view that the merits of the plaintiffs' case impacts the overall settlement size.

In one recent paper, Choi takes a broader view of the PSLRA's impact on federal securities litigation. He inquires whether the PSLRA screening effects are limited to non-meritorious cases.\(^9\) Choi points out that the PSLRA, while raising the bar against the filing of frivolous litigation, may also make it harder for plaintiffs to bring meritorious cases that lack the necessary outward indicia.

\(^6\) Cox and Thomas, Does The Plaintiff Matter?, supra note 9, at 1628.
\(^7\) Perino, Institutional Activism, supra note 54, at 23.
\(^8\) Laura E. Simmons and Ellen M. Ryan, Securities Class Action Settlements: 2007 Review and Analysis (Cornerstone Research 2008), at 10.
of fraud to satisfy these more difficult filing hurdles. Using a data set containing all IPOs of U.S. corporations from 1990–1999, he finds that pre-PSLRA non-nuisance suits without “hard evidence” of fraud, such as an SEC investigation, or an accounting restatement, would be less likely to be filed in the post-PSLRA period and have a greater likelihood of being dismissed. Choi concludes that, while the PSLRA made it harder to bring frivolous actions, it also made it harder to bring meritorious ones. Professors Choi, Nelson and Pritchard make a number of complementary findings to Choi’s just discussed work in a later paper, including that the PSLRA had the effect of discouraging suits that would have produced positive, non-nuisance settlements in the pre-PSLRA time period.

We therefore see that merits do appear to matter in the settlements reached in class actions. Somewhat ominously, however, Professor Choi’s study reveals that in the post-PSLRA era the merits sometimes are not enough to enable valid suits to survive the PSLRA’s discovery bar and heightened pleading requirement.

6. Cases Filed, Speed of Filing and Percentage of Damages Recovered

Three other potential indicia of high plaintiffs’ side litigation agency costs are the number of securities fraud class actions filed annually, the length of time elapsed between the announcement of a potential fraudulent occurrence and the filing of such an action and the percentage of damages recovered in a settlement. One early study by Perino of the effects of the PSLRA found that data from the 1996–2001 period claimed that the number of securities class actions filed after the enactment of the statute had increased, that the number of these suits against high technology issuers had remained relatively steady and that cases continued to be filed early in an effort to get to the courthouse first. He concluded that the PSLRA was not working as Congress had intended it.

100 Id. at 601–602.
Looking first at the overall numbers of suits, in the years following the passage of the PSLRA, the number of securities fraud class actions filed has fluctuated from year to year substantially. A 2008 survey by Cornerstone Research shows that from 1996 to 2007 the number of securities fraud class actions filed in the U.S. varied from a low of 111 to a high of 242 with the average close to 192 cases per year.\(^{104}\) This is lower than the average for 1991–1994 (185 total suits) that are reported in Perino’s paper, although the difference seems unlikely to be significant. However, if we dig deeper into the Cornerstone figures and exclude cases that are not listed as arising out of special one-time issues (such as the options backdating scandals), the average case filings for the 2006–2008 period drop to about 110 securities fraud cases a year, a much larger decline.\(^{105}\) These trends could, of course, change in the future.

Filing time changes are harder to assess. The initial filing of a complaint in the post-PSLRA world is a less significant event than prior to 1995 because of the lead plaintiff provision. The lead plaintiff provision requires a notice to be sent out to all affected investors asking them if they wish to petition to become the lead plaintiff for any putative class of security holders. This effectively delays the commencement of the case for several months while investors file their petitions and the court decides whom to select amongst them. For that reason, the race to the courthouse effect is significantly mitigated and most plaintiffs’ law firms will now delay filing a case until they have conducted significant pre-filing discovery.

A number of defense side commentators have claimed that securities fraud class actions recover only a small fraction of the damages incurred by investors.\(^{106}\) While we are not privy to the models used in making these calculations, the denominators in these fractions appear to be calculated without reference to the very sophisticated damage models utilized by defendants in individual cases involving securities fraud class action claims. Rather, these published values seem to utilize relatively simple, so-called “plaintiffs’ damages” models, that calculate damages based on straightforward calculations of stock price drop times trading volume. While these plaintiffs’ damages models have the advantage of simplicity, and can be employed using publicly available data, they are only one possible measure of damages and will routinely yield very high values for the denominator in a percentage of damages recovered calculation. A more meaningful measure of the percentage

\(^{104}\) Cornerstone Research, Securities Class Action Filings 2008: A Year in Review (available at www.cornerstone.com).

\(^{105}\) Id. at 4.

\(^{106}\) See, e.g., Laura Simmons and Ellen Ryan, Securities Class Action Settlements, 2007 Review and Analysis, Cornerstone Research, at 7 (claiming that settlements during 1996–2006 recovered a median of 3.6% of estimated damages).
of damages recovered could be constructed only if the parties to these cases are required to disclose as part of any settlement the damage models and calculations that formed the basis for their agreement to settle the case. Until that time, researchers will be unable to make informed estimates of the important parameters for these calculations.

IV. Norms and Culture

A. Who Detects Fraud?

We are now well into the revisionist era regarding the efficiency of capital markets. While at one time it could be safely proclaimed that the efficient market hypothesis is the “context in which serious discussions of financial markets takes place,”107 today this statement stands substantially qualified in the wake of the wealth of behavioral economic literature that supports a view that markets are noisy. But if markets are not all knowing, driven by hundreds of data crunching analysts to reach the “right” conclusions, the contemplative researcher is left to ponder the question, how does securities fraud get detected?

Griffin’s study of 847 companies who had restated their financial performance, or made some other corrective disclosure, and had subsequently been the subject of a securities class action, found that analysts were not the first to detect the accounting changes at reporting companies.108 To be sure, the analysts make their most significant revisions of covered companies in the month of the restatement/corrective disclosure is announced.109 Nonetheless, their actions followed those of insiders and short-sellers whose abnormal trading behavior preceded the corrective disclosure by several months. Thus, financial frauds, like so many corporate secrets, appear not to be well kept secrets as their announcement is preceded by abnormal price and trading volume movements in the company’s securities. Equally of interest is that in the period after the restatement/corrective disclosure, the number of analysts covering these firms declines significantly.110

109 Not surprisingly this is also the same time frame when holdings by financial institutions decrease significantly.
110 Id.
Furthermore, the SEC seems not to be the most important actor in detecting corporate fraud. Dyck, Morse and Zingales studied a sample of 230 cases of corporate fraud over the time period 1996 to 2004. They found that the SEC was responsible for uncovering only six percent of these frauds. In their study, they saw larger numbers of these cases being detected by financial analysts, auditors, short sellers and equity holders. Finally, they found that private securities litigation uncovers relatively few frauds.

Thus, the traditional guardian angels of investors – analysts, the SEC, and private suits – are not the first to sense and react to the foul odor of financial fraud. Insiders and their probable tippees are the first to reflect the advent of a later corrective disclosure, and will benefit from doing so before other investors have an opportunity to react.

B. Corporate Governance, Executive Compensation and Shareholder Litigation

Good corporate governance practices should lead to better quality disclosures, better monitoring of management, a reduced incidence of fraudulent misconduct by corporate managers and an improved alignment of corporate managers' incentives with those of shareholders. Firms that commit fraud generally have poor corporate governance structures relative to other firms. These firms will have fewer outside board members, a lower number of audit committee meetings, more frequently join the positions of CEO and Chairman of the Board, and are less likely to use Big Four accounting firms. This raises the questions of whether securities fraud class actions target firms with weak corporate governance systems and what effect the filing of such a suit may have on the targeted firm’s future corporate governance practices.

A number of studies seek to tease out the relationships between corporate governance practices and securities fraud litigation. Strahan studies whether securities fraud class actions mitigate the conflicts that exist between managers

112 Id. at 2.
113 These findings support a call for stronger enforcement of the insider trading rules by the SEC and private parties.
and shareholders in a dispersed ownership system. He finds that firms with greater ex ante levels of corporate governance problems are more likely to be sued in securities fraud class actions. He also finds that class actions can lead to corporate governance improvements with the likelihood of CEO turnover increasing by almost fourteen percent when an above average quality securities fraud class action is filed, controlling for other factors.

Bohn and Choi provide similar findings about the link between corporate governance structures and the likelihood of being sued in a securities fraud class action. They find that firms with weak corporate governance structures are more likely to face such a suit than a set of matched firms. Moreover, they discover that the targeted firms had fewer outside directors on their boards and that these firms' directors held relatively fewer directorships at other firms than the matched sample firms.

In another paper, Mohan examines how a firm's corporate governance structure may affect the quality of its disclosures and whether better quality disclosures in turn lead to a lower likelihood of being targeted with a securities fraud class action. Mohan finds that firms with stronger corporate governance practices make better disclosures and that this leads to a reduced risk of being sued in a securities fraud class action. These findings provide an interesting foundation for Beck's and Bhagat's observation that companies that disclose unusually optimistic earnings projections are more likely to be targeted with securities fraud class actions.

Although not specifically focused on securities fraud class actions, a related study by MarcuiKayityte, et al., finds that after accusations of fraud, companies raise the number of independent directors on their boards and oversight committees, although operating performance and stock price performance did not improve compared to a matched sample of firms that

116 Id. at 25.
118 Id. at 962.
James D. Cox and Randall S. Thomas were not accused of fraud. They conclude that firms improve their internal monitoring systems after experiencing corporate fraud and that these changes help to mend the harm caused by the fraud and restore the firm’s reputation. To the extent that securities fraud class actions are filed following the announcement of a fraud, we would anticipate finding a similar correlation between corporate governance improvements and these suits, although teasing out a causal relationship may prove very difficult. This seems like a promising area for further research.

A number of other studies have examined how corporate pay practices affect the likelihood of fraud and the filing of securities fraud class actions. Agency theory predicts that in public corporations with widely dispersed share ownership that top executives should be given restricted stock and stock options as part of their compensation package to better align their interests with those of the firm’s investors. Reflecting this thinking, incentive pay levels at American corporations have rapidly escalated since 1980 and reached levels far in excess of those seen at virtually all non-U.S. companies. Optimal contracting theory has generally assumed that stock price and other performance hurdles attached to the variable components of executive pay are not manipulated, even though in recent years it has become increasingly open to question whether this is correct. As a result, more scholars have begun studying the connections between top executives’ pay package composition and pay levels to determine if they may be related to the incidence of financial fraud and to an increased likelihood of a firm being hit with a securities fraud class action.

Several papers find correlations between high levels of executive compensation, financial fraud and the likelihood of a company being targeted by a securities fraud class action. For instance, Mohan finds that companies that have high levels of total managerial compensation and option grants compared to a set of other industry and size matched firms are more likely to be sued in a securities fraud class action. She also finds that the presence of a large institutional block holder reduces this litigation risk. Peng and Roell’s study reaches a slightly different, although similar conclusion: “the option

component in executive compensation is positively and significantly associated with the incidence of class action lawsuits...,” holding constant a wide range of firm characteristics.\textsuperscript{124} Importantly, they also find that litigation class periods are correlated with “upward earnings manipulation, high insider sales and options exercise, and the underlying incentives for these activities."\textsuperscript{125} Talley and Johnsen uncover an interesting, if disturbing, connection between managerial compensation and false reporting.\textsuperscript{126} Their analysis shows that a one percentage increase in the quantity of a manager’s incentives predicts a 0.3 percent increase in the likelihood of her firm being targeted with a securities law suit and increases the expected settlement costs by $3.4 million. In a related paper, Johnson, Ryan & Tian find that, controlling for firm corporate governance structures, firm characteristics and CEO specific variables, “the likelihood of fraud is positively related to incentives from unrestricted stock, and is unrelated to incentives from vested options, unvested options and restricted stock.”\textsuperscript{127} They argue that firms should switch from giving executives unrestricted shares to packages that contain restricted stock and consider longer vesting periods and greater fraud prevention measures as restricted shares become vested.

In summary, these studies are consistent with the view that where compensation packages create strong incentives to manipulate accounting earnings, or stock price, that stock prices are more likely to be manipulated by false reporting, and this leads to an increased likelihood of shareholder litigation. More positively, the studies report that good corporate governance structures, such as institutional blockholders, or better designed compensation systems, may reduce or even eliminate the risk of fraud, and therefore of litigation. However, we would add, within companies where governance does not provide the antidote, securities fraud class actions may serve as ex post substitutes for these systems.

\textsuperscript{124} Lin Peng and Ailsa Roell, Executive Pay and Shareholder Litigation, 12 Review of Finance 141, 142 (2007).
\textsuperscript{125} Id. at 144.
C. Reputational Sanctions

An important but understudied question is whether firms are punished for committing fraud by mechanisms other than shareholder litigation. One can imagine a host of ways that corporations could suffer once it becomes known that they have lied publicly, or been caught manipulating their financial results. In an important recent study, Karpoff, et al., find that while the litigation sanctions are far from trivial, averaging $23.5 million, the reputational sanction suffered by the offending entity for committing fraud is huge, with the decline in the present value of future cash flow being in excess of 7.5 times the litigation sanction.\(^{128}\) The authors’ calculation is that for every dollar that the fraudulent representation inflates its market value upon disclosure of the violation it loses a dollar plus an additional $3.08 and the loss is larger than this if the firm survives (about 88% of this amount is reputational cost with the balance being legal defense costs). So understood, telling a lie and getting caught is not a value-enriching strategy. In the face of such serious costs borne by the firm as a result of its managers’ deceptions, it is not surprising that in a related paper the same investigators report that nearly 94 percent of the individuals identified as being responsible for the false statements lose their jobs by the end of the enforcement proceedings and a majority of these are fired by their firms.\(^{129}\) Culpable managers are more likely to lose their jobs when their misconduct is accompanied by insider trading, the firm is young or financially troubled, their conduct was harmful to the company, and when the firm has an independent board.\(^{130}\) These findings suggest that markets do play an important role in punishing fraud, and that shareholder litigation serves a secondary function in this regard, although it does add meaningful additional monetary sanctions and may serve to stimulate the firm to discipline the wrongdoers harshly.

128 See Karpoff, et. al., supra note 25.
129 See Jonathan M. Karpoff, D. Scott Lee & Gerald S. Martin, The Consequences to Managers for Cooking the Books, J. FIN. ECON. (forthcoming 2008), available at http://www.fma.org/Orlando/Papers/KLM070111.pdf (93.61 percent of those identified in the government prosecution lose their job and for responsible parties who are officers 92.39 percent lose their jobs; firing occurs more quickly when the board chair is not held by the firm’s chief executive officer).
130 Id. (culpable managers are more likely to retain their positions when they have significant holdings in the firm or the SEC drops charges against them). Directors also suffer reputational consequences when the SEC files charges against their companies, or when their firms pay large dollar settlements in private securities fraud class actions. Eric Helland, Reputational Penalties and the Merits of Class-Action Securities Litigation, 49 Journal of Law and Economics 365 (2006). However, outside of those two situations, the filing of a private securities fraud class action appears to have no reputational effect on directors. Id.
V. Conclusions

The existing studies of the U.S. enforcement system provide a rich tapestry for assessing the value of enforcement, both private and public, as well as market penalties for fraudulent financial reporting practices. The relevance of the U.S. experience is made broader by the introduction through the PSLRA in late 1995 of new procedures for the conduct of private suits and the numerous efforts to evaluate the effects of those provisions.

We believe that the evidence reviewed here shows that the PSLRA’s provisions have largely achieved their intended purposes. For example, many more private suits are headed by an institutional lead plaintiff, such plaintiffs appear to fulfill the desired role of monitoring the suit’s prosecution and their presence is associated with suits yielding better settlements and lower attorneys’ fees awards. SEC enforcement efforts, while significant, have tended to focus on weaker targets, suggesting that the big fish get away. Equally importantly, markets impose their own discipline on companies whose managers release false financial reports and, in turn, firms discipline the managers who are responsible for false and misleading reporting, perhaps because of the presence of, or potential for, private enforcement actions.

As rich as the empirical landscape is, there is much work that needs to be done. Studies have yet to evaluate whether enforcement actions, either by the government or the private class action leave the company worse off in the long run than if there had there been no suit at all. With settlements coming largely from either the firm itself, or its D&O insurance policy, there is cause to wonder whether large settlements, the reputational harm to the firm, and the discord of management displacement in the wake of the revelations of wrongdoing, leave firms not only wounded, but mortally wounded. We might also speculate whether the type of settlement wrested from the offending corporation impacts its future financial performance. Here we speculate that governance reforms, perhaps taken on voluntarily when the defalcation came to light, or introduced as part of the settlement itself, might put the company in a stronger position to weather the onslaught of business forces. In the end, the data we review presents a most intriguing, even hopeful, mosaic on the value of private enforcement actions for financial reporting, but the mosaic remains incomplete.