After the Enron and WorldCom crisis, followed by one of the major financial disasters in history, which took place in 2008, securities law has been increasingly enforced in order to avoid that negligence and malpractice lead to more financial meltdowns. Nevertheless, an important issue must be analyzed, which is the success rate of Securities Exchange Commission investigations versus Securities Class actions. The authors, Stephen J. Choi & A.C. Pritchard do a remarkable job in this comparison in their paper “SEC Investigations and Securities Class Actions”, by analyzing important factors that are involved with this matter but also by developing formulas that produce interesting results. It is remarkable to witness the corporation’s position in this legal matter as a defendant and the consequences of the investigations/actions.

The Article at hand produces interesting results with their investigation and comparative study. Furthermore, in the analytic process, some of the issues involved with securities, SEC investigations and securities class actions touch on some other issues that are worth exploring more into depth. Insurance policies, commonly known as D&O’s, the Securities and Exchange Commission budget and staff, follow up on criminal investigations and procedures, a more detailed analysis of the background of securities class actions, the commitment with the corporation that CEO’s and CFO’s have to endure, the Private Securities Litigation Reform Act (PSLRA) as a buffer for class actions and its results, the role of litigation lawyers are some of the topics further explored in this document.
First and foremost, one of the most important matters addressed in this paper is about the insurance policies obtained by the companies in order to cover themselves from payments due, in case the SEC or the judges determine it. The authors mention in their paper that the value paid by insurance companies and defendants in general is high, which makes sense due to the fact that statistics themselves reflect how companies would rather settle, even though there is a low chance for them to lose the case.

Although the paper does not report specific figures for the matter, it could have been enlightening to add some information to the article in terms of how this is dealt with in every day practice and what current issues it brings or might bring along. In addition, discussing possible counter measures or at least ways in which the company can battle back or work through in order to remain functional might have been worth exploring. These ideas might have deserved further exploring considering these high amounts of money could bankrupt a company, or at least put it in financial troubles.

Regarding Directors and Officers Insurance Policies, it would have been useful to know the statistics on insurance policies’ premiums and how higher those premiums can get for D&O insurance policies after the insurance company has to pay high amounts of money as a consequence of Directors or Officers’ negligence. In other words, how much more expensive D&O policies get after the insurance

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1 The authors do not mention how much money is exactly paid neither for the premium of the insurance policy nor for the covered amount as a whole. When one of the authors exposed the paper and was questioned by this matter, he stated that these amounts are kept very confidential and undisclosed, due to the shocking high amount of money handled by the involved parties.
policy has been paid and how often the insurance policies are used in the market. Furthermore, when there has been a sanction by the SEC or by a Court, additional negative consequences will come with it. It may be possible that the insurance company might not want to insure the sanctioned company in the future, creating a domino effect to other insurance companies in the market because they will have second thoughts as if to insuring the sanctioned company as well due to the company’s acquired bad reputation as a consequence of the sanction/judgment. Similarly, it would have been valuable to know if this could possibly encourage shareholders who bring derivative actions to file a suit against the company, knowing and being fully aware that the company would prefer to settle.

On the other hand, considering the unlikely probability that the company did not have a D&O insurance policy at the time of the sanction/judgment, the money to pay for the law suit would have to come directly from the shareholder's pockets, meaning that the same person who brought the suit would be pretty much taking money from one of her pockets and putting it into her other one. Now, considering that companies in practice have the insurance policy, the shareholder could be capable of filing the class action law suit and just expect to be paid even though there was no damage or negligence whatsoever.

There may be cases were a company is targeted by both SEC investigations as well as from securities class actions. When the company is targeted by both sides, it would mean that the SEC as well as the plaintiffs will be attempting to obtain pecuniary sanction/retribution from the company, which
creates more expenses to the company itself. Moreover, what is interesting in this topic is the process the Securities Exchange Commission follows in order to decide or not to proceed with the investigation, considering this entity has limited budget and staff.

“Through much of the last decade, the SEC was an agency under siege. As congressional zeal for deregulation reached its peak in the mid-1990s, growth in the SEC’s workload greatly outpaced growth in agency resources. Between 1995 and 2002, for example, the number of mutual funds subject to SEC inspection rose from just over 5,700 to more than 8,200, but the number of SEC inspectors remained the same. Between 1991 and 2001, the number of cases the Enforcement Division opened rose sixty-five percent, but the Division’s staff grew by only twenty-seven percent. Overall, from fiscal years 1993 through 2000, the SEC’s budget grew modestly from $253.2 million to $382.4 million.”

Although it would have involved a different kind of analysis and investigation, this might have been interesting for the reader. “Despite the government’s considerable post-Enron enforcement success, some commentators remain skeptical about the pace and focus of the criminal investigations and prosecutions.”

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2 Enron’s Legacy, Kathleen F. Brickey, James Carr, Pg. 17.
3 Enron’s Legacy, Kathleen F. Brickey, James Carr, Pg. 29.
At this point, it is important to clarify the present and practical reality of securities class actions. This specific type of class action is currently rising to approximately 47% of all class actions\(^4\). For this reason, it consumes a significant portion of judicial resources. Furthermore, this means that securities class actions are fundamentally subsidized by American taxpayers\(^5\). Other than the fact that these types of class actions are immensely superior to the other ones, there are other reasons why they to be analyzed more carefully in terms of the money that is spent in them,

“First, they take longer to resolve than most other class actions, and this tendency is increasing. Second, they require the court to play a more active monitoring role… Third, the Plaintiff in a securities class action is disadvantaged in comparison to plaintiffs in other forms of class actions in that it cannot obtain discovery until the plaintiff has first satisfied a heightened pleading test… Finally, the settlement process in securities class actions has become more complicated, as a growing number of sophisticated class members may decide to opt out of the class or may object to the settlement’s fairness or the reasonableness of the attorney’s fees.”\(^6\)

\(^4\) Reforming the Securities Class Action: an Essay on Deterrence and its implementation, John C. Coffee, Jr., Pg. 9.

\(^5\) Reforming the Securities Class Action: an Essay on Deterrence and its implementation, John C. Coffee, Jr., Pg. 9.

\(^6\) Reforming the Securities Class Action: an Essay on Deterrence and its implementation, John C. Coffee, Jr., Pg. 11.
The formulas applied in the Article demonstrate CEO’s and CFO’s harsh reality when it comes to these situations. It may strike as pretty obvious that more CEO’s and CFO’s get fired after a “successful” SEC investigation or class action favorable judgment; nonetheless, this is mathematically proven by the Authors. Similarly, managers tend to leave the companies when there are poor stock market returns, which prove that in the United States, the corporate culture is not patient in hard times but it rather appears to be prone for a rapid and swift management modification. In connection to this point, it’s worth mentioning the context in which CEO’s and CFO’s perform their duties as well as their legal obligations. These directors from large companies are obliged by law to comply with a series of information that would make them think twice if they realized how unsecured their jobs really are,

“On June 27, 2002, the SEC issued File No. 4-460: Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934. This order required the CEOs and CFOs of public companies with revenues greater than $1.2 billion during their last fiscal year to file written statements, under oath, regarding the accuracy of their companies’ financial reports and their consultation with the companies’ audit committees. This order stems from the SEC’s concern about investors’ growing distrust of financial statements after scandals involving
once well-respected companies such as Enron and WorldCom, and auditors such as Arthur Andersen.\textsuperscript{7}

With the Private Securities Litigation Reform Act (PSLRA), Congress intended to put securities class actions under the control of institutional investors who had a lot of money and interest in the outcome of the litigation at hand with the hopes that these large investors will maximize recoveries. The Article mentions that after the approval of the aforementioned Act, 50\% of all class actions were dismissed, hence diminishing the target of private class actions. Nevertheless, this scenario deserves further exploring. Was the PSLRA successful?

\textit{“Over time, however, a series of developments brought more public pension funds into the fray. The publicity that attended the scandals involving Enron, WorldCom, Tyco, and Cendant likely played an important role, as did the enormous recoveries obtained in those cases. Lawyers seeking appointments as lead counsel also contributed by building relationships with institutional investors. Law firms wined and dined investment managers, volunteered to monitor institutional portfolios for signs of fraud, and made campaign contributions to politicians who had influence or control over public pension funds in what some have suggested are pay-to-play relationships. Today, institutional investors are important players in securities-fraud class actions. Now that institutional investors are}

\textsuperscript{7} To Swear Early or not to Swear Early? En Empirical Investigation of Factors Affecting CEO’s Decisions, Gerald J. Lobo, Jian Zhou, Pg. 3.
participating more often, it remains to consider whether the mechanism created by the PSLRA is working as anticipated.\textsuperscript{8}

Under this presumption, Congress meant well but it seems that lawyers are getting an even bigger slice of the pie than they used to. This matter raises an important topic to consider, which is the welfare of small security class action parties involved. If the attorney’s fees are higher, then the client will get less money and the ultimate beneficiary will be the litigation’s lead council. “The present structure of securities of securities class actions benefits a trio of interest groups – corporate officials, plaintiff’s attorneys and insurers, but not shareholders.”\textsuperscript{9}

In connection to the previous paragraph, another important issue related to securities class actions is the “meritorious” requisite. In order for the security class action not to be dismissed, it has to be meritorious, which is the action that produces a judgment after the end of a trial. Nonetheless, trials are not particularly massive in this specific area because cases that are not in fact dismissed are almost always settled\textsuperscript{10}. The meritorious requisite is a hard one to determine without a judgment, therefore difficult to measure. This requisite connects to the Article because it worked immediately after it was implemented, but class actions returned to their previous statistic results which reflect that the PSLRA did not

\textsuperscript{8} Setting Attorneys’ Fees in Securities Class Actions: An Empirical Assessment, Lynn A. Baker, Michael A. Perino, Charles Silver, Pg. 3 (1679).
\textsuperscript{9} Reforming the Securities Class Action: an Essay on Deterrence and its implementation, John C. Coffee, Jr., Pg. 1.
\textsuperscript{10} The Screening Effect of the Private Securities Litigation Reform Act, Stephen J. Choi, Karen K. Nelson, A.C. Pritchard, Pg. 4.
work. Either this latter fact is happening or the temptation to incur in fraud has exponentially grown as well.

“The number of suits being filed, however, has not declined. After an initial dip, the number of securities fraud class actions has returned to, and even exceeded in some years, its pre-PSLRA level. (Foster et al., 2005). The larger number of filings suggests that the PSLRA may have done little to discourage the filing of frivolous suits, although it may have increased their likelihood of dismissal.”

Litigation lawyers have earned a lot of money and power through securities class actions, especially when the client is the leading party in the action. One of the SEC’s faculties is to monitor and discipline lawyers, although, it has been a common practice for the SEC to focus its energies and resources to transactional lawyers. Recently, due to the massive securities scandals, the SEC has broadened its spectrum to the investigation and discipline of litigation lawyers as well. There are certain cases where the SEC has put a considerable amount of pressure to lawyers which sometimes brings negative consequences,

“The SEC staff that is investigating and prosecuting a client is also allowed to investigate the professional conduct of the litigator representing that client. The Article explains that the SEC’s rules governing litigator conduct are unclear and therefore susceptible to agency abuse. The SEC can use

ethics investigations (or even threats of investigations) to remove attorneys from cases or to intimidate attorneys into less zealous advocacy. During ethics investigations, the SEC can further erode the attorney-client relationship by pressing litigators for confidential information ordinarily protected by the attorney client privilege. By dividing the client from the attorney, the SEC can gain the upper hand in its investigation of the client.\(^{12}\)

One of the main issues to consider in the comparison between private actions and SEC regulations are the resources each side has available in order to complete its objective. On one hand, the private sector that is bringing the class action probably has the resources to take these cases all the way through, or at least until a settlement is reached, considering it has a leading party with a great deal of resources and interests in the outcome, as discussed previously. On the other hand, the SEC has a more modest budget to operate with. Considering the aforementioned citations regarding the SEC funding there is no doubt that the budget is increasing gradually, the problem is that it is not increasing as fast as the market is and sometimes, even government will impair the SEC’s capacities,

“Sarbanes-Oxley authorized the appropriation of $776 million – a seventy-seven percent increase – for the SEC for fiscal year 2003 - and authorized use of the funds to achieve pay parity with other financial regulators, to improve technology and security, and to add at least 200 new professionals

\(^{12}\) Divide and Conquer: SEC Discipline of Litigation Attorneys, Julie Andersen Hill, Pg. 2 (273).
to the agency’s staff. But the provision authorizing additional resources for the SEC did just that – it authorized the appropriation of more funds, but did not actually provide them. In his remarks at the Sarbanes-Oxley signing ceremony, President Bush lauded Congress for enacting sweeping reforms that included “new funding for investigators and technology at the Securities and Exchange Commission to uncover wrongdoing,” and he promised to use the Act’s new enforcement tools “to the fullest.” But just eighty days later, his administration proposed a budget of only $568 million for the SEC – some $200 million less than Sarbanes-Oxley authorized. Although Congress ultimately passed, and the President signed, an appropriations bill allocating $716.4 million to the SEC for fiscal year 2003, the agency’s efforts to rapidly hire new staff were impeded by delayed enactment of the bill and by cumbersome civil service rules.\textsuperscript{13}

After extensive explanation and statistical comparison, the paper concludes that class actions are more successful than SEC investigations. At first, every reader inclines towards the assumption that class actions are more effective than SEC investigations because of monetary facility mostly, bearing in mind that lawyers in charge of the leading class action party have high resources to accelerate the process. In other words, class actions are more attractive for people who want to earn some fast dollars, including lawyers who know that the company which they are going to attack will most likely settle, considering they are aware of

\textsuperscript{13} Enron’s Legacy, Kathleen F. Brickey, James Carr, Pg. 18-19.
their insurance. The real turning point in class action law suits is the evident price drop of shares. This gives the Courts enough to proceed with the trial because proof of price drop in shares, once demonstrated, must be very hard to overturn or to convince the judges otherwise.

In conclusion, after analyzing the Article and more specifically some related points, the fact that securities class actions are more successful than SEC investigations is not shocking because there is evidence which clearly points out that monetary resources as well as judicial (Lawyers, interns, etc.) power are incredibly important in the American corporation system. Furthermore, there are additional variables to include to this equation that make securities class actions more successful. The fact that there are insurance policies with undisclosed premium amounts just indicates the amount of money at stake in these cases. It would be supremely informative to know in detail how insurance companies as well as reinsurance entities have managed to make a profit out of Directors’ and Officers’ insurance policies. On the other hand, there are other aspects mentioned in the present Article that are connected with securities class actions and the SEC investigations. For instance, it is safe to say that public controlling entities have tried to regulate lawyers’ participation in this whole securities world but sometimes without much success. Leading parties in class actions with advantages over the other members and the lack of control of litigation lawyers are just a couple of examples on how lawyers are taking advantage of this whole situation. This is precisely a reason why lawyers are getting a bigger piece of the pie as well as why
class actions have not dropped over the past years. Apparently, settling is very easy and corporations don’t make it more of a challenge because of the high quantities of money at their disposal.
SEC Investigations vs. Securities Class Actions

Comparison and Analysis of Success Rate

Based on the paper by Stephen J. Choi & A.C. Pritchard:

“SEC Investigations and Securities Class Actions”

Course: Economics of Business Law (Written Seminar/Thesis)

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