No. 13-317

In the Supreme Court of the United States

HALLIBURTON CO. AND DAVID LESAR,
Petitioners,
v.
ERICA P. JOHN FUND, INC., FKA ARCHDIOCESE OF MILWAUKEE SUPPORTING FUND, INC.,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF FOR THE COMMITTEE ON CAPITAL MARKETS REGULATION AS *AMICUS CURIAE* SUPPORTING PETITIONERS

Hal S. Scott
C. Wallace DeWitt
COMMITTEE ON CAPITAL MARKETS REGULATION
125 Mt. Auburn St., 3rd Floor
Cambridge, MA 02138

Lewis J. Liman
Counsel of Record
Leslie N. Silverman
Mitchell A. Lowenthal
CLEARY GOTTLIEB STEEN & HAMILTON LLP
One Liberty Plaza
New York, NY 10006
(212) 225-2000
lliman@cgsh.com

Counsel for Amicus Curiae

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INTEREST OF *AMICUS CURIAE*[1]

Founded in 2006, the Committee on Capital Markets Regulation (the "Committee") is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. The Committee's reports, releases, and comment letters provide lawmakers and regulators with concrete policy recommendations based on rigorous empirical research. Its membership includes thirty-two leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by Glenn Hubbard (Dean, Columbia Business School) and John L. Thornton (Chairman, The Brookings Institution) and directed by Prof. Hal S. Scott (Nomura Professor, Harvard Law School). C. Wallace DeWitt serves as the Committee's Executive Director of Research. The Committee is an independent and non-partisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

The Committee has a strong interest in reforming the U.S. securities class action enforcement system, which imposes significant

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[1] All parties have consented to this filing in letters on file with the Clerk of the Court. No counsel for a party has authored this brief in whole or in part, and no person other than *amicus*, its members, and its counsel has made a monetary contribution to the preparation or submission of this brief. *See* Sup. Ct. R. 37.

costs on U.S. corporations and shareholders and severely undermines the competitiveness of U.S. capital markets.[2] This brief sets forth the Committee's policy views regarding the economic and competitive effects on U.S. capital markets of the "fraud-on-the-market" presumption of reliance adopted in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

SUMMARY OF ARGUMENT

The Court adopted the fraud-on-the-market presumption, in part, because it believed the presumption was necessary to advance the goals of the Securities Exchange Act of 1934 ("1934 Act"), which "was designed to protect investors against manipulation of stock prices." *Id.* at 230. The Court described private civil actions under Rule 10b-5 as "an essential tool for enforcement of the 1934 Act's requirements." *Id.* at 231.[3] It feared that "[r]equiring proof of individualized reliance from each member of the proposed plaintiff class

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[2] The Committee's *Interim Report*, released in 2006, sets forth, *inter alia*, a comprehensive reform program for the enforcement of U.S. securities laws, including proposed changes to the securities class action regime. *See* Comm. on Capital Mkts. Regulation, *Interim Report of the Committee on Capital Markets Regulation* (2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

[3] Rule 10b-5 refers to Rule 10b-5 of the Securities and Exchange Commission ("SEC"), 17 C.F.R. § 240.10b-5, adopted under Section 10(b) of the 1934 Act.

effectively would have prevented respondents from proceeding with a class action, since individual issues then would have overwhelmed the common ones." *Id.* at 242. The presumption of reliance solved this purported problem, and the Court reasoned that "by facilitating Rule 10b-5 litigation, [it] support[ed] the congressional policy embodied in the 1934 Act." *Id.* at 245. In other words, the four-member majority in *Basic* believed more litigation—including class litigation—was needed to "to protect investors against the manipulation of stock prices." *Id.* at 230.

However, in the 25 years since *Basic* was decided, empirical research has shown that, rather than protect investors, the U.S. securities fraud class action system imposes heavy costs on U.S. corporations and shareholders and places U.S. capital markets at a decided competitive disadvantage *vis-à-vis* other global financial centers, where securities enforcement is typically the exclusive province of the public civil and criminal authorities and individual (i.e., non-class) civil actions. Since its founding, accordingly, the Committee has advocated reform of the U.S. system.

As this Court and others have recognized,[4] securities class actions frequently feature

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[4] *See*, *e.g.*, Advisory Committee's 1998 Note on subd. (f) of Fed. R. Civ. P. 23, 28 U.S.C.A. Fed. R. Civ. P. 23 at 161

exorbitant settlements, extracted from defendants through the *in terrorem* effect of potential damages at trial. Win or lose, companies—and ultimately their shareholders—are also saddled with costly legal bills in defending against such suits. Yet, as this brief will demonstrate, empirical data suggest that the burdens imposed on companies and shareholders by securities class actions are unjustified by their purported benefits, namely investor compensation and deterrence of corporate wrongdoing. Indeed, the Department of Justice and the SEC have in recent years significantly increased staff resources devoted to securities enforcement efforts, further undermining the assumption—not embraced in legislation—that there was a need for a separate private class action enforcement mechanism under Section 10(b).

In his dissent from the Court's first endorsement of the "fraud-on-the-market" presumption of reliance in *Basic,* Justice White worried that the decision would "have many adverse, unintended effects as it is applied and interpreted in the years to come." 485 U.S. at 251 (White, J., dissenting). A quarter century of experience has confirmed Justice White's prescience, as overwhelming evidence has mounted that the costs of the United States' present securities class action mechanisms overwhelm any

(2012). *See also AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740 (2011).

plausible societal benefit. Congress has responded to this evidence by narrowing the bases for those actions through the passage of the Private Securities Litigation Reform Act of 1995 ("PSLRA") and the Securities Litigation Uniform Standards Act of 1998, and this Court, too, has in a number of recent decisions[5] continued to trim the expansive scope of the judicially implied private right of action under Rule 10b-5. The Committee therefore urges the Court to reconsider its adoption of the fraud-on-the-market presumption of reliance in the class certification context and overrule the *Basic* four-Justice majority.

ARGUMENT

I. THE COSTS OF SECURITIES CLASS ACTIONS TO THE U.S. ECONOMY AND CAPITAL MARKETS ARE UNJUSTIFIABLE

A. Securities Class Actions Impose Significant Costs on U.S. Corporations and their Shareholders

Irrespective of their merit or whether they reach trial, securities class actions impose significant

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[5] *See, e.g.*, *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2298 (2011); *Morrison v. Nat'l Austl. Bank*, 130 S. Ct. 2869 (2010); *Stoneridge Inv. Partners, LLC, v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 153 (2008); *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 314 (2007).

costs. Although Congressional action and the recent decisions of this Court have to some degree reduced the number of securities class action claims, the collective impact of these changes in law has been limited. Since 2007, an average of 181 securities class action suits has been filed per year, almost exactly matching the historical average from 1996 (the first year following enactment of the PSLRA) through 2011. In 2012, 142 federal class actions alleging securities fraud were filed, while courts approved 93 settlements with an aggregate value of $3.3 billion. Renzo Comolli et al., NERA Econ. Consulting, *Recent Trends in Securities Class Action Litigation: 2012 Full-Year Review* 6, 23-31 (2013). From 2000 through 2012, the aggregate value of securities class action settlements amounted to approximately $68.1 billion. *Id.* at 31. The historical peak of such settlements is over $19 billion in 2006. Ellen M. Ryan & Laura E. Simmons, Cornerstone Research, *Securities Class Action Settlements: 2011 Review And Analysis* 1 (2011). It is important to note, too, that the filing of securities class actions is cyclical and generally follows the market. In bull markets, such as at present, there is a natural tendency for fraud claims to decline, only to surge once again when the market turns and damage claims become more enticing as they are facially easier to allege.

It is difficult to overstate the pall of uncertainty cast across the U.S. economy by the threat of securities class actions. Since 1996, over 40% of corporations listed on major U.S. stock exchanges

have been targeted by a securities class action suit. Bradley J. Bondi, *Facilitating Economic Recovery and Sustainable Growth Through Reform of the Securities Class-Action System: Exploring Arbitration as an Alternative to Litigation*, 33 Harv. J.L. & Pub. Pol'y 607, 615-16 (2010). Even where such actions never materialize, the mere threat is sufficient to impose significant costs. For example, insurance costs for a Fortune 500 company are six times higher in the United States than in Europe, *see* Comm. on Capital Mkts. Regulation, *Interim Report*, *supra*, at 78. Studies have shown that targets of securities class actions face deteriorating profitability and operational efficiency compared to peer firms—even three years after settlement—and run a higher risk of bankruptcy. Lynn Bai et al., *Lying and Getting Caught: An Empirical Study of the Effect of Securities Class Action Settlements on Targeted Firms*, 158 U. Pa. L. Rev. 1877, 1896-1904 (2010).

While the *Basic* fraud-on-the-market presumption is not solely responsible for the high levels of securities litigation in the United States, the presumption is an essential predicate to shareholder securities class actions. In order to prevail at the class certification stage, a plaintiff must convince the court "that the questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy." Fed. R. Civ. P. 23(b)(3). In

establishing the predominance of such "common questions" in a private securities fraud claim under Rule 10b-5, the element of "reliance" tends to be a determinative inquiry. Thus, by significantly lowering the bar from proof of individual reliance—as in a traditional face-to-face fraud claim—to proof of purchase from a "well-developed market," *Basic* vastly expanded the ability of the plaintiffs' bar to file and obtain certification of securities class action suits. In subsequent cases, the efficient market underpinnings of *Basic*'s fraud-on-the-market presumption have been found by courts to be met simply on the basis of factors such as exchange listing or analyst coverage. *See*, *e.g.*, *Cammer v. Bloom*, 711 F. Supp. 1264 (D.N.J. 1989).

B. Securities Class Actions Undermine the Vibrancy and Competitiveness of U.S. Capital Markets

Given that competitor economies have eschewed adopting the U.S. approach,[6] it is unsurprising that foreign private issuers often cite the U.S. class

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[6] Securities class actions do not exist under the legal systems of other competitor markets for IPO activity, such as the United Kingdom, Hong Kong, or Singapore. *See*, *e.g.*, Comm. on Capital Mkts. Regulation, *Interim Report*, *supra*, at 2-3.

action regime as a primary reason for avoiding participation in U.S. public capital markets.[7]

The severity of these competitive effects has been exhaustively documented by the Committee's research. *See* Comm. on Capital Mkts. Regulation, *Interim Report, supra,* at 71. For years, such suits have contributed to driving significant quantities of capital abroad or into private markets, as shown in a series of competitiveness measures compiled by the Committee. *See Competitiveness Measures*, Comm. on Capital Mkts. Regulation, *available at* http://capmktsreg.org/tag/competitiveness/. These measures, which track 13 metrics of equity raised in public markets, the relative size of the private (*i.e.*, Rule 144A) and public equity markets in the United States, U.S. cross-listings and delisting by foreign private issuers, trading on U.S. and foreign exchanges, and the regional origin of U.S. investment bank revenues, demonstrate a significant decline in the competitiveness of U.S. capital markets since 1996. *Id.* As of the third quarter of 2013, the U.S. share of global IPOs by foreign companies sits at 8.1%, the lowest level since 2008 and a substantial decline from the 11.4% recorded in 2012. *Continuing Competitive Weakness in U.S. Capital Markets*, Comm. On Capital Mkts. Regulation (Nov. 21, 2013), *available at* http://capmktsreg.org/2013/11/ continuing-

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[7] *See* Brief of *Amicus Curiae* NYSE Euronext In Support of Respondents at 28, *Morrison v. Nat'l Austl. Bank* 130 S. Ct. 2869 (2010) (No. 08-1191).

competitive-weakness-in-u-s-capital-markets-2. This measure remains far below the historical average of 26.8%. *Id.* The U.S. share of the top 20 global IPOs remains depressed, with only one of the top 20 global IPOs in 2013 occurring in the U.S. public markets. *Id.* Foreign companies that raise equity capital in the United States do so overwhelmingly via private (*i.e.*, Rule 144A) rather than public markets. During the third quarter of 2013, over 88% of initial offerings of foreign equity in the United States were conducted through Rule 144A offerings rather than public offerings. *Id.*

While numerous factors affect U.S. competitiveness, securities class actions are widely understood by market participants as a leading cause of the decline. Numerous independent reports have concurred with the Committee's view that securities class actions detract from the competitiveness of U.S. capital markets. A 2007 report, commissioned by then New York City Mayor Michael R. Bloomberg and Senator Charles E. Schumer and endorsed by then New York Governor Eliot Spitzer, cited securities class actions as a major contributor to the high "cost of doing business in the US financial services industry." Senator Charles E. Schumer and Mayor Michael R. Bloomberg, *Sustaining New York's and The US' Global Financial Services Leadership* 75 (2007), *available at* http://www.nyc.gov/html/om/pdf/ny_report_final.pdf. A 2008 report of the U.S. Chamber of Commerce and a 2007 report of the Financial Services Forum each reached similar

conclusions. *See generally* Ctr. For Capital Mkts. Competitiveness, U.S. Chamber of Commerce, *Strengthening U.S. Capital Markets: A Challenge For All Americans* 13 (2008), *available at* http://www.uschamber.com/reports/strengthening-us-capital-markets-challenge-all-americans; Fin. Servs. Forum, *2007 Global Capital Markets Survey* 1, 6 (2007), *available at* http://crapo.senate.gov/documents/FINAL2007ForumIPOStudy.pdf..

II. THE PURPORTED BENEFITS OF SECURITIES CLASS ACTIONS—COMPENSATION AND DETERRENCE—ARE UNSUBSTANTIATED IN THEORY OR FACT

Compensation of defrauded investors and deterrence of malfeasance in corporate disclosure are the most commonly cited benefits of securities class actions. *See Basic*, 485 U.S. at 231 (describing private civil actions, including class actions, under Rule 10b-5 as "an essential tool for enforcement of the 1934 Act's requirements"). The theoretical and empirical case for each rationale is weak.

A. Securities Class Actions Do Not Efficiently Compensate Defrauded Investors

In securities class actions, long-term institutional investors effectively sue themselves. In light of the substantial legal fees associated with such actions—on the order of 25-35% for plaintiffs, with comparable defense costs, as well—

institutional shareholders consistently lose money on securities class actions, since settlement payments by their portfolio companies generally exceed actual recoveries paid to such shareholders. *See* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 Colum. L. Rev. 1534, 1538 (2006); *see also* Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' and Officers' Liability Insurer*, 95 Geo. L.J. 1795, 1815 n. 95 (2007). Modern portfolio management techniques compound the circularity of class action recoveries, with recoveries "largely paid by diversified shareholders to diversified shareholders [representing] a pocket-shifting wealth transfer that compensates no one in any meaningful sense and [yet] incurs substantial wasteful transaction costs in the process." Comm. on Capital Mkts. Regulation, *Interim Report*, *supra*, at 79.

The situation is similarly perverse with respect to short-term shareholders. With annualized share turnover rate reaching approximately 86% at the end of 2011, *see Facts & Figures*, NYSE Technologies, *available* at http://www.nyxdata.com/nysedata/asp/factbook/viewer_edition.asp?mode=tables&key=317&category=3 (last visited Jan. 2, 2014), the decision as to which short-term shareholders may recover and which must pay is "decidedly random." *See* Hal S. Scott & Leslie N. Silverman, *Stockholder Adoption of Mandatory Individual Arbitration For Stockholder Disputes*,

36 Harv. J.L. & Pub. Pol'y 1187, 1189 (2013). An investor with a diversified portfolio is likely to be on the winning and losing sides of numerous class actions, sometimes receiving a distribution and sometimes paying for another investor's recovery.

Since the passage of the PSLRA, over 3,900 securities class action filings have yielded only 20 trials. Unless dismissed by a court, almost all such actions are settled between the parties, with less than 0.5% of filings resulting in a verdict. Comolli et al., NERA Econ. Consulting, *supra*, at 39. Due in large part to the strong incentives of plaintiffs' attorneys to settle and reap fees without the risk of a trial, studies have shown that plaintiffs generally settle for a small fraction of their "estimated damages," from which sums plaintiffs' attorneys extract their customary fees. *See* Ryan & Simmons, Cornerstone Research, *supra*, at 7-8.

Moreover, net of legal fees, a significant portion of actual settlement amounts is never distributed to class members, whether because such members cannot be located, because they fail to submit claims to the court, or because the costs of distributing relatively trivial amounts would exceed the value of the underlying claim. *See* Kevin M. Forde, *What Can a Court Do with Leftover Class Action Funds? Almost Anything!*, 35.3 Judge's J. 19, 19 (1996). Only 40-60% of potentially eligible shares submitted a claim for distribution in a sample set of settled securities class actions between 2001 and 2008. See Scott & Silverman, *supra*, at 1193. By contrast, the authority of the

SEC to force profit disgorgement in administrative and judicial proceedings and compensate investors by drawing on the "Fair Fund" established under the Sarbanes-Oxley Act of 2002, represents a far more efficient means of making defrauded investors whole. *See id.* at 1195.

B. Securities Class Actions Do Not Contribute Significantly to the Deterrence of Corporate Wrongdoing

The case for the deterrent value of securities class actions is similarly weak. Individuals commit fraud, but corporations—and ultimately their innocent shareholders—are left to pay the cost of the ensuing securities class actions. Indeed, hypothetical future class action settlements and judgments have only an indirect and glancing effect on incumbent management. "Managers seeking short-term profits from stock performance are unlikely to be deterred by the later possibility of class actions whose impact will fall on all stockholders." *Id.* at 1190; *see also* Jonathan M. Karpoff et al., *The Consequences to Managers for Financial Misrepresentation*, 88 J. Fin. Econ. 193 (2008). Over 90% of individuals responsible for corporate wrongdoing ultimately lose their jobs, with the majority being terminated. *Id.* at 194.

Such consequences represent a far stronger deterrent to management than any putative effects of securities class action suits, as any additional quantum of deterrence derived from class actions appears to be relatively trivial. Empirical evidence

suggests that the most significant source of deterrence of management malfeasance is the threat of *disclosure* of wrongdoing, with all the attendant reputational costs, rather than the specter of anticipated litigation. One study found that firms lose approximately 40% of their market value when news of serious corporate misconduct is reported, of which decline only 8.8% is related to anticipated litigation costs. *See* Jonathan M. Karpoff et al., *The Cost to Firms of Cooking the Books*, 43 J. Fin. & Quant. Analysis 581, 582 (2008); *see also* John Armour et al., *Regulatory Sanctions and Reputational Damage in Financial Markets* 10 (Dec. 28, 2011) (unpublished manuscript) (*available at* http://ssrn.com/abstract=1678028).

Moreover, the United States boasts one of the world's most robust public securities fraud enforcement regimes, with the Department of Justice and SEC responsible for criminal and civil enforcement actions, respectively. Since 2009, the SEC has devoted considerably greater resources to its Enforcement Division, and in 2011, the agency filed "735 enforcement actions, an 8.6 percent increase from 2010," obtaining almost $2 billion in penalties and disgorgements. U.S. Sec. & Exch. Comm'n, *FY 2011 Performance And Accountability Report* 2 (2011). In fiscal 2013, the SEC obtained a record $3.4 billion in monetary sanctions (disgorgement and penalties)—a 10% increase over 2012 and 22% higher than in 2011—and filed 686 enforcement actions. Press Release, U.S. Sec. &

Exch. Comm'n, *SEC Announces Enforcement Results for FY 201*3 (Dec. 17, 2013), (*available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540503617#.UrDAHE3nbcs). State attorneys general and securities officials also play a significant enforcement role. The SEC's enforcement powers are further enhanced by its close cooperation with other federal and state officials, as well as self-regulatory organizations ("SROs"), referring 586 investigations to SROs or other state, federal, or foreign authorities in fiscal 2011. U.S. Sec. & Exch. Comm'n, *FY 2011 Performance*, *supra*, at 64.

In bringing enforcement actions, public authorities consider a broad array of factors, not merely which cases will bring the largest or speediest payouts to plaintiffs' counsel.[8] "The SEC, for example, carefully considers whether to pursue the corporation (and therefore the stockholders) or just the officials and directors in an individual capacity, recognizing that stockholders bear the brunt of recoveries against corporations." Scott & Silverman, *supra*, at 1199. Critically, where appropriate, the SEC targets individual

[8] Although some abusive practices have been curtailed by the PSLRA, allegations of "pay-to-play," a *quid pro quo* scheme whereby plaintiffs' firms exchange political campaign contributions for appointment as lead counsel in actions brought by state pension funds, continue to surface. *See*, *e.g*., Mark Maremont et al., *Trial Lawyers Contribute, Shareholder Suits Follow*, Wall St. Journal, Feb. 3, 2010.

wrongdoers rather than the corporate enterprise, so innocent shareholders do not suffer as they do when companies settle securities class action claims.

Thus, contrary to the four-member majority's assumptions in *Basic*, private class actions are not necessary to protect investors. Government enforcement and individual private actions are more effective at furthering the goals of the 1934 Act and, unlike private class actions, do not impose unnecessary heavy costs on U.S. corporations and innocent shareholders.

CONCLUSION

For the foregoing reasons, *amicus curiae* urges the Court to reverse the judgment of the Circuit Court.

Respectfully submitted,

Hal S. Scott
C. Wallace DeWitt
COMMITTEE ON
CAPITAL MARKETS
REGULATION
125 Mt. Auburn St.,
3rd Floor
Cambridge, MA 02138

Lewis J. Liman
Counsel of Record
Leslie N. Silverman
Mitchell A. Lowenthal
CLEARY GOTTLIEB STEEN
& HAMILTON LLP
One Liberty Plaza
New York, NY 10006
(212) 225-2000
lliman@cgsh.com

Counsel for Amicus Curiae

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