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INVESTOR PROTECTION: A REVIEW OF PLAINTIFFS' ATTORNEY ABUSES IN SECURITIES LITIGATION AND LEGISLATIVE REMEDIES

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

JUNE 28, 2006

Printed for the use of the Committee on Financial Services

Serial No. 109–102

U.S. GOVERNMENT PRINTING OFFICE

31–531 PDF WASHINGTON : 2007

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
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INVESTOR PROTECTION: A REVIEW OF PLAINTIFFS' ATTORNEY ABUSES IN SECURITIES LITIGATION AND LEGISLATIVE REMEDIES

Wednesday, June 28, 2006

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:07 a.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Ryun, Shays, Gillmor, Castle, Lucas, Manzullo, Kelly, Ney, Biggert, Miller of California, Kennedy, Tiberi, Barrett, Brown-Waite, Feeney, Gerlach, Hensarling, Renzi, Davis of Kentucky, Fitzpatrick, Campbell, Pearce, McHenry, Ackerman, Sherman, Meeks, Moore of Kansas, Capuano, Ford, Crowley, Israel, Clay, McCarthy, Baca, Matheson, Miller of North Carolina, Scott, Velazquez, Davis of Alabama, Wasserman-Schultz, and Maloney.

Ex officio present: Representative Frank.

Chairman BAKER. I'd like to call this meeting of the Subcommittee on Capital Markets to order this morning.

Let me first acknowledge that Mr. Kanjorski, the ranking member of the subcommittee, is unable to participate in today's hearing.

Unfortunately, due to unexpected flooding in Pennsylvania, he has returned home to an almost certain mandatory evacuation order, so our thoughts are with him this morning, as I know he did intend to participate.

Mr. Frank, of course, as the ranking member of the Full Committee, will participate in today's hearing for that and other reasons, as well.

Today the subcommittee meets to discuss actions and securities class action litigation, particularly the elements of H.R. 5491, the Securities Litigation Attorney Accountability and Transparency Act.

While I believe the securities litigation area is in need of a more comprehensive reform, this bill represents a modest first step in that direction.

A recent indictment of the country's leading securities firm, Milberg Weiss, and revelations accompanying this indictment raise

significant questions. Are plaintiffs' interests in class action suits really being treated in the most appropriate manner?

The actions alleged in the indictment are egregious. Over a 20-year period, Weiss and two of the named partners allegedly kicked back millions of dollars to individuals in exchange for serving as the named plaintiffs in more than 150 class action and shareholder derivative suits.

The scheme allegedly manufactured suits for the firm and solidified its dominance in the arena of securities cases.

If these allegations are proven to be true, the firm and the attorneys engaged have breached their fiduciary duty to the investors whom they are charged to represent.

The dominance of the Weiss firm is unparalleled. There is a Anjan V. Thakor study of 755 securities class action settlements over a 10-year period. The firm handled 43 percent of the settlements, netting $1.7 billion in fees and expenses.

The second nearest competitor came in at a meager 7.8 percent, just under $200 million.

Although dominant 10 years ago, Milberg Weiss allegedly continued to abuse its dominance by engaging in this scheme of kickbacks up until, reportedly, 2005, until after the U.S. Attorney began its investigation.

With these allegations before us, and H.R. 5491, it is appropriate the committee review the industry practice and behavior to determine if investor protection requires us to act in a more direct manner.

These actions, I feel, are justified, warranted, and to ensure reasonable investor protection, there may be a need, in fact, to do more, but the provisions of the bill, I think, at a minimum, are essential.

Finally, there are those who question even the propriety of the hearing. Mr. Weiss, in his response to me, at our voluntary invitation for him to appear, questioned the committee's legitimacy and right to conduct this examination.

This overlooks the fact that executives of Arthur Andersen, WorldCom, Enron, Global Crossing, mutual fund operators, Fannie Mae, and Freddie Mac, all of whom were facing some level of legal jeopardy, be it civil or criminal, did not dissuade this committee from engaging in inquiry and having representatives of those entities appear before this committee.

It is essential, I believe, to determine whether this conduct was an aberrant act or merely an instance of a single individual, or more disturbingly, a pattern and practice within an entire industry.

This is really what's known as oversight. It's never fun, but it's a job that this committee has to conduct in the interests of all engaged in our financial securities markets.

Although allegations of political motivations have been made with regard to this hearing, I would take the committee back to the appearance of Frank Raines in October of 2004, and in that case, subsequent events, I believe, have proven the importance of this committee's work and of staying the course.

And I wish to be very clear. Mr. Weiss is not under indictment. He actually continues his practice as of this moment, representing numerous plaintiffs in class action suits.

He was voluntarily invited today to discuss the actions that the firm was taking to ensure that the alleged abuses would no longer continue. Instead, he has chosen simply to question the motivations of the committee as well as my personal motivation.

His letter, of course, will be made public. I do consider the response an unprofessional one to this committee's inquiry.

However, despite the absence of Mr. Weiss, whom I believe refuses to appear because further discussion and disclosure about the conduct would perhaps further degrade the firm's reputation, we do have a very distinguished panel, a panel that I know will not shy away from legitimate discussion on how to best provide investor protection.

Whether the panelists agree with my perspective or not, I know they will state their opinions in an articulate manner.

I believe investor protection is best served by seizing ill-gotten gains and returning them to the people from whom they were taken.

Others believe, perhaps rightfully so, that upon successful pursuit of wrongdoers, seizing assets for the satisfaction of the plaintiff' attorney or the State government in which the suit is filed is balanced justice. I find that interesting.

I do know this. If you are robbed and your money is taken, you really just want your money back. The victim does not care if the loss came as a result of fraudulent market operatives, a clever trial lawyer, or a deft regulator. If any of them took your money, you still feel robbed.

I choose to defend the investors from all of them—to get the money and simply give it back.

Mr. Frank?

Mr. FRANK OF MASSACHUSETTS. Mr. Chairman, I am very disappointed in the calling of this hearing.

No one questions the usefulness of a hearing on protecting investors. Indeed, I am disappointed that this committee has had so few of them and that the focus in this case is so narrow.

But to have a hearing which you originally titled, "A review of a pending indictment," is a terrible abuse of the important principle of the separation of powers.

You said, Mr. Chairman, that previously people have been indicted who faced some degree of legal jeopardy, civil or criminal.

To equate the possibility of a civil lawsuit, including one not yet filed, with a pending indictment, is as fundamental a misunderstanding of the requirements of the American legal system as I have heard propounded officially.

I thought Mr. Weiss's letter to you was quite justified. I would ask to put into the record now the letters between yourself and myself and Mr. Kanjorski—

Chairman BAKER. Without objection.

Mr. FRANK OF MASSACHUSETTS.—in which we made the point that a hearing called, "to review the pending indictment," your original title, is a terrible mistake, and then, in response to our complaint, you said, "Well, I'll change the title." But you haven't

changed the focus. You have people who are going to talk about the indictment.

You say, "Well, Mr. Weiss wasn't indicted." True. The firm of which he is a named partner has been indicted. It is to discuss the indictment of the firm, and that is simply entirely inappropriate.

You say, Mr. Chairman, you want to look at the pattern and practice here. Fine. You don't need to look at the indictment in this particular case to do that.

And yes, I do question, frankly, the motives of this hearing.

I want to protect investors. You know, we have recently read a lot about the backdating of stock options. Where's the hearing on that? Where's the hearing that the SEC is now looking into?

You say, Mr. Chairman, "Well, this is called oversight." I can understand why you would have to explain to people the meaning of the phrase "oversight," since we as a committee, indeed as a Congress, have in recent years done so little of it. But oversight includes looking at whether or not there is or isn't enforcement.

I would like for us to have a broad hearing on investor protection. The issues that you mention are legitimately part of that. But a review of a pending indictment? Have we become some kind of a court, some kind of a judicial body?

Is this a longing for the days of the Schiavo bill when we decided that we would intervene and reverse the courts in Florida? Because that's what we are talking about, a review of a pending indictment. That is as far from a legitimate legislative purpose as I can see. Mr. Weiss's letter was entirely appropriate.

Now, as to the substance here, yes, I want to look into this, but I want to look into a lot of other issues, as well.

Let me say at this point, and I spoke to Mr. Kanjorski, who is busy now with a potential flood in his district, we recently had a decision by the circuit court striking down the SEC's effort to require registration of hedge funds, a very serious issue.

I think the hedge fund issue and the role of hedge funds in this economy and the impact that they can have is a very serious one. This committee has ignored the issue.

Mr. Capuano and I had written and asked for a hearing on that issue. We can't have that. Instead, we have to have a hearing on a pending indictment, because we apparently don't have time to have a hearing on the subject of hedge funds.

Mr. Kanjorski and I are preparing legislation now that will at the very least restore to the SEC the power that it thought it had before that circuit court decision regarding hedge funds, and I would hope that we would find time for a hearing about the issue of hedge funds.

We have the Securities and Exchange Commission deprived of authority that it wanted to exercise with regard at least to registration. That's a very serious issue and has a significant impact not just on investors but on the whole systemic issues before us.

So there are a number of areas that we want to look at.

I think what's happened is, and we see this with legislation filed to repeal parts of Sarbanes-Oxley, with this notion that the only thing apparently going into this hearing, the only problem that investors face is that some lawsuits brought in the name of investors are too zealously brought and not properly structured.

Are there no other problems that investors face? Are there no other abuses? As I say, the backdating of stock options, the refusal of boards of directors to pay attention to advisory votes, the problem of executive compensation, the problem of boards of directors receiving substantial negative votes and the members of the shells having no ability to deal with that?

I think what we—maybe, you know we get into titles, and you changed the name of this. You were originally calling it "a review of a pending indictment." I think you should have called it, "The empire strikes back," because that's what we have here.

We have obviously on the part of many of my colleagues the feeling that this business of interfering with the people who run corporate America has gone too far. This is just beyond where we should be. And so we're going to repeal part of Sarbanes-Oxley—not you, Mr. Chairman, but others have advocated that. We're going to push back here.

Now, looking at every individual advice, I do believe that there is room—not room, but need for a revision of how Sarbanes-Oxley affects smaller corporations. The chairman and I both said that to Mr. Cox when he was here last. Let's have an ongoing, balanced look at how best to protect investors.

But a hearing that ignores the backdating of stock options, a committee that has not looked into hedge funds and always refused to do that, where you have sentiment on your side in particular, some on ours for repealing part of Sarbanes-Oxley, to make that the thrust of our approach, to act as if the real problem here is that the poor corporate leadership is being unduly picked on and harassed, and who ignore all these other issues, and then to top it off, frankly, by I think grandstanding entirely inappropriately in violation of the appropriate role of Congress in a system of separation of powers, by having a "review of a pending indictment" for which I can certainly find no precedent, which is a good thing about the judgment of our predecessors, is to make a mockery of the role of this committee, and I am very disappointed.

Chairman BAKER. I thank the gentleman for his statement.

Mr. Ryun?

[No response]

Chairman BAKER. Mrs. Biggert?

[No response]

Chairman BAKER. Mr. Castle, statement?

[No response]

Chairman BAKER. Mr. Hensarling?

Mr. HENSARLING. Thank you, Mr. Chairman.

And one, I want to thank you for holding this hearing. I listened very closely to the ranking member, whom I have the utmost respect for, but as I read some of the written testimony, we appear maybe to be at different hearings here.

I think there are some very serious issues to be discussed here today about the attorney-driven securities class action suit, its impact upon our economy, and its impact upon investors.

Much of what he said may have been accurate, it may have been inaccurate, but much of it, I believe, is frankly irrelevant.

As I look at our panel, I don't see anybody from Milberg Weiss represented here today. We're not here to prosecute. We're here to legislate.

Beyond a reasonable doubt may be a burden to convict, but it certainly is not a burden to legislate and frankly, I think this committee has an obligation, when we see serious headlines, to look into the underlying matters.

It's not just simply the case of Milberg Weiss. I think it was just this last week that the Chicago Tribune broke a story of some serious accusations of general counsels pinching funds that had been lead plaintiffs' in class action lawsuits—receiving massive legal fees for apparently no work.

Again, I don't know all the facts underlying these, but these are serious accusations that I believe this committee has an obligation to look into.

I think this is a perfect follow-up to our earlier hearing that dealt with the impact of our place in the global securities market.

And we know that we're losing ground and we know that is a worrisome trend for our jobs, for our economy, and we know from our testimony that frankly, being an overly litigious society is at least one of the primary factors that are causing many companies to decide to list on other exchanges besides our own.

And so I think, frankly, there's a number of practices we have to look at here today, and I look forward to hearing the testimony. I think much good could be done.

And I'm particularly interested in this unique aspect of using the power of free enterprise and competition in selecting lead counsel for these cases and exploring its impact on investors, and I believe, frankly, a little transparency, a little accountability, a little free enterprise may go a very long way to protecting our investors, our jobs, and our economy.

And I want to thank the chairman for calling this hearing, and I yield back.

Chairman BAKER. I thank the gentleman.

Mr. Ackerman.

Mr. ACKERMAN. I thank the Chair.

Unlike Mr. Frank, whose remarks are always very measured, I would like to say that I am absolutely furious that we're having this hearing today.

At the outset, let me say that I know Mr. Weiss. I'm a friend of Mr. Weiss, and in the interests of full disclosure, I don't believe he's ever contributed to my campaign.

Nine years ago, approximately five members of his 500-member organization did contribute to my campaign, none of them over $500. I want to say that at the outset.

Mr. Chairman, there's a war going on in this country between investors and consumers on the one hand, and corporate America, that seeks protection from any kind of meaningful lawsuit, and that war is getting rather vicious.

The Administration and their corporate friends are using any means possible to try to degrade the plaintiffs' bar and to discredit and defame any of the players therein, and will use any means at their disposal, and I am sorry to see that today, this committee becomes a tool in that war.

You started out by saying, Mr. Chairman, that the, "allegations before us."

This is not a court. There should be no allegations before us. We're not here to judge allegations in an ongoing judicial proceeding. How dare we involve ourselves in that?

It was just said by my colleague across the aisle that we're here to legislate. We are here to legislate. That is our job. We are not the judiciary. We're not the Justice Department. We're not the Administration.

Mention was just made that what we should do for people who lost money in investments is to give their money back. If anybody even cared to read the indictment, to read the charges, there is no charge that any investor lost more than one penny, not even one penny.

This is a fight over who gets to represent classes, not the loss of money to investors. That is not charged in this allegation.

Let me also say that I am appalled, absolutely appalled at the fact that the committee has invited a sitting Federal judge, who has no business before this committee, to talk about a matter that's before the courts.

I took time last night to call some Federal judges. They were absolutely aghast that a sitting Federal judge, under the canons of judicial ethics, would testify on a matter of changing the law on issues that affect people in his courtroom.

I read his testimony. It makes reference to Milberg Weiss. And maybe if we get to that point, I'll ask him if it's not true that even Milberg Weiss has a current case before his bench. This is an absolute conflict.

I think that the judge should recuse himself of all such cases if he's going to take an activist role and today become the poster boy for judicial activism to change the law under which he rules.

Mr. Chairman, this is a hit. This is an axe job against a particular firm that has not been found or proven guilty, that has not even begun the case of defending itself. This committee participates in an ongoing smear before the trial even begins.

I say shame on us. We should not be involved in that. We have legitimate issues to address. We have legitimate concerns. There is legislation purportedly before us that we're discussing today, but that's a ruse for what's really going on here.

Mr. Chairman, you said in your invitation a moment ago, you invited Mr. Weiss and that he declined, probably because his appearance here would tend to degrade his firm.

I think that's an important statement that you have made, knowing full well that the person to whom we refer is also a live target of this criminal investigation.

And to say, "Oh, too bad, the guy doesn't want to come here and defend himself"—this isn't a courtroom. But in making that statement, Mr. Chairman, which I absolutely agree with, that it would tend to degrade his firm—I would like to make a motion.

May I, Mr. Chairman?

Chairman BAKER. The gentleman was recognized for an opening statement. At the appropriate time, the gentleman certainly will be recognized for a motion.

Mr. ACKERMAN. In that case, I will wait for that appropriate time.

Chairman BAKER. I thank the gentleman. His time has expired.

Mr. Feeney.

Mr. FEENEY. Mr. Chairman, unlike some others in this committee, I haven't made up my mind one way on whether there are serious abuses, and I just look forward to hearing the testimony.

I will tell you, I'm both an attorney and a shareholder, and I'm interested in appropriate suits on my behalf as an investor, but what I'm not interested in as an investor are suits that are diminishing the value of my shares because of unnecessary defense or overzealous prosecution.

So I think there's a balance in basically the private way we protect investors against deliberate or negligent fraud by management. I hope we strike that balance right.

But I don't think enormous windfall profits to trial attorneys are the type of economic growth that I'm most interested in encouraging.

So I'm here, anxious to hear the testimony.

Chairman BAKER. I thank the gentleman.

Mr. Moore.

Mr. MOORE OF KANSAS. No statement, Mr. Chairman, except I am interested in hearing the testimony of the witnesses here today.

Thank you. I yield back.

Chairman BAKER. I thank the gentleman.

Mr. Pearce.

Mr. PEARCE. Thank you, Mr. Chairman.

I find it amazing that we're told that we're not here to judge the allegations.

As I review much of the hearings through the last month, I've listened as people have alleged that the financial services field is wrongly discriminating, charging too much interest to minorities, and those are allegations which are still in the process. We've listened to them. I think we will probably take action on those that are suitable, as we should.

So I appreciate having the hearing today, because maybe we have a war between investors and corporate America, but we also have a love affair between investors and corporate America, because more Americans own stock now than ever before.

And Mr. Feeney addressed the need of our investors to maximize the wealth, maximize their value without it having to be deteriorated by class action suits or judgments which are simply going into the pockets of our trial lawyers.

So I personally am happy that you're having the hearing and I look forward to the testimony.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Mr. Crowley.

Mr. CROWLEY. I thank the chairman for yielding.

The question I have is, why are we here?

I went to bed last night and before I went to sleep, I don't think we changed the Constitution prior to my going to sleep last night.

And this morning, I am here. We're going to be judges this morning, we're going to—as the case is before our Federal courts, that

will judge the performance or the actions of one particular company or law firm in this case, Milberg Weiss, wouldn't prudence be that we wait until our courts have acted before we look at this particular case and its effect on our markets?

I would imagine that many shareholders would prefer that, and pointing up one of my colleagues' mentioning of shareholders and his owning some shares here, I'd prefer to wait and see what the courts have to say about this before we here make a judgment about any one particular case.

I would also like to associate myself with my colleague from New York, Mr. Ackerman, in regards to a member of the judiciary here before the committee who may very well have to hear testimony on this particular case or similar cases like it. I have concerns about that, as well, and would associate myself with the remarks of the gentleman from New York.

With that, I'll yield back the balance of my time.

Chairman BAKER. I thank the gentleman.

Mr. McHenry.

Mr. MCHENRY. Thank you, Mr. Chairman. Thank you for holding this hearing.

I must disagree with my colleagues on the other side of the aisle. I think this is a very helpful hearing.

They keep bringing up the firm Milberg Weiss, and I look at the committee hearing, and the title of it, Mr. Chairman, if I've the correct committee hearing notice, is, "Investor protection: a review of plaintiffs' attorneys' abuses in security litigation and legislative remedies."

I certainly think this hearing is mostly likely about legislative remedies, but if they're bringing up Milberg Weiss, I assume that really pertains to a review of plaintiffs' attorneys' abuses in security litigation.

Well, it's kind of perplexing they would bring up Milberg Weiss if that weren't the case, that perhaps that was a firm that was abusive and securities litigation.

So Mr. Chairman, you know, I think it's perplexing that the other side keeps talking about this.

A colleague said that this side of the aisle is a tool for our corporate friends. Well, Mr. Chairman, I would simply retort that perhaps it's the other side that's the tool for the trial bar.

I yield back the balance of my time.

Chairman BAKER. I thank the gentleman.

Mrs. McCarthy.

Mr. FRANK OF MASSACHUSETTS. Will the gentlelady yield to me for 30 seconds?

Mrs. MCCARTHY. I will yield to the gentleman from Massachusetts.

Mr. FRANK OF MASSACHUSETTS. I would just point out to the previous speaker that the original title of the hearing was, "A review of the indictment."

So the notion that we are the ones who brought it up is, of course, about as far removed from reality as we get even in this hearing room from time to time.

The original purpose—the original title of the hearing was, "A review of the indictment." The chairman, when Mr. Kanjorski and I

objected, wrote back and said, "Okay, I'll change the title, but I won't change the focus."

In fact, the memorandum sent out by the committee in its first substantive sentence says, "The law firm of Milberg Weiss and two of its partners were indicted."

So the focus on the indictment is the chairman's focus, not ours.

I thank the gentlelady.

Mrs. MCCARTHY. Taking my time back, again, I'm looking forward to the hearing, but I have to say that, you know, we have seen this Congress, certainly in the last 10 years that I've been in Congress, try to do everything they can to take away the ability of our trial lawyers to help people that rightfully should be able to sue.

If we look at a number of corporations in the last several years that have abused their powers—and Enron certainly is right there on the top of them—that it is our job to protect certainly our constituents and certainly those that need to be protected.

You know, I consider myself a pro-business person, but when I look at these CEO's, they're putting the stockholder over their employees 9 times out of 10, don't particularly care what their employees do, and that's why we're dealing with pensions, possibly losing health care, and we're wondering why the middle-income families in this country are feeling the pain.

So I will listen to the testimony, and I am surprised that we have a sitting judge, and I don't know the law that much, but I am surprised that we have a sitting judge who possibly will be talking about a case that's not even put to trial yet.

With that, I yield back the balance of my time.

Chairman BAKER. I thank the gentlelady.

Mr. Campbell?

Mr. CAMPBELL. Thank you, Mr. Chairman.

I have not been a Member of this Congress or this committee for very long, but if I'm not mistaken, this committee and this Congress, after the Enron, WorldCom, and so forth debacles, acted to have hearings and in fact took action on those items with Sarbanes-Oxley law and others long before many, if not all of the convictions in those cases occurred.

In fact, it was only earlier this year that the primary convictions on Enron actually occurred, and I don't think that anyone on this committee believes that this committee or this Congress should not have acted with Sarbanes-Oxley or whatever remedy we felt was appropriate until now, some 3 years after the shareholders in the Enron and WorldCom cases had lost their money.

What we are dealing with here is similar to those cases, is an allegation of wrongdoing upon which shareholders have been harmed, and I don't really see any distinction between hearings dealing with the allegations on Enron and WorldCom or the allegations here.

So I thank you for the hearing, and I look forward to the testimony.

Chairman BAKER. I thank the gentleman for his statement.

Mr. Clay.

Mr. CLAY. Thank you, Mr. Chairman.

Mr. FRANK OF MASSACHUSETTS. Will the gentleman yield to me for 10 seconds?

Mr. CLAY. I yield to the gentleman.

Mr. FRANK OF MASSACHUSETTS. The difference is this. No one who was under indictment was summoned. Those were hearings not about indictments.

And you are talking now about a hearing where it said originally, "a review of the indictment," and it was only changed for cosmetic purposes, and the invited witness was the named partner in the firm that is under indictment.

And if the gentleman does not think there is a difference between someone who is under indictment in our system and someone who isn't, that's the core of our question.

We are saying that at the point that an indictment comes and you are focused on a particular individual or a particular company, firm, whatever, with criminal liability, that ought to make a difference.

I thank the gentleman.

Mr. CLAY. I thank the gentleman.

It is alarming to see the discovery of additional alleged ways to defraud investors in their retirements—their children's college funds, trusts for their families, and other current or future plans for their investments.

There is currently a case in court, no decision has been rendered, in which a law firm is accused of giving $11.3 million in kickbacks to paid plaintiffs. The indictment alleges that the firm received well over $200 million in attorney fees from class action lawsuits over the past 20 years. There is a 20-count indictment in this case.

My concern centers on the alleged amounts of money involved and the fear of this not being an isolated case.

These alleged schemes potentially are costing billions of dollars to investors. It is the investors who ultimately pay the judgments. We must stop this bleeding of our investment resources.

However, in our haste to do something about this problem, we must not put in remedies that further complicate the problem.

H.R. 5491, the Securities Litigation Accountability and Transparency Act, has been introduced as a remedy for this issue.

I, as well as many others, have concerns that the loser pays provision of the bill could add a threat to plaintiff attorneys that would result in discouraging meritorious lawsuits as well as the intended frivolous lawsuits.

Many are concerned that if a judge determined that their case was not substantially justified, the plaintiffs could be forced to pay the defendants' legal fees. This could eliminate those law firms that work on a contingency basis and only the large firms would be able to take the risk of these cases.

I also have concerns about Section 4 of H.R. 5491. This provision removes the right of plaintiffs to choose their lead attorneys.

The Consumer Federation of America writes that, "Allowing judges to impose a competitive bidding process suggests that costs are the only relevant factor to consider when selecting counsel and that judges are better able than investors to determine what is in their best interest. Under the worst-case scenario, investors could be forced to accept representation by a lower-cost firm that lacks

the expertise and experience of other available counsel and could lose their case as a result."

I look forward to hearing the witnesses' testimony and the discussion of these and other salient issues on this subject.

I also commend Chairman Baker for bringing forth legislation and I hope that we can work on compatible legislation to address this need.

I yield back the balance of my time.

Chairman BAKER. I thank the gentleman for his statement.

Mr. Gillmor.

Mr. GILLMOR. Thank you, Mr. Chairman.

I'll only say I think it's very timely, what you're doing, and I think it's very important that we examine some of the abuses in this area.

And I yield back.

Chairman BAKER. I thank the gentleman for his delightfully constructive statement.

Mr. Miller.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman. I will make an opening statement, even though I did not intend to when I arrived, and I wonder, after all of the opening statements, what is really left for the witnesses to say this morning.

The law recognizes that there are people we should be able to trust; we should be able to count on them to act on our behalf, and to deal with us fairly, honestly, and openly. Those are fiduciary relationships.

A lawyer has that relationship with their client. A client should be able to count on their lawyer to act on their behalf, and to deal with them fairly, openly, and honestly.

The law also recognizes that corporate officers are supposed to have that relationship with shareholders, and that shareholders can count on corporate officers to act on their behalf, to act fairly, openly, and honestly.

If lawyers are betraying the trust of their clients, I'm outraged. I join in the outrage of those on that other side.

But I also hope that they will join in the outrage that I feel if corporate officers are betraying the trust of shareholders to abuse their position, to take advantage, and to betray the trust of the people who should be able to trust them.

Chairman BAKER. I thank the gentleman.

Pursuant to the notice of the vote on the Floor, it would be my intention, with everyone's concurrence, to recognize Ms. Velazquez, if she chooses to make any opening statement.

I don't believe there's an additional member on our side that wishes to make an opening statement.

I would ask the gentlelady to make her statement and then we would recess for the votes, much to the delight of our panel, I'm sure.

Mr. FRANK OF MASSACHUSETTS. There is only one vote, apparently. There is a motion to adjourn.

Chairman BAKER. A long day.

Mr. FRANK OF MASSACHUSETTS. So buckle your seatbelts, it's going to be a bumpy ride today.

Chairman BAKER. Yes. I'm looking forward to that excitement.

There being no objection, Ms. Velazquez?

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

I ask unanimous consent to submit my statement into the record.

Chairman BAKER. Absolutely, without objection.

In that light, since we have a 15-minute vote, we will just come right back. We have one, and rather than rush any person to conclude their statement, we will stand in recess pending the single vote.

Thank you.

[Recess]

Chairman BAKER. I'd like to reconvene the meeting of the Subcommittee on Capital Markets.

At the time of the committee's recess, I do not believe there was an additional member requesting recognition for opening statements.

That being the case, I would now begin to move to our panel of witnesses.

Mr. ACKERMAN. Mr. Chairman?

Chairman BAKER. Mr. Ackerman?

Mr. ACKERMAN. Would this be the appropriate time?

Chairman BAKER. The gentleman is being recognized for what purpose?

Mr. ACKERMAN. To make a motion.

Chairman BAKER. The gentleman is recognized.

Mr. ACKERMAN. Let me just get myself organized here for a second.

Mr. Chairman, pursuant to the rules of the committee, the Rules of the House, and section 2(K)5 of Rule 11, I move that the committee go into executive session, and I ask to be heard on the motion.

Chairman BAKER. The motion is in order. The gentleman's motion, however, is not debatable, and the committee would proceed—

Mr. ACKERMAN. Mr. Chairman, I'm reading the rules, and it does not say that the motion is not debatable, and in the absence of an assertion, every motion is debatable.

Chairman BAKER. I'm advised by the committee parliamentarian that a discussion as to why the committee would go into a non-public consideration of a legislative matter is not a debatable measure, by precedent of the House.

Mr. FRANK OF MASSACHUSETTS. Parliamentary inquiry, Mr. Chairman?

Chairman BAKER. The gentleman is recognized.

Mr. ACKERMAN. Reserving the right to appeal the decision.

Chairman BAKER. Understood.

Mr. FRANK OF MASSACHUSETTS. Mr. Chairman, you're ruling that the motion is not debatable when it comes to the parliamentarian, who is entirely legitimate in his ruling, so I will not contest that, but I did want to get clarification, because does that apply to the provision that says whenever it is asserted by a member of the committee that the evidence or testimony may tend to degrade, defame, or incriminate any person, that ruling says that even if you say the purpose is that the testimony would tend to defame or degrade or incriminate, that is still nondebatable?

Chairman BAKER. I am advised that is correct.

Does the gentleman insist on his motion?

Mr. ACKERMAN. Mr. Chairman, reserving the right to insist, Mr. Chairman, am I correct in saying that it was your statement that, "Mr. Weiss chooses not to appear before the committee because that would apparently degrade"—your words again—"his firm"?

Does not that fit into Paragraph 5, "Whenever it is asserted by a member"—that would be me, in this case—"whenever it is asserted by a member of the committee"—and that would be you in this, case, too—"that the evidence or testimony at the hearing may tend to degrade, defame, or incriminate any person," etc.?

You've said it, I've said it, and I've read the hit man-like testimony of some of our witnesses, and they say it, and do it.

And does this not say "may" and then we go into executive session?

Because if it's important for us as legislators to hear the testimony of the witnesses, I don't think it is necessary to degrade this committee itself by dragging us into the act of degrading people who are accused, and who have not had the opportunity to defend themselves in court.

Chairman BAKER. If I understand the gentleman's inquiry properly, it is as to whether or not we should go into executive session. The gentleman's privilege motion is in order.

The matter, however, to which I object, is the debate of the motion to go into executive session, pursuant to the parliamentarian's advising me that a debate of the motion to go into executive session thereby makes public the very issues which the gentleman would seek to make non-public by entering into executive session.

Therefore, the matter before the committee, as I understand it at the moment, is your motion to go into executive session, which I then ruled is in order, however, it is not debatable.

Therefore, the committee should immediately proceed—

Mr. ACKERMAN. I would appeal the decision of the Chair.

Chairman BAKER. And the gentleman now moves to appeal the ruling of the Chair, which is also in order, which would—Mr. Ryun?

Mr. RYUN. Mr. Chairman, I move to lay the appeal on the table.

Chairman BAKER. Which is also in order. Mr. Ryun is within his right to move to table your motion to appeal the ruling of the Chair.

There being no further motion—

Mr. ACKERMAN. I would request a roll call vote.

Chairman BAKER. There being no further motion in order at this time, the question is the matter before the committee, to which the gentleman from New York requests a roll call vote.

The clerk will call the roll on the motion to table the motion to appeal the ruling of the Chair.

The clerk is coming around to call the roll here. Just one moment.

Mr. ACKERMAN. Mr. Chairman?

Chairman BAKER. Mr. Ackerman.

Mr. ACKERMAN. I would ask unanimous consent, using my sense of math over my sense of justice, to withdraw the motion to appeal from the decision of the Chair and proceed directly to the vote.

Chairman BAKER. I appreciate the gentleman's offer, and I would first have to turn to Mr. Ryun and ask him to withdraw his motion to table the motion.

Mr. RYUN. Mr. Chairman, I withdraw the motion.

Chairman BAKER. Mr. Ryun withdraws his motion.

Mr. Ackerman is recognized. He withdraws his motion.

We are now back to proceeding to our first witness?

Oh, I understand. Now you want to vote on the motion to go into executive session.

That motion is not debatable. That motion is before the committee, and we will now vote on the motion to go into executive session.

The clerk will call the roll, please.

The CLERK. Mr. Ryun.

Mr. RYUN. No.

The CLERK. Mr. Ryun votes no.

Mr. Shays.

[No response]

The CLERK. Mr. Gillmor.

Mr. GILLMOR. No.

The CLERK. Mr. Gillmor votes no.

Mr. Bachus.

[No response]

The CLERK. Mr. Castle.

[No response]

The CLERK. Mr. Lucas.

Mr. LUCAS. No.

The CLERK. Mr. Lucas votes no.

Mr. Manzullo.

Mr. MANZULLO. No.

The CLERK. Mr. Manzullo votes no.

Mr. Royce.

[No response]

The CLERK. Mrs. Kelly.

Mrs. KELLY. No.

The CLERK. Mrs. Kelly votes no.

Mr. Ney.

Mr. NEY. No.

The CLERK. Mr. Ney votes no.

Mr. Fossella.

[No response]

The CLERK. Mrs. Biggert.

Ms. BIGGERT. No.

The CLERK. Mrs. Biggert votes no.

Mr. Miller of California.

[No response]

The CLERK. Mr. Kennedy.

Mr. KENNEDY. No.

The CLERK. Mr. Kennedy votes no.

Mr. Tiberi.

Mr. TIBERI. No.

The CLERK. Mr. Tiberi votes no.

Mr. Barrett.

Mr. BARRETT. No.

The CLERK. Mr. Barrett votes no.
Ms. Brown-Waite.
[No response]
The CLERK. Mr. Feeney.
[No response]
The CLERK. Mr. Gerlach.
Mr. GERLACH. No.
The CLERK. Mr. Gerlach votes no.
Ms. Harris.
[No response]
The CLERK. Mr. Hensarling.
Mr. HENSARLING. No.
The CLERK. Mr. Hensarling votes no.
Mr. Renzi.
[No response]
The CLERK. Mr. Davis of Kentucky.
Mr. DAVIS OF KENTUCKY. No.
The CLERK. Mr. Davis votes no.
Mr. Fitzpatrick.
[No response]
The CLERK. Mr. Campbell.
Mr. CAMPBELL. No.
The CLERK. Mr. Campbell votes no.
Mr. Kanjorski.
[No response]
The CLERK. Mr. Ackerman.
Mr. ACKERMAN. Aye.
The CLERK. Mr. Ackerman votes aye.
Ms. Hooley.
[No response]
The CLERK. Mr. Sherman.
[No response]
The CLERK. Mr. Meeks.
Mr. MEEKS. Aye.
The CLERK. Mr. Meeks votes aye.
Mr. Moore of Kansas.
Mr. MOORE OF KANSAS. Aye.
The CLERK. Mr. Moore votes aye.
Mr. Capuano.
Mr. CAPUANO. Aye.
The CLERK. Mr. Capuano votes aye.
Mr. Ford.
[No response]
The CLERK. Mr. Hinojosa.
[No response]
Mr. Crowley.
Mr. CROWLEY. Aye.
The CLERK. Mr. Crowley votes aye.
Mr. Israel.
[No response]
The CLERK. Mr. Clay.
Mr. CLAY. Aye.
The CLERK. Mr. Clay votes aye.
Mrs. McCarthy.

Mrs. MCCARTHY. Aye.
The CLERK. Mrs. McCarthy votes aye.
Mr. Baca.
Mr. BACA. Aye.
The CLERK. Mr. Baca votes aye.
Mr. Matheson.
Mr. MATHESON. Aye.
The CLERK. Mr. Matheson votes aye.
Mr. Lynch.
[No response]
The CLERK. Mr. Miller of North Carolina.
Mr. MILLER OF NORTH CAROLINA. Aye.
The CLERK. Mr. Miller votes aye.
Mr. Scott.
Mr. SCOTT. Aye.
The CLERK. Mr. Scott votes aye.
Ms. Velazquez.
Ms. VELAZQUEZ. Aye.
The CLERK. Ms. Velazquez votes aye.
Mr. Watt.
[No response]
The CLERK. Mr. Davis of Alabama.
Mr. DAVIS OF ALABAMA. Aye.
The CLERK. Mr. Davis votes aye.
Ms. Bean.
[No response]
The CLERK. Ms. Wasserman-Schultz.
Ms. WASSERMAN-SCHULTZ. Aye.
The CLERK. Ms. Wasserman-Schultz votes aye.
Chairman BAKER. Mr. Sherman, how is he recorded?
The CLERK. Mr. Sherman is not recorded.
Mr. SHERMAN. Please record me as an aye.
The CLERK. Mr. Sherman votes aye.
Mr. Baker, I hadn't actually finished the roll yet.
Chairman BAKER. I'm sorry. Will members withhold, please?
Mr. Frank.
Mr. FRANK OF MASSACHUSETTS. Mr. Chairman, I have to explain that since I am on the committee ex officio, along with the chairman, in the absence of the chairman, I will not vote.
I think it's only appropriate if the chairman is here for me to vote, since we are both here ex officio.
I would have voted aye if I had voted.
Chairman BAKER. I respect and appreciate the ranking member's sense of fairness.
The CLERK. Mr. Baker.
Chairman BAKER. I vote no.
The CLERK. Mr. Baker votes no.
Chairman BAKER. Mr. Miller?
Mr. MILLER OF CALIFORNIA. No.
The CLERK. Mr. Miller votes no.
Chairman BAKER. Mr. Israel?
Mr. ISRAEL. Aye.
The CLERK. Mr. Israel votes aye.
Chairman BAKER. Mr. Shays?

Mr. SHAYS. No.

The CLERK. Mr. Shays votes no.

Chairman BAKER. Mr. Castle?

Mr. CASTLE. No.

The CLERK. Mr. Castle votes no.

Chairman BAKER. Mr. Renzi?

Mr. RENZI. No.

The CLERK. Mr. Renzi votes no.

Chairman BAKER. Mr. Fitzpatrick?

Mr. FITZPATRICK. No.

The CLERK. Mr. Fitzpatrick votes no.

Chairman BAKER. The clerk will report.

The CLERK. Mr. Chairman, the ayes are 16 and the nays are 20.

Chairman BAKER. The gentleman's motion has failed.

We will now proceed to hearing the testimony of our panel of witnesses.

Mr. FRANK OF MASSACHUSETTS. I think it's safe to say goodbye to most of the members who just dropped in to vote.

[Laughter]

Chairman BAKER. I think the gentleman is correct. This is the first time, in a long time, that the Capital Markets Subcommittee has been full.

Mr. BARRETT. Yes, but Mr. Chairman, some of us did vote, while the other abstained from voting.

Mr. FRANK OF MASSACHUSETTS. Which means I get all the more credit for showing up.

Chairman BAKER. But some are doing a great service by showing up, voting, and then leaving.

Let us now proceed to our first witness.

Mr. ACKERMAN. Mr. Chairman?

Chairman BAKER. The gentleman from New York.

Mr. ACKERMAN. I request that the witnesses be sworn.

Chairman BAKER. The gentleman has asked that the witnesses be sworn.

I have no objection to the witnesses being sworn, and if there is no further objection from anyone on the panel, or discussion, at this time, I would ask all witnesses please to rise.

If you would please respond appropriately, do you swear to tell the whole truth and nothing but the truth, so help you, God?

[Witnesses sworn]

Chairman BAKER. For the record, all witnesses answered affirmatively to the inquiry.

I thank the gentleman.

We will now proceed to hear our first witness on the panel, the Honorable Vaughn R., Walker, Chief Judge, U.S. District Court, Northern District of California.

Let me, for all witnesses, make the normal advisory. We request the witnesses to constrain your remarks to 5 minutes. Your full written testimony will be made part of the official record, and we do appreciate your patience and participation here today.

Judge, please proceed at your own leisure.

STATEMENT OF THE HONORABLE VAUGHN R. WALKER, CHIEF JUDGE, U.S. DISTRICT COURT, NORTHERN DISTRICT OF CALIFORNIA

Judge WALKER. Thank you, Mr. Chairman, and members of the committee.

It's a pleasure to be here to speak today to House Resolution 5491, and that is what I'm going to be talking about.

In light of the comments that have been made, let me just say, in particular with reference to some of the comments made by Congressman Ackerman, that I think it's always appropriate for the Congress to examine and to investigate how the laws that it enacts work in actual practice. That's always appropriate for the Congress to do.

Congress enacted much securities regulation legislation over the years, much of it having to do with how cases involving those laws are litigated, and I think it's quite appropriate for the House and for the Congress to examine that and from time to time, when appropriate, to hear from judges who are called upon to apply those laws to determine whether or not they are working in the way that Congress intended them to work.

Let me say that I come to this particular subject matter, the subject matter of securities litigation, from a little different perspective than others.

Most lawyers in these cases appear on one side or the other, always for the plaintiff or always for the defendant.

Well, I've practiced on both sides, and now as a judge, I've practiced on all three sides of these cases, and it is from that perspective that I offer the comments on H.R. 5491.

Class actions are, at bottom, a privatization of a public function, public law enforcement.

It is as if a public law enforcement function has been delegated to private parties to bring these actions, to maintain these actions, to pursue them on behalf of parties who are injured, and it operates in the same way that public law enforcement does.

The general public does not ask for law enforcement officials to initiate the machinery of justice, and in the same way, absent class members do not ask for these class actions to be initiated.

The only direct attorney-client relationships that exist are those that exist between the named plaintiffs, or the lead plaintiffs, and counsel in the cases.

There are, with respect to these cases, relatively few of the kinds of controls that are analogous in other contexts of public contracting, controls that ensure transparency, competition, and the other measures that we all believe are appropriate when a public function is delegated to private parties.

Congress, in 1995, perceived that there were abuses in this area, and as you well know, enacted the Private Securities Litigation Reform Act of that year, imposing essentially two requirements: one, a lead plaintiff requirement; and two, a heightened pleading requirement.

I would suggest to the committee that things have not quite worked out the way that I think Congress intended.

Relatively few lead plaintiffs have come forward in the form of institutional investors, as was envisioned by Congress when it enacted the lead counsel provisions of the 1995 Act.

Studies have shown that only about a fifth, perhaps a third of institutional investors have come forward to serve as lead plaintiffs, to monitor the litigation, to control and watch counsel, and to make important decisions about when to settle and how to settle and how to litigate the case.

It is still true that most of these cases are lawyer driven, lawyer brought, and lawyer controlled.

And secondly, the heightened pleading standards of the legislation, I think, have also not quite turned out the way that Congress intended in 1995.

What those heightened pleading standards have essentially done is to front-end load much of the work of these cases to require a great deal of litigation at the very beginning and to increase, actually, the cost of the litigation, and to increase the cost to securities issuers by putting—by essentially incentivizing them to put a lot of cautionary language into their offering documents, cautionary language and other measures that essentially have very little informational value to investors.

H.R. 5491 makes several steps that I think are very helpful.

The disclosure provisions to require that counsel and lead plaintiff disclose the relationships that they have among one another is a very helpful measure—a requirement to disclose some of the interrelationships that have been troubling in this area.

Secondly, the provision that provides for competition as a means by which a judge can impose some controls over the costs to investors of these cases to try to bring down attorney fees to a more reasonable level.

In cases where there have been active large institutional investors as lead plaintiffs and in cases in which there has been competitive bidding in the selection of lead counsel, the costs to investors of the fees and expenses in those cases have been substantially less than in the traditional form of organization of those cases, and the recoveries in those cases have been just as significant in the cases that have proven to be meritorious.

Two other points which I would make very briefly.

That is, first, I think the committee should look at an additional provision that would put some limitation on the ability of counsel to aggregate a group of unrelated plaintiffs and thereby qualify for the most adequate plaintiff or lead plaintiff provisions of the act.

That has permitted counsel to put together groups that are large, that are unwieldy, and that do not exercise any effective control over the litigation.

So I would suggest that the committee may wish to look at that possibility.

And finally, at the fee shifting provision of H.R. 5491, let me just say that would be a far more effective and measured way of getting at the problem which Congress attempted to get at with the heightened pleading requirement. It would essentially impose upon those persons who bring actions that are not substantially justified the costs of the action and, therefore, provide an incentive not to bring cases that cannot substantially be justified.

So I would think that perhaps with, I'm sure, the changes that will be wrought through the legislative process, the fundamental ideas that are put forth in H.R. 5491 are worthy of very serious consideration, and Mr. Chairman, I am pleased and honored to have the opportunity to come and address the committee on this subject.

[The prepared statement of Judge Walker can be found on page 90 of the appendix.]

Chairman BAKER. I thank the gentleman for his participation and his statement.

Our next witness is certainly not new to the committee, the Honorable William F. Galvin, secretary of the commonwealth, Commonwealth of Massachusetts.

Welcome, sir.

STATEMENT OF THE HONORABLE WILLIAM F. GALVIN, SECRETARY OF THE COMMONWEALTH, COMMONWEALTH OF MASSACHUSETTS

Mr. GALVIN. Thank you, Mr. Chairman.

Mr. Chairman, Ranking Member Frank, thank you again for your invitation.

As secretary of the Commonwealth of Massachusetts, I am the chief securities regulator in Massachusetts, and among other provisions, my office administers and enforces the Massachusetts Uniform Securities Act.

The work of my Securities Division includes the review of securities offerings, the listing of securities professionals, and significant enforcement work.

Enforcement cases brought by my office have addressed some of the most substantial and timely problems in the financial marketplace: false and misleading analyst reports from national brokerages; market timing of mutual funds; abusive practices in the sales of annuity products; and fraudulent conduct by investment advisors.

I must stress that the great majority of financial firms conduct an honest business and most issuers of stock are not defrauding investors.

However, my office has repeatedly seen that small investors are at a serious disadvantage when they deal with the dishonest sellers of securities and dishonest companies.

It is imperative that investors at all levels have effective remedies in cases when they are defrauded. Class action litigation has been an effective remedy, especially for small investors.

My office also incorporates Massachusetts corporations and charters business entities in Massachusetts.

I'm very sympathetic to the needs of legitimate businesspeople and their companies, but business corporations ultimately belong to their shareholders. Corporate executives and directors owe fiduciary obligations of care and loyalty to the corporation and its shareholders.

I speak today for the interest of investors.

If investors are to defend themselves from misconduct and fraud by officers and directors, we must preserve their remedies under the securities laws. Ultimately, giving investors strong and effec-

tive remedies will help prevent misconduct by company management.

The way I see it, the right to civil litigation is an essential part of the free market. It's a free market force that guarantees that there will be financial consequences for fraud and wrongdoing, and it operates as a deterrent in the marketplace to continuing misconduct.

My office has committed significant resources to enforcement. We are a strong cop on the beat, although the resources of any regulatory agency will always be limited.

Regulators cannot police the financial marketplaces alone. Since the 1930's, investors' private right to sue has also operated to police and deter investment fraud. Both of these tools are essential to maintain the integrity of our financial markets.

We are concerned that the provisions of the Securities Litigation, Attorney Accountability, and Transparency Act will stifle the ability of plaintiffs to obtain recourse when the securities laws are violated.

While my office has returned more than $20 million directly to investors, I'm still concerned that many times so-called Fair Funds or pool compensation funds do not effectively reach defrauded investors. Civil actions offer a more precise remedy.

Let me speak about some of the specific provisions that I'm concerned about.

The loser pays provision. This provision may be seriously detrimental to the interests of retail investors because their attorneys will be required to take on greater financial risk in a class action.

This provision would reverse the long-standing "American rule" that each party in an action should be responsible for its costs unless the action involves abuse of the legal process, potentially imposing on a defendant costs—on a plaintiff—that will chill investors and their attorneys from pressing legitimate claims.

Litigation always involves many uncertainties. If there is a risk that the costs of defense counsel may fall on plaintiffs' counsel, lawyers and parties who cannot afford that risk are that exposure will back away from even meritorious investor suits.

I note that Federal Rule 11 already requires that court filings not be made for any improper purpose, and that legal arguments be warranted, and that a party violating these requirements will be subject to court sanctions, including paying defendants' costs and legal fees.

The loser pays provision of this legislation will add very little value to the current court rules.

With regard to conflict of interest disclosure, I have no comment on this section, except to ask whether legislation that targets the practice of a particular law firm is the proper way to approach these issues.

I note the law firm in question is currently the subject of a Federal indictment for the practices that this section would address, and it seems to me that the courts should be the ones to make those decisions as to the guilt of that firm before we pursue general remedial action.

The court's role in selecting counsel for plaintiffs' class is a particularly troubling part of the bill. It's not clear why this section is necessary, and appears not to be advisable.

The Private Securities Litigation Reform Act of 1995 created a presumption that the investor with the largest financial stake in a case should serve as lead plaintiff and it should choose and negotiate with class counsel.

This law has led to more institutional investors acting as lead plaintiffs in class actions, so these cases are often led by sophisticated plaintiffs with meaningful resources.

If the proper party is acting as lead plaintiff, the selection of counsel should rest with them.

Section 4 of this bill goes beyond requiring that the court should simply approve or disapprove counsel for the plaintiffs, and instead embroils the court in the selection of plaintiffs' counsel.

The legislation will allow the court to employ alternative means in the selection and retention of counsel for the plaintiff, including a competitive bidding process.

Clearly, a bidding process is not the best way to select counsel when significant issues are at stake in complex and technical litigation.

This provision also raises disturbing constitutional issues, including the right to be represented by counsel, freedom of association, and freedom of contract. In the end, it is simply common sense that if the proper lead plaintiff is in place, that plaintiff is in the best position to select its counsel.

I urge that this legislation not be adopted.

Even after the passage of the Sarbanes-Oxley Act, we continue to see disturbing examples of fraud in the financial markets, from the failure and bankruptcy of the Refco commodity firm just a few months after its IPO went to market, to the unfolding stories relating to the backdating of executive stock options, there are still fresh examples of fraud and misconduct in the financial marketplace.

But there is often a common thread running through these scandals, and that is the application of two sets of rules, one set for connected insiders, which will allow them to exact unjust profits from the marketplace, and the other set of rules for the average American investor that has them pay the price for the fraud of the connected insiders.

Private suits play an important part in keeping companies honest.

As successive Congresses have encouraged and often required American families to assume the risks of the marketplace for their pensions and other aspects of their financial future, I urge you to protect and not diminish this important tool to fight abuse and fraud against investors.

Thank you.

[The prepared statement of Mr. Galvin can be found on page 87 of the appendix.]

Chairman BAKER. I thank the gentleman.

In light of the pending motion to rise on the Floor, and not to put the next witness under any constraint with testimony, I sug-

gest the committee now recess, record votes, and return as quickly as possible.

[Recess]

Chairman BAKER. If I may, I'd like to reconvene our hearing.

At the time of the committee's recess, we had just concluded, or Mr. Galvin had concluded his remarks, and we were to move to our next witness.

I welcome to the committee today Mr. Theodore H. Frank, resident fellow and director, AEI Liability Project of the American Enterprise Institute.

Welcome, sir.

STATEMENT OF THEODORE H. FRANK, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE AND DIRECTOR, AEI LIABILITY PROJECT

Mr. FRANK. Thank you, Mr. Chairman, and members of this subcommittee, for your kind invitation to testify today.

I serve as a resident fellow at the American Enterprise Institute, but I'm not testifying here on their behalf, and the views that I'm sharing here today are my own.

There are areas of securities class action reform that are unavoidably divisive, but this bill should not be one of them. The small steps taken by this bill are non-controversial means to reduce corruption in the securities litigation process, benefitting shareholders and plaintiffs' law firms that play by the rules.

Securities class actions affect almost every element of American business. Between 1997 and 2005, there were 225 securities class actions brought against members of the Fortune 500.

From 1996 to 2005, securities class action settlement totalled $37 billion. Not all of that settlement money reflects wrongdoing.

As Justice Stevens noted about securities class actions in a unanimous Supreme Court decision in March, even weak cases brought under the securities laws may have substantial settlement value, because the very pendency of the lawsuit may frustrate or delay normal business activity.

There is a war, with investors on one side and lawyers on the other. It's worth noting that the majority of institutional investors, who suffer the greatest losses from stock fraud, don't want anything to do with the vast majority of securities litigation, because they recognize that they are made worse off by it.

Settlements in such lawsuits provide money to the plaintiffs' left-hand pocket by taking it from their right-hand pocket with a substantial commission to the plaintiffs' attorneys involved for facilitating the transaction.

In the WorldCom litigation, Forbes Magazine calculated that the lead plaintiff, Public Pension Fund, lost at least $2 million net from its settlements, because it also held stock in the defendant banks, while the plaintiffs' attorneys, who donated generously to the elected official who approved the fee agreement, collected more than $300 million.

This is ironic, given that the lawsuits against the bystander banks accused the defendants of having conflicts of interest.

The recent indictment shines a small light on a small portion of a great problem of corruption in the plaintiffs' bar. The very fact

of someone pleading guilty to accepting kickbacks exhibits that the PSLRA's attempt to impose market discipline on securities litigation has failed.

If securities class action attorneys were facing market competition, there would be no windfall worth fighting for with millions of dollars in alleged under-the-table payments, much less the risk of prosecution.

I would argue that sweeping reform is needed. This bill is not that sweeping reform, but it represents some incremental reforms that improve the system for honest players on both sides of the table, and therefore, should be uncontroversial.

Most notably, courts differ over whether the PSLRA, the Private Securities Litigation Reform Act, permits competitive bidding. As a result, courts are reluctant to implement auctions, and the benefits auctions provide to investors and to honest plaintiff law firms are rarely realized.

This bill fixes the statutory ambiguity by making competitive bidding to chose lead counsel explicitly permissible.

Auctions should lead to lower-priced representation. When a court appoints a law firm within setting the fees, the attorneys' incentive is to maximize their take, but if a law firm is selected by auction, attorneys compete to provide the lowest reasonable bid.

Empirical research supports these theoretical contentions. Both Judge Milton Shadur, a Carter appointee who has experimented with competitive bidding in his court, and Professor Michael Parin, in a 2006 working paper, find that auctions substantially reduced attorneys' fees and increased returns to the class.

Parin's study predicted that fees could be cut by more than half. This money, which amounts to hundreds of millions of dollars a year, could be going directly into investors' pockets instead of those of attorneys.

It further suggests that class action attorneys are gouging at a price twice what a fair market competition would produce, the equivalent of one's local service station charging $6 a gallon for gasoline on a normal spring day in 2006 without extenuating circumstances.

In the case of an overcharging service station, one can choose to buy gas elsewhere. Unnamed class members have little recourse to limit fees obtained by plaintiffs' firms who did not agree to a market-based price at the front end.

The language of the bill is permissive, not mandatory. Thus, courts will have the freedom to attempt alternative approaches, for example structuring auctions for when there isn't a trustworthy institutional investor as a lead plaintiff. This judicial discretion will provide helpful data on how best to help investors when Congress next revisits the securities laws.

I'd love to talk about any of these issues in the more detailed testimony, written testimony, with any of the members who would like.

[The prepared statement of Mr. Frank can be found on page 75 of the appendix.]

Chairman BAKER. I thank the gentleman for his testimony.

Our next witness is Professor James D. Cox, Duke University School of Law, Duke University.

Welcome, sir.

STATEMENT OF JAMES D. COX, BRAINARD CURRIE PROFESSOR OF LAW, DUKE UNIVERSITY

Mr. COX. I also thank the committee for inviting me to share my views, both in writing and orally here.

Congressman Feeney mentioned earlier the necessity of achieving some balance, and I want to share and amplify some data points that are in my sworn statement that filings of securities class actions peaked in 2003–2004; there was a 17 percent decline in 2005 from that of 2004.

Following the PSLRA, we found a significant increase in the granting of motions to dismiss and motions for summary judgment.

Before the PSLRA, the rate was about 19 percent on filed cases; after that, it's in excess of 40 percent, a 107 percent change in that short period of time.

My paper captures some of the explanations for this, some of which is the PSLRA, some is doctrinal shifts that have occurred, and a number of things. All these have had a chastening effect on the number of filings of class actions.

As to the question of auctions, I want to just mention one thing.

Arranged marriages should always cast—we should always cast a skeptical eye toward any sort of arranged marriages, and I think we should do that particularly when we find in the last 3 years a growing trend, and it is a significant increase in the trend of financial institutions stepping forward to apply and then be selected as a lead plaintiff.

Our own surveys and canvassing of funds has revealed to us that the relationship that they have with the law firm, and they do look around for a variety and are not just generally married to one law firm, is important to their decision to become a lead plaintiff.

I commend to the committee a review of the very thoughtful Third Circuit Task Force Report on Selecting Lead Counsel, where they conclude generally that auctions are a bad idea, but save them for rare situations, such as Judge Walker widely saw was happening in the Oracle case, the very first case to introduce auctions, and that would still be a possibility today.

Courts do not prohibit auctions. They are permitted in situations where the court thinks that there's not an appropriate counsel here, and that's certainly true under the guidance of the Third Circuit Task Force Report.

So I believe that auctions remain alive and well, a fallback position when the court believes that there's reason to question whether there's suitable and appropriate counsel there.

As to the fee shifting arrangement, which is the Rule 11 modifications that we find in H.R. 5491, let me just point out four problems with that.

One, there's a certain internal inconsistency. What happens with this draft language that you have is you're adding a new section to the rule.

Earlier what happened with the PSLRA is a mandated finding by the presiding court about whether Rule 11 has been satisfied. That has not been changed in H.R. 5491.

So the life of the provisions that you're proposing would be in a situation where the judge has already made a finding that there's no reason for Rule 11 sanctions and so, therefore, you're likely to find counsel for the defendants seeing that this just continues the litigation burdens, the expense, and the bother of litigation, by so moving, so you need to look at internal inconsistency.

The other thing you may want to ask is, why was it in the PSLRA that they changed Rule 11 for securities litigation? And the reason was they found that defense counsel was reluctant to move for Rule 11 sanctions in these cases.

So now you're introducing where you were prior to pretty much PSLRA, and that was found to be deficient at that point. I'm not quite sure how things have changed.

The other thing I want to just share with you, the third point I'll say, as a reader of advance sheets—that's what I'm going to be doing when I'm waiting for my 3:30 plane this afternoon—I can just share with you that I find, in reading those cases, you know, a lot of close questions when the defendant's motion to dismiss is granted on the pleading issues, that I don't think this is a slam dunk for thinking that there's a lot of Rule 11 cases that are going to be arising by tinkering around with the standards here, because I think that these are vetted within the law firms' offices and these are close cases, so I don't think you're going to find that.

I will say the following, that courts have imposed, in a handful of instances, I must say, Rule 11 sanctions pursuant to the PSLRA.

Whereas before the PSLRA, there were extremely isolated instances over 25 years of imposing Rule 11 sanctions, in the 10 years since the PSLRA, you now find a handful of cases where that's happening.

And the final question I would have is, anytime that we start talking about loser pay principles, anything that introduces friction into access to the courts, I just want to point out a wonderful phrase that's part of our democracy, and distinguishes our country from countries around the world, and it's the expression, "Access to justice."

That's a wonderful expression. Let's be very careful before we start tinkering with anything that's going to cause that to be qualified in any substantial way without producing equally substantial benefits.

The final thing I'd say is that the third provision in H.R. 5491 calls for greater disclosure of information about how counsel was selected, conflicts of interest.

I would fully support that. I believe it should not be isolated to securities class action.

My sworn statement suggests that perhaps this is something that should be universal across class actions.

Many judges do inquire very closely with respect to conflicts of interest, how the plaintiff is selected, counsel, in a class action, whether it be a securities class action or a non-securities class action.

This is something that should be uniform across judges, and to the extent that all judges don't do that, then I think there are grounds, as there is proposed in this legislation, for making it uniform across all class actions.

Thank you for your time, and I'll be glad to work with the committee and the staff in supplying other information that's come out of our studies of securities class action settlements.

Thank you very much.

[The prepared statement of Mr. Cox can be found on page 62 of the appendix.]

Chairman BAKER. I thank the gentleman for his statement.

I will start with questions.

First, Secretary Galvin, I noted in your written testimony a concern about so-called Fair Fund distributions, but in the resolution of the Putnam settlement, which was $110 million in the aggregate, of which the State of Massachusetts received half, the SEC received half, there was, as I understand it, a distribution of $5 million back to Putnam Fund's shareholders.

How was the determination made as to who was entitled, and to the amount each recipient ultimately received?

Mr. GALVIN. As a matter of fact, that process is still ongoing.

We're trying to determine—most of the losers in that case were investors who operate through pension funds or 401k's.

We're attempting now to work through a schedule with Putnam to get those monies back.

My policy has been that I want to make sure that the victims are made whole first. The only monies that the State generally gets are monies that compensate us for our investigation or in some way are actually a punitive penalty for conduct. We do not preference our taking over the individuals.

In the Putnam case, we're still in the process of negotiating the details of getting back people's money.

Obviously, when you're talking market timing, calculating the exact damage is extremely difficult. When you're talking an aggregated fund, such as many of the victims here were, it's even more complicated, but we're still committed to that goal.

My frustration, as referred to in my remarks, is that so often, for instance, in the research analysis cases, I think you'll find that most of that money is still sitting over at the SEC or under court jurisdiction where they're trying to figure out how to get it back to those who were harmed.

I think class actions provide a better remedy for figuring out exactly who is most adversely affected. I think that that's an important tool to have when you're trying to make people whole, especially in complex financial cases.

Increasingly, the victims of these types of financial crimes are indirect in the sense that they are members of pension funds, they are affected by involvement in mutual funds. Calibrating their precise loss is extremely difficult and time consuming, but I still think it's a goal.

I share with you the idea that the important thing is to put people back, get people back their money, and if it's been stolen from them, to get it back for them.

Chairman BAKER. Well, why not, then, if you're going through the difficult task of making judgments about whom is entitled to the funds in the first place, deducting out your cost of administration? Certainly that can't be $50 million out of the $55 million settlement.

Why would you not, after having established the fact and precedent that you wish to give money back.

I believe in your statement you also indicated in the aggregate, through efforts of your office, you have returned about $20 million to investors.

What is the legitimate reason for keeping $50 million at the State level as opposed to giving it back, or some significant percentage, to those identified recipients?

Mr. GALVIN. Well, I don't think we have.

First of all, the Putnam case was a joint case between Massachusetts and the SEC, and obviously, as you know, from some of my previous appearances before this committee, I do subscribe to the theory that the SEC has superior jurisdiction, and obviously, in that regard, we give them some leeway in determining how these cases are decided.

We've always preferenced Massachusetts investors, especially, and others.

In the case of Putnam, you also had a number of investors from outside of Massachusetts who were adversely affected by the conduct. In that case, the SEC was the better party to speak for them, more than I was.

Chairman BAKER. Well, that's correct. The settlement was $110 million. SEC received $55 million of it. All of the $55 million, pursuant to SEC explanations, will go to Fair Funds distribution, and that merely—

Mr. GALVIN. That hasn't been distributed. I mean, that's my criticism.

Chairman BAKER. Well, of $7 billion targeted by the SEC subject to Fair Funds identification as being ill-gotten gains, $5 billion has been collected in assets and over $3.1 billion, I believe, to date, has actually been distributed.

So the progress is more significant than most would believe. I'm just getting to the principle, rather than actual operative facts, and that is, should we not give the money back to the individuals as opposed to retention for State government purposes?

Mr. GALVIN. My sympathy is to give it back to the individuals, and I think it's been proven by the actions we've taken.

I do think this whole issue is an evolving one and I think it speaks to the larger issue of this legislation and what we're here about.

You know, it's interesting that we're talking about 1995, the last time the Congress acted in this area, and I would urge you to look at all the changes that have occurred in the financial marketplace since 1995, and what we've uncovered.

You know, it's not just because of State regulators and Federal action, but—and perhaps also the action of this committee.

I think we're a lot more aware today of the risks that people have, of some of the misconduct that's going on, and the amounts of money that are affected.

Just the mutual fund scandal alone, the Putnam—

Chairman BAKER. If I can sort of cap, because I'm getting ready—my time is going to expire in just a second, you do not have objection to the principle of a Fair Fund, but rather concerns about

the operative distribution of funds assigned to a Fair Fund, is that—

Mr. GALVIN. If a Fair Fund is truly fair, I'm for it.

Chairman BAKER. That's what I needed to hear, and I have more on the subject, and I wanted to get to Judge Walker with a series, but I'm out of time, so I'll go to Mr. Frank at this time. I'm sorry, Mr. Ackerman.

Mr. ACKERMAN. Will we have more than one round, Mr. Chairman?

Chairman BAKER. I suspect so, yes.

Mr. ACKERMAN. Thank you, very much.

Chairman BAKER. Mr. Ackerman was asking as to process, will we have more than one round of questions, and I just wanted to disclose to everybody that that's our intention.

Mr. ACKERMAN. Thank you.

I just want to make it clear for those people who might be listening, or just reading the initial transcripts, of really what's going on here.

What we've heard from the witnesses sounds very reasonable. What they've addressed verbally is really the issue, and the issue is legitimate, regardless of whether you have an opinion or not, or agree with one side or the other; the issue is real.

But this is a ruse. This is a beard. The real purpose here, after listening to the reasonable witnesses that the majority presented, is not the statements that they said in which there was not one mention, I think, listening, trying to listen carefully, of a specific law firm, but the real intent was at the beginning to put into the record the voluminous pages of their testimony, which does almost entirely address itself to ripping apart and damaging the reputation of one particular law firm that hasn't yet been tried, certainly hasn't been found guilty.

I'm still puzzled by the appearance of Judge Walker. I don't know how he justifies, and I heard his written testimony, but I read—I heard his oral testimony, I read his written testimony. He's here lobbying on a bill.

I don't know if he's registered as a lobbyist. I don't know that he's recused himself, or is going to, in cases that come before him and deal with this matter—that deal with how attorneys who appear before him are going to get compensated.

I know he has very strong opinions. He's expressed them, and appropriately so, at peer review and other forums. But the particular case that he cites, and he only cites one case by name, is the case that was cited initially in this hearing.

The judge states that he's been on all three sides of the issue—the corporate side, the plaintiff side, and now the bench.

I would contend that he's on two sides of the separation of powers issue—sitting on the bench, and now coming here trying to help us write the law, and perhaps if we don't like the law, we'll be on all three sides of that, and maybe we can veto it.

On the testimony, Judge, that you present, you say, "Mention has been made here today of the recent indictment of Milberg Weiss law firm and two of its partners," etc.

This was given out a couple of days ago, so I guess you knew that mention would be made here.

You then say, "The factual recitals of the Milberg indictment tell of millions of illegal kickbacks to lead plaintiffs, misrepresentations to courts, breaches of fiduciary duties to investor class members," quote and unquote.

That kind of drags their name through the mud just by the very mention of it in the way—you go on to say, "The defendants in that case are entitled to a fair trial"—that's pretty generous—"and the government may not be able to prove the facts alleged in the indictment", etc.

You don't even indicate that the facts might not be true. Your concern is the government may not be able to prove the facts, which in and of itself may be able to stand the smell test.

But you go on to say, "or persuade the courts that that those facts, if proved, constitute the alleged crimes," "but," you continue to say, "the indictment is significant nonetheless."

So even if there's no case, the indictment becomes significant.

"These allegations need not"—your words—"need not be proved true beyond a reasonable doubt for them to awaken Congress to the need to review," etc., etc.

So while in your courtroom you may have a standard of reasonable doubt, you're suggesting to people who make the law that we base the law on a case that may have no merit and legislate on some problem that may or may not exist, and I'm not saying that it doesn't, but that's your suggestion to us, and I don't think that's fair.

Interesting, you go on to cite another case that was in the—reported in the Chicago Tribune a week ago about allegations, and it's interesting, you don't mention the name of this law firm, and you don't mention the name of its partners, and you don't mention the injustices that they were allegedly charged with.

It's interesting that you just stay on Milberg Weiss.

Chairman BAKER. If the gentleman—

Mr. ACKERMAN. You're very much to the point. You're on message.

Chairman BAKER. If the gentleman can begin to—

Mr. ACKERMAN. And that's what concerns me.

Chairman BAKER.—to wind up, I want to make sure every member, and we will do multiple rounds to make sure the gentleman gets all of his questions in.

Mr. ACKERMAN. Can I have another half a minute, just to finish the thought?

I thank the Chair for his indulgence.

And in one other place, you say, "Significantly, in at least two of the class actions listed in the indictment against Milberg Weiss," etc., etc., Milberg Weiss was able to inject itself into"—that's a pretty loaded word, "inject itself into the legislation with a client, and that they would not have met the criteria for most adequate plaintiff."

That's pretty much an opinion that we're not writing here.

And you go on to talk about the Oxford—and I'm finished with this, Mr. Chairman.

"It's worth noting that in one of these cases, Oxford Health involved the largest kickback"—not even alleged—"single kickback payment"—then you have "alleged in the Milberg indictment."

I don't know if you read the whole indictment. Is it not true that Mr. Vogel, whom I believe is the person who is—who received the kickback, isn't it true that he was never appointed the lead plaintiff, never even represented the class?

I don't know how you make this analogy without that even being the case.

You're trying the case here, Your Honor, with only part, with only the prosecution side, and without full knowledge of the facts.

Chairman BAKER. The gentleman's time has expired.

Was it his intention to afford the judge an opportunity—

Mr. ACKERMAN. Oh, absolutely, if the Chair would—

Chairman BAKER. If the gentleman chooses to respond.

Judge WALKER. Thank you very much, Mr. Chairman, and Mr. Ackerman.

First of all, we're not talking about a case which we're trying here in this committee room, Mr. Ackerman. The defendants in that case are going to have their day in court.

There have been guilty pleas already in connection with that case, and of course that puts—

Mr. ACKERMAN. Your Honor, just to be fair, the guilty pleas were by witnesses who were found guilty in other cases and are looking for deals, not any of the people accused in this firm, is that correct?

Judge WALKER. I'm thoroughly familiar with how this works, of course.

Mr. ACKERMAN. I just want to make sure everybody else understood that.

Judge WALKER. And I believe that it is not incumbent upon this committee to wait until the resolution of a lawsuit to decide that a lawsuit or a criminal prosecution may raise questions which the committee would want to look at.

What I think the committee should be interested in, and I hope is interested in, is how these cases work in actual practice.

After all, the people who are charged with the responsibility of representing wronged investors carry very serious fiduciary obligations to those investors, and as attorneys, they have to do more than simply be free of a criminal conviction. They should avoid impropriety, and indeed, avoid the appearance of impropriety.

What I said in that portion of the written statement, and what I think is significant for the committee, is that when there are charges of this kind, whether proven in a courtroom to a standard of criminal liability, nevertheless would be grounds for this committee to look at the process and examine it and determine whether it is working in the best interests of investors and the best interests of the economy.

And the provisions of the proposed legislation, I believe, are substantial and should be seriously considered by the committee as a reform of this litigation process.

And with all due respect, sir, judges do know something about litigation, and I think can offer some insights to the Congress when it comes to how litigation works in actual practice, and I would hope that the committee and Congress would hear from judges from time to time on that subject.

Chairman BAKER. The gentleman's time has expired.

Mr. ACKERMAN. If I could just follow up?

Chairman BAKER. Okay, 30 seconds, please.

Mr. ACKERMAN. It's always good to hear from judges.

Was your viewpoint on this overturned by the Ninth Circuit?

Judge WALKER. There was a case that went up on a petition for writ of mandate in connection with a selection of class counsel that I made in a case. That was reversed on the grounds that the process of bidding in that case did not comply with the lead counsel provisions of the 1995 Act. That is correct.

Mr. ACKERMAN. Thank you.

Chairman BAKER. The gentleman's time has expired.

Mr. Hensarling?

Mr. HENSARLING. Thank you, Mr. Chairman.

Although I have a number of questions for the panel, I must admit, after listening to a lot of opening comments after my own, I feel compelled to say a few things, because I'm somewhat taken aback by the reaction to this hearing.

Some have protested the mere existence of this hearing because they didn't like its previous title.

I happen to know, for example, that the most famous song of the Beatles, "Yesterday," was once termed "Scrambled Eggs" before they chose to call it "Yesterday." I'm not sure that the popularity of the song was ever burdened by its previous title.

Some have protested this hearing because they see it as some type of interference in ongoing litigation.

I think I've read everybody's biography, but let me ask the first question.

Are any of you four gentleman directly involved in the Milberg Weiss litigation?

[Chorus of noes.]

Mr. HENSARLING. Listening to the testimony, I don't frankly know how any reasonable person could come to that conclusion.

Following the logic of some of our friends on the other side of the aisle, and I think this point was made earlier when we followed what appears to be the logic of some, Sarbanes-Oxley would not have been passed 4 years ago, it would have been passed perhaps several weeks ago once Jeff Skilling and Ken Lay were finally convicted.

Some have said that this is a hearing to attack, I guess, the reputation or integrity of a firm, and I think I've just witnessed an attack on one particular witness.

I think I know why he's here, or at least I know one of the reasons that I'm very happy he's here.

That is, there is a legitimate issue on the usefulness of a competitive bidding process in class action securities litigation, and whether you agree with it or don't agree with it, I think it would be very difficult to conclude that the justice who initiated this and has 15 years of experience in it, you would have to conclude that he's an expert at the issue.

So with that, I would like to ask my first question to Judge Walker.

I've seen at least three studies that make a fairly compelling case that in the competitive bidding process, fees have been significantly reduced as much as a factor of 50 percent.

In your own court, can you explain what you've observed, how the auction process reduces attorneys' fees?

Judge WALKER. Let me just tell you, Congressman, how it began.

It began in 1990 when lawyers were contending for the leadership position in a securities class action, and the contention was all on very subjective grounds, personality conflicts. It was East Coast versus West Coast, that sort of thing, none of which seemed to me mattered as far as the interests of the investors were concerned.

And I simply suggested to the lawyers that they submit proposals for the representation of the class based upon the price of their services and the quality of those services, and that was met, I must say, with silence in the courtroom.

Subsequently, what I received was a joint proposal. The battle having been resolved, the parties gave up their respective positions and submitted a joint proposal.

Well, needless to say, I didn't think that that was in the interests of the investors.

And in fact, they had prepared a transcript of the meeting at which this joint proposal was worked out and it sounded very much like some of the things that you read about in price fixing cases. It sounded very much like that. I used to do that kind of work when I was practicing law.

But in any event, that's how it began.

And the results were very satisfactory from the point of view of the class. Recovery was had, a very substantial recovery. It came in early in the case. And the fees were substantially lower than the standard 25 percent, one-third fee that typically had been awarded.

The same was true in other cases in which competitive bidding had been used in the selection of class counsel.

Now, I must tell you that I do not advocate competitive bidding in all cases and I don't have—I'm not without some reservations about it.

If you have a lead plaintiff which is a responsible institutional investor or other investor in whom the court can have confidence that the investor is monitoring the lawyers, interested in the litigation, is following it, and is making decisions of the kind that a client would make, there's no need for any kind of competitive selection process because that lead plaintiff will have done that itself, or himself or herself.

In addition, it's not altogether clear what means of compensation is the most advantageous to the class.

Is it a decreasing percentage to take advantage of economies of scale in litigation or is it an increasing percentage in order to incentivize the lawyer, or is it the kind of system that Judge Lewis Kaplan developed in the Southeby's case, in which he set a certain amount of money below which the attorneys would get nothing and above which they would get a percentage of the recovery?

So I completely agree with Professor Cox that competitive bidding is a useful tool in the arsenal of a judge who is interested in protecting the interests of the class and ensuring that the class gets fair, good, and reasonable economic representation—

Chairman BAKER. The gentleman's time has expired.

Judge WALKER.—and we should not abandon that tool.

Chairman BAKER. I thank the gentleman.

Mr. Frank.

Mr. FRANK OF MASSACHUSETTS. Mr. Chairman, first of all, I want to deal with rather bizarre misrepresentations of our arguments.

No one has suggested that it's inappropriate to inquire into the subject matter. No one has suggested waiting for legislation until trials are completed. These are total fantasies.

What we are saying is that it should be possible to go into the subject matter without focusing on a pending indictment, and that title was relevant because the title indicated what the intent was, to focus on the indictment.

And we did think that it was inappropriate for a Congressional committee to do a review of an indictment, and frankly, I think there was some indication of this being the purpose because, Judge Walker, I have to agree with one of the particular points Mr. Ackerman made.

I'll be honest with you. I think it's disingenuous in your testimony where you say on Page 4 in your prepared testimony submitted earlier, "Mention has been made here today of the recent indictment of the Milberg Weiss law firm," as if somebody else had brought it up and you felt compelled to comment on it.

You obviously came here as part of a plan to discuss it and to be critical of the firm. I'm a great believer in the First Amendment. In some places that would be an appropriate thing.

For a sitting Federal judge to come to a Congressional committee and pretend that it somehow just came up when it was part of an intent to focus on it is part of what we're upset about.

Now, I do have a couple of questions.

For Mr. Frank, in your first statement, you say, "When Congress passed the 1933 and 1934 Acts, there was no private right of action. Such a right was created by judicial fiat and accepted as a fait accompli by the Supreme Court."

Now, judicial fiat and fait accompli are not usually words of approbation.

Do you take the view that we would have been better off if such a right had never been created? Do you oppose the very existence of a private right of action?

Mr. FRANK. No, I didn't say that.

Mr. FRANK OF MASSACHUSETTS. No, no, I know you didn't say—you said it was judicial fiat and a fait accompli.

I never heard anybody talk about fiat and fait accompli about things they liked, so you sound here critical of the very existence of a private right of action.

Do you think it was a mistake to have created a private right of action?

Mr. FRANK. I think it's a mistake for the judiciary—

FRANK OF MASSACHUSETTS. No, no. No, that's not the question.

Do you think it was a mistake to have created a private right of action, simple straightforward question.

Mr. FRANK. It depends on the scope of the private right of action.

Mr. FRANK OF MASSACHUSETTS. The one that was created. I'm not talking about one up on Mars.

Do you think that it was wrong in 1946 that it was created by a district court opinion and accepted in 1971 by the Supreme Court? Do you wish that hadn't happened?

Mr. FRANK. Do you mean as a matter of a judicial decision-making or do you mean as a matter of public policy?

Mr. FRANK OF MASSACHUSETTS. Public policy.

Mr. FRANK. As a matter of public policy, the right that was created was overbroad.

Mr. FRANK OF MASSACHUSETTS. So would you want any private right of action in these cases?

Mr. FRANK. I would like some right of private action.

Mr. FRANK OF MASSACHUSETTS. You had described that in writing, but you basically objected to the very existence of the right as it existed from 1971?

Mr. FRANK. No, I objected to the judicial—

Mr. FRANK OF MASSACHUSETTS. As it existed?

Mr. FRANK. No, I objected—

Mr. FRANK OF MASSACHUSETTS. You said it was overbroad. That means as it existed then.

Mr. FRANK. Well, to some extent I object to it, and to some—

Mr. FRANK OF MASSACHUSETTS. Yes, all right, I want to get—now, as to auctions, you said that auctions save money.

Should the Federal Government use auctions and other governments use auctions when they're hiring outside counsel? The Federal Government may not do it as much. It does sometimes. State and local governments also do it.

Do you advocate the use of auctions when State and local governments hire outside counsel, as a possibility?

Mr. FRANK. It depends on the situation.

Mr. FRANK OF MASSACHUSETTS. Well, yes. Then you would say that in some cases say there should be auctions by them?

Mr. FRANK. There should be a competitive bidding process. That's, I think, a different concept than an auction. An auction implies that the only element is price.

Mr. FRANK OF MASSACHUSETTS. So would you differentiate between the kind of selection process you would use in class action cases from what a, say, a local government maybe ought to do when hiring outside counsel?

Mr. FRANK. Well, it depends on whether there are named class members; it depends on a variety of—

Mr. FRANK OF MASSACHUSETTS. All right. To be honest, I—well, let me ask the other—how about the "loser pays" principle. Let me ask this.

Judge Walker, the loser pays, principle, are you in favor in this case?

Judge WALKER. I do favor it—

Mr. FRANK OF MASSACHUSETTS. Good. What about in patent cases, do you favor the loser pays principle?

Judge WALKER. Yes, and we have a modified form of a "loser pay" in patent cases—

Mr. FRANK OF MASSACHUSETTS. So you're not just for the loser pay principle in class action cases—

Judge WALKER. Oh—

Mr. FRANK OF MASSACHUSETTS.—you're for generally applying it?

Judge WALKER.—absolutely not. No, I think it would be very constructive—

Mr. FRANK OF MASSACHUSETTS. Mr. Frank—

Judge WALKER.—I would just say—

Mr. FRANK OF MASSACHUSETTS. No, no, you answered the question.

Judge WALKER. Well—

Mr. FRANK OF MASSACHUSETTS. Mr. Frank, do you think that the loser pay principle should be applied in, say, patent cases, in cases where two businesses are suing each other?

Mr. FRANK. Yes. Yes, I do.

Mr. FRANK OF MASSACHUSETTS. So you're for the loser pay principle in general, not just—

Mr. FRANK. Yes—

Mr. FRANK OF MASSACHUSETTS.—in the class action cases.

Let me say, Mr. Chairman, at this point, I would like to introduce into the record a statement from the Consumer Federation of America, which is on the bill where it expresses—"express our opposition to H.R. 5491," and also from the AFL–CIO associate general counsel Damon Silvers, "H.R. 5491 will protect perpetrators of corporate fraud and increase legal fees to plaintiff lawyers at the expense of working"—to Mr. Galvin, just one last question—

Chairman BAKER. Just, without objection, that's admitted.

Mr. FRANK OF MASSACHUSETTS. Thank you.

Are there other issues that you think we should address, because I think nobody has an objection, everybody is in favor of addressing in these hearings and legislatively the whole question of how best to protect shareholders, and the argument here is that this legislation will lead to better protection of shareholders.

Are there other factors that you think we should be considering if we were to deal with legislation?

Mr. GALVIN. Absolutely. I think there's a multitude of issues.

For instance, in the idea of remediation, one of the things that I've been most concerned about is the arbitration process.

We force investors into arbitrations that are oftentimes rigged against them, and that's a condition of buying stock, and that's something that I think the Congress ought to be looking at.

That actually affects many people in this country who don't go—can't go to litigation, that are trying to get recovery of losses.

And there's one example.

I think the whole issue of the pricing and the timing of options that was mentioned in my testimony is another.

The hedge fund issue, which I think cuts across our entire financial services system, indeed our entire economy, that's another example of something that I think demands a lot more attention than it's been getting.

Mr. FRANK OF MASSACHUSETTS. I thank the secretary, who has been a great leader in consumer protection and shareholder protection, and I hope that we can pursue these—

Chairman BAKER. The gentleman's time has expired.

Mr. Feeney.

Mr. FEENEY. Thank you, Mr. Chairman.

I think the testimony from all of our panel has been quite interesting.

First of all, Your Honor, I want to tell you that I'm hardly offended by your being here. Matter of fact, I consider your testimony interesting, persuasive, and very much appropriate.

Congress, collectively and individually, all the time gives advice to the president and to our sister branch in the judiciary. Sometimes we do it officially. It's called a resolution. Sometimes we do it unofficially. It's called criticism of judicial decisions. I engage in it on a frequent basis.

And I can't ever remember being offended by something that a judge said off of the bench. I'm regularly offended by decisions that come from the bench.

But for example, you know, Justice Breyer's recent book, Act of Liberty, I find terribly, terribly interesting, and I'm glad that he shared it with us. I wrote a full critique of his book because I thought it was wrong, but I'm delighted that he shared his view with us.

And I think that your testimony, especially given your experience, is particularly helpful, from my perspective.

Chairman BAKER. Would the gentleman yield for just one moment, for just a procedural matter?

Mr. FEENEY. I'll yield under any circumstances, but I hope it doesn't come out of my time.

Chairman BAKER. Absolutely not. The gentleman's time will be honored.

I understand Secretary Galvin needs to leave the hearing. Certainly we want to accommodate him.

There were questions on the second round we'd like to forward. We will put those in writing and—

Mr. GALVIN. I apologize for having to leave, but I have made other commitments that require my departure.

Chairman BAKER. We certainly understand. I just wanted to make clear for the record that we would follow up with our questions by correspondence.

Mr. GALVIN. I look forward to working with the committee.

Chairman BAKER. I thank the secretary for his appearance.

The gentleman is recognized on the remainder of his time.

Mr. FEENEY. Thank you very much, Mr. Chairman.

We appreciated having the gentleman from Massachusetts with us.

Professor Cox, I understand that there are significant portions of H.R. 5491 that you don't think are necessary, but you do agree that there are some problems, and you refer to them in your testimony.

In a recent article, you actually analyzed some of the pay to play allegations and suggested that perhaps a total bar of appointments from a law firm that's made political donations is appropriate.

As a former lawyer, I'm terribly troubled by some of the allegations, and we don't need to have a trial here of any particular names. We can talk about hypotheticals and legal ethics and appropriateness, and I think that all of us can hopefully agree.

With respect to the pay to play practices, could you describe those as they may be happening in the real world out there, and tell us what, if anything, you think Congress may need to do, since you point out in your article, the American Bar Association has sort of a, you know, ambiguous inference or implication that this may be wrong, but none of the 50 States has apparently directly barred this.

So maybe you can address what pay to play is, what the problem is, and how Congress may need to address it.

Mr. COX. Pay to play exists on several fronts. The front we looked at in terms of trying to find out if there is some relationship between, for example, State treasurers, State controllers, etc., decisions of funds under their control could become lead plaintiffs or not.

And there are, you know isolated stories that we were first able to collect in the press that suggested this was a problem.

Second thing we looked at was to go from State to State to find out how many law firms, plaintiff law firms registered as lobbyists.

We did find, I believe, nine States where there were at least one, sometimes seven plaintiffs' law firms that had registered as lobbyists in those States.

We teed up then the idea that many States had wisely, in light of the brouhaha that accompanied the Cendant settlement where there were allegations of pay to play, where Pennsylvania law firms mysteriously were making contributions to somebody running for statewide office in the State of New York, and then was selected as lead plaintiff in the Cendant litigation—strange connection there, I would think, but leave that as it is.

Many States then introduced procedures to insulate the decisions about becoming the lead plaintiff totally from those who would be political officers, etc., head of advisory committees.

And we think that's a good practice, certainly a prophylactic requirement, and we think that, to just wrap this up, because I don't want to eat into your time needlessly, thinking that this is fair game, I think, when you're a presiding judge and you have an institution, I think it's worth asking those questions about—that probe exactly how it came that you selected this law firm to represent—

Mr. FEENEY. Well, professor, if I can interrupt, Judge Walker may do that. But should we require it of other judges who may not be as thorough as Judge Walker is?

Mr. COX. Yes. I found nothing objectionable in that portion of H.R. 5491 on that point.

Mr. FEENEY. Can I give you a hypothetical that is a little bit historical? I don't think it's in play today.

Supposing that it turned out that a particular industry, like the tobacco industry, was sued by a group of 10 or 12 law firms who ended up in a settlement, having never needed to take the case to trial, that resulted in hundreds of millions of dollars per law firm, and supposing it turned out that those law firms had one significant thing in common, that they had made contributions to attorneys general in various States and their respective party treasuries; would that be an ethically troubling problem for you as a professor of law?

Mr. COX. The answer to that is that it would certainly be a troubling problem, just sort of given my makeup, okay?

Whether I'm going to entangle that with ethics or not is another question.

Going forward, I would think we'd want to learn from that experience and try to squeeze that out. I mean, now if we start doing

it with lawyers doing that, I mean, I think we go right down the list and there's lots of other entanglements.

I just speak as somebody who, you know, grew up in Kansas and lives in Durham, North Carolina. We see things a lot differently than maybe what goes on around here.

But I find all those entanglements troubling.

Chairman BAKER. The gentleman's time has expired.

Mr. Miller.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

I did not practice in this area. I did not bring class actions when I practiced law.

But all the concerns that I have heard today, and about this subject generally, ring a bell with me, because when I went to law school, my understanding was that class actions were fundamentally different. The courts were adjudicating the rights of people who weren't there, who weren't sitting in the courtroom, who had never met their lawyers, and who had no control of the litigation.

And for those reasons, the rules of court put a pretty strict burden on the judge to make sure that people were not abused, that people whose rights were being adjudicated were being treated fairly by the named plaintiffs who were different from the class members and from their lawyers.

And looking at Rule 23, it seems to me that every concern that anyone has expressed today is already reflected in the rule.

In appointing a counsel, first of all, the counsel for a class has to be approved by the court. At the end of the litigation, their attorneys' fees and their reimbursement of cost has to be approved by the court, with everyone put on notice, all the members of the class put on notice, and allowed to come forward and have their say, and the opposing party put on notice.

And then the court has to enter findings of fact and conclusions of law, and is required to act in the best interests of the class members.

And the criteria for selecting counsel for a class seemed to me to hit all the right considerations.

The court has to consider the work the counsel has done in identifying or investigating potential claims in that action, the experience in handling class actions, other complex litigation and claims specifically of the type asserted in that action, a knowledge of the law, the resources the counsel could bring to representing the class.

The court may also consider more than one applicant to be counsel for a class, and required to consider all those considerations, and also to require any applicant to propose terms for attorney fees and nontaxable costs. That's at the front end.

And at the back end, they also have to approve the award of attorneys' fees.

Judge Walker, it appears, based on just reading Rule 23, that if litigants or class members are having their rights seriously abused by their lawyers, if their lawyers retain them, then the judge responsible for the litigation, the judge assigned the litigation has seriously failed the duties given to the judge under Rule 23.

I'm sorry. Is there some consideration in Rule 23 that you think should not apply in selection of counsel?

Judge WALKER. To the contrary, Mr. Miller. I think Rule 23 should apply to selection of counsel in securities class actions.

The problem is that we have the overlay of the lead counsel provisions of the 1995 Act, which make difficult the kind of comparative or competitive selection process that Rule 23 now envisions.

I would say further that the comparative or competitive processes that Rule 23 now contains were not there in 1990 when the first bidding case came down. That basically is an outgrowth of the decisions made by judges, including myself, and the learning that the courts obtained through that process.

But let me just comment further on a very troubling aspect of Rule 23 and all class actions, not just securities class actions, and that's the situation that the judge faces at the end of the litigation.

At the end of the litigation, typically, the parties have settled. There's a fund of money. The defendants have agreed to pay in the money and they've agreed not to contest the plaintiffs' and plaintiffs' counsels' application for fees.

And there is nobody there who really represents the class, other than the lead plaintiff, and if the lead plaintiff is not a vigorous advocate for the class, the judge really doesn't have an adversarial presentation, and that's what we need in court. That's the raw material with which we work, an adversary—an advocate on one side and an advocate on the other side, and through that clash, we try to reach a just result.

And, in the absence of a vigorous lead plaintiff, you simply don't have the raw material to make these determinations.

Mr. MILLER OF NORTH CAROLINA. But Judge Walker, that seems to be contemplated in any Rule 23 case.

In any class action, the court has to pause and consider that the plaintiffs before the court and their counsel are not like most plaintiffs and most counsel, most parties and their counsel, that there are people who are not there whose rights are being adjudicated.

Any settlement, the court has to approve. The court has to look at it skeptically, and not just accept the arguments of those in the courtroom. The court needs to understand that a class action is different.

This is understood by the rules for the entire time that Rule 23 has been in effect, the entire time that we've recognized class actions. Courts have to understand, judges have to understand this case is not like other cases.

Judge WALKER. And my point is—

Mr. MILLER OF NORTH CAROLINA. And that seems to be reflected already by the rules.

Judge WALKER.—is that that adversarial process is absent once the parties have resolved the case and gone away.

Mr. MILLER OF NORTH CAROLINA. Right.

Judge WALKER. And the judge only has one side of the case.

Mr. MILLER OF NORTH CAROLINA. And the rule says to judges, "You do not have the adversarial process you usually have. You cannot just listen to the people who are in the courtroom. You have to pause and consider the position of those who aren't here before you approve the settlement."

Judge WALKER. That is true.

Mr. MILLER OF NORTH CAROLINA.—before you approve the settlement,'; before you approve attorneys' fees, before you approve lead counsel or counsel for a class."

Professor Cox—

Judge WALKER. That is true, but let me just add one comment.

A judge just can't pull these facts out of thin air. A judge depends upon the parties to present the facts and to present them in an adversarial fashion, and when the adversarial process no longer exists, then the raw material for the kind of decision making you're talking about is simply absent.

Chairman BAKER. And can the gentleman begin to wrap up? You're over your time.

Mr. MILLER OF NORTH CAROLINA. I was going to ask Professor Cox if he thinks that Rule 23 does not reflect the considerations that apply in class actions, in how the court is supposed to supervise the conduct of lawyers for a class in a class action.

Mr. COX. I would concur with Congressman Miller, to be brief.

And I would just say another thing, that as we've discussed this in the hallways at my law school and other law schools, one question we've always had is why judges don't more frequently resort to some other mechanisms to try and squeeze these fees down or evaluate a settlement.

You know, you've seen some instances outside the securities arena of using special masters to come in and take a look at it, to introduce some sort of close scrutiny, and there are some mechanisms out there.

But I agree, I think we overtax our courts. We need to expand the number of judgeships, etc. But at the same time, I think there's more that the judges can be doing here, and I would encourage that, with all due respect.

Chairman BAKER. The gentleman's time has expired.

Mr. Campbell.

Mr. CAMPBELL. Thank you, Mr. Chairman.

Judge Walker, in your oral testimony, I believe that—I'm going to paraphrase here, and ask you if it's correct—in class action securities litigation where there is not a sophisticated institutional lead plaintiff, that the lead—the attorneys in that case are basically acting, when they're representing hundreds of thousands of shareholders, in a public trust. Is that a fair clarification or fair—

Judge WALKER. I think that's a fair understanding yes.

Mr. CAMPBELL. Of what you said.

Do either of the other members of the panel disagree with that?

[No response]

Mr. CAMPBELL. No? Okay.

And we have seen violations of that public trust in the past, or abuses of that public trust by plaintiffs' law firms, have we not?

Judge WALKER. That's certainly what appears to have motivated the 1995 Private Securities Litigation Reform Act, that Congress determined that there were problems that needed to be addressed.

Mr. CAMPBELL. Right. And I take it neither of you disagree with that?

Mr. COX. I don't know whether I agree with it or not. I mean, I generally supported some of the reforms, but not all the reforms of the PSLRA.

Mr. CAMPBELL. My point was simply that abuses of this trust that we just defined have occurred.

Mr. FRANK. Yes.

Mr. COX. The answer to that has to be yes, but on what scale, of course.

Mr. CAMPBELL. Right. Okay.

Then the next question is, what do we do about it?

And if these—which is what this hearing, I believe is about—if these attorneys are operating in a fashion of public trust, and therefore we have an obligation to ensure that that public trust is protected, does the existing laws, do the existing laws in this area adequately protect the public trust, or is there more that we should do?

Now, I believe that Judge Walker implied that you believe there's more that we should do in that regard?

Judge WALKER. Well, that's right, and I agree entirely with Professor Cox as well, that there's more that judges can and should do.

I think there's more that—

Mr. CAMPBELL. How do we sitting up here entice, or whatever, judges to do more that they should do, then?

Judge WALKER. Well, I don't know that you can entice them, Congressman, but certainly the provisions here in the Act, particularly the disclosure provisions, and I would suggest a provision governing aggregation and also a provision which allows a judge to either directly or indirectly engage in a competitive selection of class counsel when there is not an active lead plaintiff sophisticated and able to take charge of the litigation would be a very constructive step in the right direction.

Mr. CAMPBELL. Mr. Frank, you, I believe, stated in your testimony that you think that H.R. 5491 is a step or something, but not where you believe the law should go in this area; is that correct?

Mr. FRANK. That's correct.

Mr. CAMPBELL. Where do you believe it should go?

Mr. FRANK. Well, I think the loser pays provision of H.R. 5491 is going to end up being toothless.

I think the substantially justified standard isn't sufficiently different enough from the Rule 11 standard that judges exercising their discretion will do so to fee shift in a meaningful number of cases.

I further think that there's an underlying fundamental problem with the securities class action where the lawsuits that are being brought are not to the public good in general.

Mr. CAMPBELL. How do we—

Mr. FRANK. Well, I think we need to limit the securities laws to cases where there's real insider trading, to where corporate executives are, for example, using misleading financial projections to get better bonuses for themselves and then view that as sort of a derivative action for the shareholder against the wrongdoing executive rather than these sort of lawsuits that make up the vast majority of securities lawsuits, where it's sort of one pocket feeding the other pocket and the only real winners are the lawyers.

Mr. CAMPBELL. So you're suggesting that the abuses we're talking about are better limited by actually changing the securities law so that those actions aren't raised at all?

Mr. FRANK. I think it's a fundamental problem in the current system, certainly.

Mr. CAMPBELL. Okay. Professor Cox?

Mr. COX. Well, I think one thing we want to do is think about providing a whole set of the right incentives, and part of the incentives is to try and have individuals go and pursue the assets of those who are responsible for the wrong.

So the statement about money going from one pocket to the other pocket is a little overblown, I think you would have to admit to that.

But it is an issue of circularity, where, you know, money goes out of a corporation if the corporation makes a payment, and the lead plaintiff continues to own that corporation, and you say, "Well, that's okay, some of that's paid by the insurance company," and of course the lead plaintiff owns the insurance company, too.

So, you know, there's this problem of circularity out there, and I think everybody identifies that, and if you're going to deal with the circularity problem, then you have to really figure out where the money is, and the money is going to be with the people who are responsible—the CEO's, the investment bankers, and others who have aided in the fraud.

And to be able to do that, if you're willing to do it, means you have to rethink the role of aiding and abetting responsibility or at least the definitions of what is a primary participant, so that those avenues can be pursued if you're going to cap or limit the recoveries against the corporation to overcome the circularity problem.

That's where I would start with things—redirect the money.

Mr. CAMPBELL. Isn't the purpose of looking for—having a lead plaintiff that is sophisticated, institutional, etc., is that, you're right, I don't see how we can here sit here and create any legislation which can judge on this circularity in every single instance, but—

Mr. COX. Oh, yes, you can. You can do a number of things.

One, you could rethink about how you design the proportionate liability standards that were introduced by the PSLRA so that perhaps that shields certain individuals from liability, and then you could also reverse Central Bank of Denver, which prohibited aiding and abetting under the anti-fraud provision.

Yes, Congressman, there are some things you could do.

Mr. CAMPBELL. I would like either Mr. Frank or Judge Walker's comment on that, and then I'll yield back, Mr. Chairman.

Judge WALKER. Well, I'd simply add this to our discussion of lead plaintiffs, Congressman.

If you were the trustee of a substantial investor that had been wronged in one of these frauds, you would face a troubling decision that you'd have to make.

Do you come in as a lead plaintiff and try to represent a class of people that you've never seen before and have no obligation to, or would you attempt to opt out of the class and pursue your own individual action?

And more and more institutional investors are doing the latter.

So we don't have a sufficient incentive, it seems to me, in the present scheme of things to provide a reason for the kinds of institutional investors or investors that we want to see come in and monitor these cases, and Congress might very well give some consideration to how it would change things to give sufficient incentives to the kinds of monitors that we think are appropriate to watch over these cases.

Chairman BAKER. The gentleman's time has expired.

Mr. McHenry.

Mr. MCHENRY. Thank you, Mr. Chairman.

I certainly appreciate you holding this hearing. I think the panelists have been very good in their testimony. I enjoyed hearing you. I'm sorry that Secretary Galvin had to leave; I had a few questions for him.

But if I could start with you, Mr. Frank, in your testimony, you provide evidence that 70 percent of securities settlements in 2004 were, "actually nuisance settlements of under $10 million, an amount that to settle is cheaper than litigating,".

And you term these settlements, "effectively legalized extortion." Those are strong words.

Can you elaborate on that?

Mr. FRANK. Certainly.

We have three stages of litigation.

One, the cases that are dismissed right up front because they don't even meet the PSLRA's pleading standards. Two, the cases that are litigated and then thrown out on summary judgment. And three, the cases that are settled.

And if you look at the distribution of settlement amounts, you find that a stunning number of these are just very small amounts.

Surely not all of the settlements under $10 million are fraudulent, but for a lot of corporations, you're facing a litigation that's very expensive to try, very expensive to get to the summary judgment stage or past the summary judgment stage to try. It takes up executive time. It takes up corporate time. And it take attorneys' fees.

And in many cases, it's just cheaper to settle, pay what is effectively an extortionate amount because the plaintiffs' lawyers are saying, "You give us money or we'll put your corporation through all of this and even if you win, because there's no loser pays, you don't get any of your money back," and it's a rational decision for the corporation to just pay off the plaintiffs' attorney.

Mr. MCHENRY. What is your remedy?

Mr. FRANK. Well, one remedy for this would be a real definitive loser pays provision that takes it out of the hands of the judge and just says, you lose a case that you bring to trial, you're compensating the defendant for what they've done," and that's the way it's done in every western democracy except the United States.

Mr. MCHENRY. Well, Secretary Galvin actually says that, in effect, that our enhancement of Rule 11 is not effective.

Can you speak to that—what we offer in our legislation?

Mr. FRANK. Certainly.

There are various differing standards one could use for fee shifting.

Right now, we have a Rule 11 standard that is used in perhaps maybe 1 percent of all the cases, if that many, and probably less than that.

The current legislation wishes to change that from the Rule 11 standard to a standard of substantially justified, which is the same standard in Federal Rule 37, the same standard in the Equal Access to Justice Act, though it's actually a little bit stricter than that because it requires the winning party to prove that it wasn't substantially justified, which is the opposite of the role it takes in the Equal Access to Justice Act.

But at the end of the day, it ends up with judicial discretion, and if you talk to securities lawyers, they'll tell you that judges don't like fee shifting if its' discretionary. They just want the case out of their courts, and if there's no fee shifting, then they don't have to have further proceedings on how much the fees are.

Mr. MCHENRY. Professor Cox, you actually have a similar statement in your testimony that says, "not likely to be effective for several reasons." And you mention some of these in your testimony. Could you elaborate?

Mr. COX. Yes.

First of all, I think Ted is right. I think that judges tend to be reluctant to impose that.

But more likely, under the old rule, individuals tended to not move, or the defendants tend not to move to it, again for a variety of reasons.

They had sometimes the burden of proof, wanting to put the litigation behind them, frequently repeat players with the parties on the other side.

You know, so there's a variety of issues there.

As to judges' unwillingness to impose Rule 11, I defer to the one judge in the room to talk about that.

But I would just say that the standards that apply in Rule 11 or that were introduced by the PSLRA, or that would be introduced by this litigation, are sufficiently tolerant to create a lot of ambiguity into the process, which is unlikely, therefore, to lead to the results that you and others would like to achieve.

Mr. MCHENRY. Professor Cox, do you support a loser pay provision?

Mr. COX. Not at all.

Mr. MCHENRY. Not at all?

Mr. COX. No.

Mr. MCHENRY. And why would that be?

Mr. COX. Well, I think I mentioned the phrase earlier. I think it really does fly in the face of an important part of American society, which is access to justice, and the loser pay rule really operates to the disadvantage of those who are outside the corridors of power or wealth.

Mr. MCHENRY. I would sort of point to power and wealth with the $9.7 billion award and settlements just last year, and the 25 to 30 percent the trial lawyers netted off of that, so you're talking about a $3 billion industry, and you're talking about them acting as if they're not in power.

I mean, I think they're fully in power, and raking the shareholders over the coals.

Mr. COX. You know, I thought the plaintiffs in these cases were the investors, and many of them are widows, widowers, and orphans, individuals—

Mr. MCHENRY. Yes, but you're talking about $3 billion that trial lawyers net off of this type of action, $3 billion, and if I may—

Chairman BAKER. The gentleman needs to begin to wind up.

Mr. MCHENRY. So I would point out that the idea that these people are out of power and indigent is almost laughable on its face when you have—

Mr. COX. I don't think it's laughable at all. I think that you need to provide rewards for the high cost of conducting this litigation—the search costs, the uncertainty of the process, and the 40 percent of the cases that get dismissed.

If you ran a business like that, you'd want a pretty good profit margin on the products that you did sell, Congressman.

Mr. MCHENRY. And I would just say that's one heck of an award, $3 billion.

If I may finish with you, Judge Walker, you know, if you could speak in terms of a lower plaintiffs' attorney having to pay, and Rule 11, if you could just touch on that, based on your experience.

Judge WALKER. It seems to me a more objective standard than Rule 11 would be useful for the subcommittee to consider, for a number of reasons.

First of all, Rule 11 applies in all sorts of cases, not simply securities cases, and there might be certain standards in a securities case that you might want to impose that would not necessarily be applicable in cases generally.

Secondly, Rule 11 is subject to judicial interpretation, which changes and evolves over time.

As Professor Cox pointed out, Rule 11 issues generally arise at the tail end of litigation, and nobody wants to deal with that at the end of litigation, because by this time, the case is pretty much over.

Rule 11 sanctions are difficult. They're essentially impractical to impose. And that's the reason that there are so few instances of them being imposed.

Finally, they relate to the signing of pleadings, primarily, rather than the conduct of litigation, and I think it would be useful for the committee to consider a sanction or a fee shift that would bring into the equation not just what was written in the pleadings, but how the litigation was conducted.

Chairman BAKER. The gentleman's time has expired.

Mr. Davis.

Mr. DAVIS OF ALABAMA. Thank you, Mr. Chairman.

Gentlemen, let me pick up where Mr. McHenry left off, on the loser pay issue.

Judge, as a former lawyer and a former assistant U.S. attorney, I'm reluctant to question a Federal judge too strongly, but I'm not sure—

Judge WALKER. It happens all the time.

Mr. DAVIS OF ALABAMA.—I'm not sure that I followed your last argument.

You mentioned some of the defects in relying on Rule 11 as a remedy for frivolous claims, and you mention the fact that, well,

the litigation is over, it's hard for the court to go back in and address these issues.

Presumably, losers pay, obviously, happens after the litigation is over, too, so why wouldn't those same arguments cut just as strongly against loser pay?

Judge WALKER. Well, if it were required that there be an award at the end of a case in which a defendant had prevailed, judges would have no choice but to get into the issue.

But under the Rule 11 standard that now exists, it's not mandatory, it's not required, and it's an unpleasant piece of business.

And judges are no different from anybody else. We don't like to do what's unpleasant.

Mr. DAVIS OF ALABAMA. Judge, let me ask you one practical concern.

You've been on the bench a while, and I was a law clerk for a district judge in Alabama, and we are both well aware that it takes all phases of litigation a very long time to move.

One concern that I have is that losers pay would weave potentially another 9 to 10 months worth of litigation, because under—and I think we all understand at this point in the hearing, we're not talking about a hard scenario that every plaintiff who loses pays.

You would have, the district judge would have the capacity to do an analysis of whether there was a substantial basis for the claim. There would be some extra layer of scrutiny.

That layer of scrutiny would presumably require hearings, possibly evidentiary hearings, possibly just arguments on motions. They would have to be scheduled.

There would no doubt be motions for additional hearings. There might be a motion for reconsideration of your first ruling. There might be an appeal of your ruling at the same time the appeal of the underlying case was going on.

It seems to me that we would weave a lot of complexity into the end of cases.

And I suppose it raises another question.

Since the appeal of the underlying ruling would be going on at the same time, what happens in terms of attorneys' fees issues and those kinds of questions if a judge were to somehow rule that, "I think a plaintiff should pay," and somehow the judge was reversed on the underlying ruling on the merits; what would happen then?

Anybody? Mr. Frank, have you thought about that kind of a standard? What would be the remedy for a plaintiff who ended up winning on appeal and after a judge found that claim was not entitled to paying?

Mr. FRANK. Well, it's the same remedy that a defendant has after losing, which is you move for a stay of the ruling pending appeal and the appeal either succeeds or it doesn't succeed, and if the appeal succeeds, you've never paid a penny, and you get your bonds back, and if the appeal doesn't succeed, then the defendant gets to execute—

Mr. DAVIS OF ALABAMA. Well, that sounds good, but for the fact of attorneys' fees.

Judge?

Judge WALKER. The award is not payable until the judgment is final, and the final—

Mr. DAVIS OF ALABAMA. What about attorneys' fees that accumulate in the interim—

Judge WALKER.—appeal has been exhausted.

But distinguish, Congressman, if you would, determining the amount of fees from whether fees should be awarded. It's the latter that is complicated.

Determining the amount of fees is generally pretty uncomplicated.

Mr. DAVIS OF ALABAMA. Yes, I think you're right.

Judge WALKER. It's generally just hours and a reasonable fee rate and—

Mr. DAVIS OF ALABAMA. The point I was making, though, gentlemen, is obviously there's a period of time in which a litigant—these cases don't happen on contingency, typically. There's a period of time in which a litigant is having to bear the legal cost of not just adjudicating the appeal or pursuing the appeal, but also the legal cost of challenging the finding of pay by the plaintiff.

And my only concern—I don't want to spend my whole 5 minutes on this—my only concern is that if you have multiple tracks that are being pursued, an appeal plus the question of who pays, that it simply builds a lot of complexity and a lot of burden for the plaintiff.

Judge WALKER. Well, but would you use that logic then to say that a plaintiff who is successful should not recover fees?

And we have lots of provisions, and quite properly—

Mr. DAVIS OF ALABAMA. What I would say, Your Honor, is that if we contemplate—

Judge WALKER.—that the plaintiff is entitled to fees, and so we have to go through that determination.

Mr. DAVIS OF ALABAMA. But the question is, if we're going to make a change in the rules as we know them, who has the burden of persuasion?

And I would argue that if there are reasons of complexity, reasons of redundancy, that might argue against a change, perhaps we should err on the side of caution.

Let me raise another line of questions.

Let me go back to Professor Cox's point. He and Mr. McHenry had an exchange over the question of is the little guy, is the little plaintiff, excluded from bringing these kinds of claims.

I'm more on Professor Cox's side of the argument than either the judge or Mr. Frank, but if I just wrap up, Your Honor, let me tell you why I think there's a lot to Professor Cox's argument.

By definition, for a plaintiff investor to even bring this kind of case, that person has to wade through a lot of transactional costs, and has to wade through a lot of gaps of information. It is not an evenly situated playing field.

It's difficult under the best of circumstances, I think you'd agree, Professor Cox, that it's hard under the best of circumstances to get plaintiffs to fully exercise and pursue their rights.

Now, you add the disincentive of a penalty at the end, of having to pay the cost of the litigation, you add that possibility, and I can't imagine that you don't raise a significant impediment to these

kinds of cases being brought, and I think that's something we ought to be concerned about.

Mr. Frank, you were trying to speak to that?

Mr. FRANK. Yes, you raise an impediment to cases that aren't substantially justified. I'm not sure why—

Mr. DAVIS OF ALABAMA. This is the problem, though, Mr. Frank. Some of the cases will be and some won't be. They all won't be found to be in the not substantially justified category.

The disincentive accrues for everybody who might be a plaintiff in one of these cases, doesn't it, Professor Cox?

Mr. COX. There's going to be heavy discounting on the benefits of me bringing this suit if there is a loser pay rule, and that's the point that Congressman McHenry was missing.

You start squeezing out the fees and you introduce the uncertainty of the loser pay rule, and those widows, those orphans, retirees' funds, etc., are going to not think twice, they're going to think seven, eight, nine times about—

Mr. DAVIS OF ALABAMA. Well, let me just end on this point.

What I think you're missing, frankly, Mr. Frank, sure, people who bring frivolous lawsuits shouldn't be able to collect anything and probably ought to bear the costs of litigation.

What I'm concerned about is the class of people who lose, but who still have a merit to their lawsuit, who lost because their judge wasn't as wise as Vaughn Walker, or who lost because their lawyer didn't file a discovery motion in time, or who lost because a witness went south in a deposition, you name it.

Chairman BAKER. Or lost because his time has expired.

[Laughter]

Mr. DAVIS OF ALABAMA. People bring a lot of good cases that are not successful, and those of us who practice law understand that.

Chairman BAKER. I thank the gentleman.

Mr. Pearce.

Mr. PEARCE. The University of Southern California would like the same option, to go back and play the last 4 minutes of that national championship game. Everyone would always like the ability to replay.

Mr. Walker, Judge Walker, you had mentioned in your testimony the need to awaken Congress to the need to review the operations.

We've heard a lot of comments and I'm sorry I haven't been able to be here for the questions, but does that seem like a valid reason to have a hearing, to awaken Congress to the need that lies out there in the circumstance?

And I have a lot more questions, so please, a shorter answer rather than a longer one.

Judge WALKER. Well, I don't think a judge is here to tell Congress when it should have a hearing or not have a hearing. That seems to me to be entirely up to Congress to decide.

Mr. PEARCE. I understand, but I'm asking if you think there's a compelling need for Congress to sit and listen to this.

You heard the early opening statements—that we are making a mistake that was foolish, that we're impeding the process of the judiciary.

Judge WALKER. I don't feel that this hearing or the consideration of legislation to change the way securities class actions are handled impedes what judges do in the least.

Mr. PEARCE. Thank you, sir—

Judge WALKER. It seems to me to be a fair and appropriate matter for Congress to consider at any time that it perceives that there's a problem.

Mr. PEARCE. Okay.

The question I have for all of you is that there are complaints that attorneys' fees are just not widely known in these class action settlements and opinions have been given that greater publication of those fees would be productive.

Again, short answers, because I have several questions in 5 minutes.

So Mr. Walker, Mr. Frank, and Mr. Cox, if you all would—

Judge WALKER. It would be very helpful to have that. It would be very helpful to judges who are called upon to set fees in cases.

Mr. PEARCE. Mr. Frank.

Mr. FRANK. I concur.

Mr. PEARCE. Mr. Cox?

Mr. COX. I fully concur, too.

Mr. PEARCE. Okay.

How would we go about that? What—would we post those on the Internet a Web site that puts all fees of all actions of this nature in one site?

Judge WALKER. I don't want to mention a university that's a rival of the University of Southern California, but Stanford University Law School has a Web site that compiles a great deal of information concerning securities litigation, and that would be one appropriate vehicle.

Mr. PEARCE. Okay. Mr. Frank, any comment?

Mr. FRANK. I think that's right. I think we just need to make the—if we require the disclosure of the information, then existing private sources can disseminate it.

Mr. PEARCE. Mr. Cox?

Mr. COX. Our work has shown, as repeated in the filed statement, that a significant problem in securities class actions is that individuals, particularly institutions, with provable claims do not submit those claims.

One of the problems is that there is no centrally located mandatory place for notice of settlements to occur. There's no uniformity in the form that has to be satisfied.

A great contribution could be made in putting money into people's pocket by not just going with the Stanford site, which is quite good, but making it a site that something has to happen mandatorily.

That doesn't require legislation, it requires probably a swift kick in the backside to the SEC to get this moving, because that's where they could have the force to do that.

Mr. PEARCE. Any suggestion, Mr. Cox, as to what that might be that would be that swift kick?

Mr. COX. Perhaps somebody on the football team.

Mr. PEARCE. Mr. Cox, you had talked about—Mr. Galvin actually had talked about it before I was called away—the risk of the

chilling effect on people from having to bear the possible risk, and you had then I think an answer to Mr. Davis, had supported something similar to that.

How can we avoid the chill on the other side, the chill that causes companies never to get into things where there might even be litigation?

That chill probably affects the price of stock just as much as any wrongdoing.

Mr. COX. I remain the eternal optimist here, and hope springs eternal and I do think that part of the dip we're seeing in the filings of securities claims, as documented in my statement, is a result of the great strengthening that's occurred since 2002 in the financial reporting process.

I think that that, following good procedures, running a good ship, is the best way to avoid a cold chill down your spine if you're a CFO or a CEO.

Mr. PEARCE. Mr. Walker, do you have a comment on that?

Judge WALKER. No, I would concur with Professor Cox.

One needs to bear in mind, however, that all of these rules and regulations and disclosure requirements do come at a cost, and I think it's fair in our system that those costs be borne by public issuers of securities, but we do have to recognize that there is a cost that these entail.

Mr. PEARCE. Mr. Cox, would you have any—oops, I see my time has expired. Thank you, Mr. Chairman.

Chairman BAKER. If you want to ask your final one and wrap up, that's fine.

Mr. PEARCE. The whole problem, Mr. Cox, of the improper relationships that appear to be highlighted in this case that's before the courts right now, how can we root that out?

I mean, you get somebody that does not do anything and gets the $750,000 fee, and I mean, this is, according to the paper, that's always going to be an attraction.

So how do you root that kind of behavior out?

Mr. COX. Well, I always think that the first line of defense in protecting the class members, and I think that's what we're really talking about, and also the whole system, are the presiding judges, and I defer to Judge Walker to say what guidance we can have.

But I think the publicity surrounding the Milberg Weiss indictment and also the recent revelations in the Chicago Tribune all are wakeup calls to judges that they need to inquire deeply into possible conflicting relationships.

And as I said before, I do support that part of H.R. 5491.

Mr. PEARCE. Mr. Walker do you, and Mr. Frank, I'll give you one last chance, then my time is expired.

Judge WALKER. I quite agree with Professor Cox's last statement. I think it is a wakeup call, both to Congress and to the judges.

Mr. PEARCE. Mr. Frank?

Mr. FRANK. I agree.

Mr. PEARCE. You guys are really compatible out there.

All right, thanks.

Thanks, Mr. Chairman.

Chairman BAKER. You should have been here earlier.

[Laughter]

Chairman BAKER. I thank the gentleman for yielding back.

By prior agreement, I had indicated that we would have a second round of questions, and so keeping my commitment to Mr. Ackerman, I'll recognize him, but it's my intention, and this is a bit unusual, if we have additional members arrive, I will not recognize them for questions.

There is a 2 o'clock hearing in this committee room, and there is time needed to prepare for that, so Mr. Ackerman and Mr. Davis will be the last of the day.

Please proceed, sir.

Mr. ACKERMAN. Thank you, I appreciate that, Mr. Chairman.

I just want to clarify a couple of points for the record.

The first one is that in the Milberg Weiss indictment, which is referenced so extensively in the written testimony of witnesses, that there is no charge or allegation that even one dollar was lost to investors by the things that they were charged with, that it basically charged—it was mostly a fight between who gets to represent the class, etc.

Secondly, there is no charge that the firm that is cited so extensively in the testimony is not a vigorous firm in the prosecution for their clients.

Third, because people mentioned it as if it were a crime or a charge that the firm received or earned $1.6 billion in fees and reimbursements, that first, there is no fee that can be paid that's not approved by the judge or the court, and second, I find it curious that nothing was made, no point was made that the firm, if that number is correct, received $1.6 billion, that they also recovered $45 billion for the people in the classes that they represented.

Fourth, I don't know of any CEO of any of the large, giant corporations that have been found guilty of corporate corruption in which the CEO of that company did not earn more money than the attorneys for the lead plaintiffs.

That having been said, I want to turn to Mr. Frank's testimony, if I may.

I find it highly unusual, because Mr. Frank's testimony reads like the opening statement in a prosecution, by the prosecutors.

The very first statement, Mr. Chairman, says, "Hello."

The second sentence says who he is, and that he's not necessarily representing the people who pay for his livelihood.

And he waits all the way to the third sentence before bringing up Milberg Weiss, and from that third sentence on, there's hardly a page that goes by that he doesn't mention Milberg Weiss, ripping them apart in the most vicious ways, expressing opinions that he could not do in a court of law, the purpose of which is only speculative, but certainly that's what his testimony is all about, and that was the purpose of his being here and the focus of so many who are involved in this, I'll call it a movement.

Pages aren't numbered, but under number two, "Abuses by the plaintiffs' bar in securities legislation, the problem of kickbacks," he says, quote:

"To illustrate the problem of illegal kickbacks, I summarize the Milberg Weiss indictment from the government's complaint."

And then he goes on and on, and on and on and on and on, about the Milberg Weiss case, testifying, in effect, as to what the charges are in the case and what his opinions are.

I'll cite just a couple of examples.

"According to the indictment, Milberg Weiss paid kickbacks to at least three groups of named plaintiffs," etc., etc., etc.

"Milberg Weiss obtained more than $216 million in attorneys' fees."

"The government alleges that the kickbacks were sometimes given in cash," laundered through this and that, going into specifics that are unproven, and really have no business before this committee or Congress.

Those are points to make in a court of law, not in a subcommittee holding a hearing on legislation, talking about who allegedly put what money in what drawer and who gave it to who.

That's no concern of ours, and the only purpose that I can think of is to smear this company that has been indicted and not yet tried.

Then on the next page:

"Some have suggested," you say, "Some have suggested that the monies were just what they were recorded as, referral fees, but this is implausible."

And you go and analyze for us why the firm is guilty and why the defense that apparently they're going to put up, according to you, should be knocked down.

That you're trying that case before me, whose only experience at this, having not gone to law school, is that of a schoolteacher, who did teach about the separation of powers to small children, and being presumed innocent until proven guilty, is very offensive.

The only purpose of doing this—you say, "Why would Milberg Weiss passively pay millions of dollars," as if they did. I don't know. Maybe you do. "Why would they do that," you say, unless this or that?

Chairman BAKER. Can the gentleman begin to wrap up, please?

Mr. ACKERMAN. The only purpose is to defame, degrade, and incriminate.

You mention the Chicago Tribune case.

"The Chicago Tribune revealed that Milberg Weiss"—the former predecessor company, law firm—as if those are facts, because a newspaper charged it—they revealed. It wasn't that they charged. They revealed. You reveal something that's true. That's a charge. There's a difference, and you know that, and you make that look like a fact.

And then in number three, and I'm wrapping up, Mr. Chairman, you say, "The Milberg Weiss indictment shines a small light on a small portion of a great problem of corruption in the plaintiffs' bar. The very fact of kickbacks"—da da da da da da da—the fact. You've now rendered a decision in your own case.

You may not be representing the people who pay your livelihood, but it seems to me that you've weighed in here in a very, very unfair way the views to which you're entitled, but testifying in this court, as if it were a court in absentia of a real court, instead of presenting the evidence that you apparently know, I don't know how, because you said you have no involvement in that case—I do

understand, I think, that as an attorney, you appeared in cases on the other side of Milberg Weiss—

Chairman BAKER. If you can, sir, wrap up.

Mr. ACKERMAN. And I'd like your response to that, Mr. Frank.

Mr. FRANK. Well, I challenge your premises on many different levels.

First of all, Mr. Vogel did, I believe it was Mr. Vogel who did plead guilty and did plead that the United States Government could prove that he took several million dollars in kickbacks from Milberg Weiss.

With respect to the Chicago Tribune, Coughlin and Milberg Weiss acknowledged that they made these payments and argue that they were appropriate, and the Chicago Tribune simply quotes judges who say, "I didn't know about these payments, and it would have made a difference in my opinion if somebody had told me about them. I don't feel that they were disclosed to me."

Mr. ACKERMAN. Excuse me. Just on that statement, isn't their assertion that they paid finders fees to another law firm?

Mr. FRANK. No, sir, not in the Chicago Tribune.

With respect to kickbacks and whether or not plaintiffs are hurt by this, I would note that this is not something that's controversial. Other plaintiffs' law firms criticize this. They say that this goes to the very center of what it is to be a class counsel.

And the point of a lead plaintiff is to act as a watchdog, and it's already a problem—

Mr. ACKERMAN. I'm sorry, their competition complained about them?

Mr. FRANK. I'm sorry?

Mr. ACKERMAN. You're saying—

Mr. FRANK. Other law firms complained about them, yes. Other law firms—

Mr. ACKERMAN. The other law firms being the law firms that they were able to best at becoming the lead law firm, other law firms—

Mr. FRANK.—other law firms.

Mr. ACKERMAN.—that didn't get the fees?

Chairman BAKER. If I may, sir, I really need to call on Mr. Davis.

Mr. ACKERMAN. And I will yield to him.

Mr. DAVIS OF ALABAMA. Thank you, Mr. Chairman. Thank you Mr. Chairman.

Let me—I have a couple of questions to close with, but Mr. Frank, you did something that's kind of remarkable a minute ago, and I can't help but comment on it.

You were asked about your prejudgment of various facts in the case by my friend from New York, and your response was that, well, someone has entered a guilty plea and made certain assertions.

Mr. Frank, if you've practiced in anybody's court for any period of time, to take one guilty plea in a case and to make a dispositive judgment about the case based on that is remarkable.

But let me move on to my other two questions.

General proposition. We hear these arguments a lot, that, "Well, we're concerned about the costs of litigation on defendants, we don't like frivolous claims," and the arguments tend to spill over.

We'll hear them in the securities context. And then we're told, "Well, we're just talking about securities cases."

And then we'll hear them in the medical malpractice context. And then we'll hear them in the civil rights context. And then we'll hear them in the products liability context.

Just so I'm clear, Mr. Frank, is your enthusiasm for losers pay limited to securities litigation or is it pretty much anytime a plaintiff walks in court?

Mr. FRANK. I believe it's appropriate in several other areas.

Mr. DAVIS OF ALABAMA. When is it not appropriate? Give me a class of civil litigation where it's not appropriate.

Mr. FRANK. I think civil rights litigation is a very good place for where it's not appropriate. I think there is a problem there, where you do have widows and orphans and indigent people who are bringing litigation.

Mr. DAVIS OF ALABAMA. Products liability?

Mr. FRANK. Products liability, I think that can be judged by the attorneys firms. These are very well-financed law firms that have received billions of dollars from tobacco litigation and other sources.

And in England, where there is losers pay, there is not a problem of bringing products liability suits, because well, the law firms that bring them—

Mr. DAVIS OF ALABAMA. This is the only concern, well, not the only, but it's one major concern I have with your argument.

The argument keeps turning into, whenever plaintiffs make a lot of money off these cases, we think the loser ought to pay.

Now, that's a nice subjective standard, but I can't imagine it's guidance for Congress.

What happens if plaintiffs have a bad year? Then we switch over and we take them out of losers pay?

I mean, it seems like that seems to be your constant refrain, that if the plaintiffs' attorneys are making a lot of money, they somehow need to be bearing the burden of losers pay, whereas if, in civil rights cases, they're not making that much money, that somehow exempts them from it. I think we need a harder principle than that.

The final point that I will make today, we have—and I don't have all the details and legal theories in front of me, but by my recollection, we've made it harder to bring securities claims in the last 10 years, we've made it harder to bring State claims in Federal court, we've made it harder to prove securities claims by requiring a higher degree of knowledge of wrongdoing. There are a number of substantive things that have been done with the law to make it harder to bring these cases.

And I think, frankly, we ought to be content with that. If by narrowing the scope of claims and narrowing the class of people who can bring them, and making Rule 23 harder as a general proposition, if that hasn't had a sufficient deterrent effect, if that hasn't had the effect of casting out a lot of frivolous or unsubstantial claims, then maybe we need to heed that lesson.

As a practical matter, it's the last point I will make, Congress has done a lot, and the Supreme Court and the appellate courts

have done a lot to narrow the scope of these kinds of legislation and claims. That itself is a disincentive, is it not, Professor Cox?

Mr. COX. That's correct.

Mr. DAVIS OF ALABAMA. That itself is something which ought to put a crimp in these cases, and I don't think that Congress needs to weigh in and have this heavy hand sitting out there.

Because you're right. It's not just securities cases you want to do, Mr. Frank. You and a lot of people on your side want to do as many plaintiffs' cases as you can, and I think it's the wrong direction.

I yield back the balance of my time.

Chairman BAKER. I thank the gentleman for yielding back.

Let me express appreciation to all of you for your time and contribution. It is my intent to move forward with H.R. 5491 subject to suggested modifications that you have brought to the committee's attention.

This hearing was a bit different from our customary practice in that witnesses were sworn before testimony.

It is my intention to leave the hearing record open for an additional 45 days. A number of members who could not be here have interest in forwarding questions of interest for them.

The responses to those inquiries would be subject to the same rules of sworn testimony.

Just to state for the record purposes, I do have my own interrogatories that I would like to forward for a number of reasons.

But having said that, I am appreciative for members' attendance and for the very productive discussion I believe we engaged in today.

Thank you, and our meeting stands adjourned.

[Whereupon, at 1:33 p.m., the subcommittee was adjourned.]

A P P E N D I X

June 28, 2006

STATEMENT OF THE HONORABLE WM. LACY CLAY
Before
The Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
"Investor Protection: A Review of Attorney Abuses in Securities Litigation and Legislative Remedies"
June 28, 2006

Good morning Chairman Baker, Ranking Member Kanjorski, Members of the Committee and witnesses.

It is alarming to see the discovery of additional, alleged ways to defraud investors of their retirements; their children's college funds; trusts for their families and other current or future plans for their investments. There is currently a case in court, no decision has been rendered, in which a law firm is accused of giving $11.3 million in kickbacks to "paid plaintiffs". The indictment alleges that the firm received well over $200 million in attorneys' fees from class action lawsuits over the past 20 years. There is a 20 count indictment in this case.

My concern centers on the alleged amounts of money involved and the fear of this not being an isolated case. These alleged schemes potentially are costing billions of dollars to investors. It is the investors who ultimately pay the judgments. We must stop this bleeding of our investment resources. However, in our haste to do something about this problem, we must not put in remedies that further complicate the problem.

H.R. 5491, the Securities Litigation Attorney Accountability and Transparency Act has been introduced as a remedy for this issue. I, as well as many others, have concerns that the "loser pays provision" of the bill could add a threat to Plaintiff attorneys that would result in discouraging meritorious lawsuits as well as the intended frivolous lawsuits. Many are concerned that "if a judge determines that their case was "not substantially justified" the plaintiff could be forced to pay the defendant's legal fees. This could eliminate those law firms that work on a contingent fee basis and only the large firms would be able to take the risk of these cases.

I also have concerns about Section 4 of H. R. 5491. This provision removes the right of plaintiffs to choose their lead attorneys. The Consumer Federation of America writes that "allowing judges to impose a competitive bidding process suggests that costs are the only relevant factor to consider when selecting counsel and that judges are better able than investors to determine what is in their best interests. Under the worst case scenario, investors could be forced to accept representation by a lower cost firm that lacks the expertise and experience of other available counsel and could lose their case as a result." (End of quote)

I look forward to hearing the witnesses' testimonies and the discussion of these and other salient issues on this subject. I also commend Chairman Baker for bringing forth legislation and hope that we can work on compatible legislation to address this need. I yield back the balance of my time.

Testimony of

James D. Cox

Before

Committee on Financial Services

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

U.S. House of Representatives

June 28, 2006

on

H.R. 5491

My name is James D. Cox. I am Brainerd Currie Professor of Law, School of Law, Duke University where my research and teaching focuses on securities and corporate law. Prior to coming to Duke in 1979, I taught at Boston University, University of San Francisco, University of California, Hastings College of the Law, and Stanford University School of Law. I have in the recent past been a member of the New York Stock Exchange Legal Advisory Committee and the National Association of Securities Dealers Legal Advisory Board. Among my publications are Securities Regulations: Cases and Materials (5th ed. Aspen 2006)(with Langevoort and Hillman)

which has been adopted in approximately two-thirds of American law schools.

I submit this statement and appear before the Subcommittee on behalf of no organization and the costs incurred in connection with my appearing before this committee are being borne entirely by myself. I appreciate the research assistance in preparing this statement of Mr. Michael S. Roach, a second-year student, at the Duke University School of Law.

I. Questioning the Underlying Supposition of H.R. 5491

H.R. 5491, "Investor Protection: A Review of Plaintiffs' Attorney Abuses in Securities Investor Protection," embraces three distinct provisions: a modification of the present procedures and substantive standard for imposing costs on the plaintiff or his/her attorney, disclosure of conflicts of interest(s) the plaintiff may have with respect to the suit, and authorization for auctions and other mechanisms for the selection of counsel to be considered by the presiding judge. In considering these reforms, or any others that might arise during the legislative process, several points should be kept in mind.

First, the total number of securities class action filings in 2005 declined 17 percent from the number in 2004. This decline is not an aberration but no doubt reflects the confluence of several on-going forces that are likely to stabilize or cause further reduction in the number of new filings. The large number of suits filed in 2003 and 2004 reflected the after effects of the wide-spread financial and accounting frauds that came to light beginning in late 2001 and throughout 2002. Also, the serious market correction that occurred through this same period gave rise, as typically occurs during such periods, to reporting abuses that ultimately produced a significant

number of class action suits. At the same time, the strengthening of board independence, particularly for the audit committee, by the listing requirements of the New York Stock Exchange (NYSE) and Nasdaq, the tightening of various disclosure requirements in SEC guidelines and forms, and the many contributions of the Sarbanes-Oxley Act of 2002 have each had their positive impact on reporting practices by public companies. Congress did its homework in 2002, culminating in the most significant reform of the American securities laws since the Great Depression. Now, financial markets are strong and stock prices on the NYSE have recently flirted with their pre-Enron high.

Second, we should also appreciate the numerous judicial decisions that reduce the likelihood of securities class action complaints surviving the defendants' motion to dismiss. The relevance of such developments is they are well-recognized hurdles that class counsel must assess in representing the class. Among the developments are the disappearance of aiding and abetting liability with the decision in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). A related development is the bright-line test for determining who is a primary participant. Pursuant to this test, a person is not responsible under the antifraud provision, even though he or she actively participated in drafting, editing, or reviewing a document known by him or her to be materially misleading, if the investor from reading the document that contains the misrepresentation cannot "attribute" the misrepresentation directly to that defendant is not in the document attributed to that actor. *See e.g., Wright v. Ernst & Young LLP.*, 152 F.3d 169 (2d Cir. 1998), *cert. denied,* 525 U.S. 1104 (1999). When the entity on whose behalf the misrepresentation is committed is bankrupt or in serious financial distress, these holdings eliminate a financially responsible party as a defendant from the suit and, hence,

reduces the viability and attractiveness of pursuing the claim. Moreover, there are multiple screening devices that courts customarily apply to forward-looking statements, such as the statutory safe harbor for forward looking statements *see* Section 27A of the Securities Act, 15 U.S.C. § 77z-2, and Section 21E, 15 U.S.C.§ 78u-5, of the Securities Exchange Act, the "bespeaks caution" doctrine that exists in all the circuits *see e.g., Kaufman v. Trump's Castle Funding*, 7 F.3d 357 (3d Cir. 1993), the "truth on the market" defense *see e.g., Phillips v. L.C.I. Internat'l, Inc.,* 190 F.3d 609 (4th Cir. 1999), and the expanding concept of what constitutes harmless "puffery" *see e.g., Eisenstadt v. Centel Corp.,* 113 F.3d 738 (7th Cir. 1997). Causation has been greatly complicated for class action plaintiffs by the Supreme Court's decision in *Dura Pharmaceuticals Inc. v. Broudo*, 544 U.S. 336 (2005), which requires the pleadings to closely connect the alleged material misrepresentation with an *actual* decline in the value of the stock following a corrective disclosure. Each of these holdings not only draws the court into the case's facts at the pleading stage, but also poses significant obstacles in the path of the class action where the allegation involves forward looking statements. And, this term, the Supreme Court held that the Securities Litigation Uniform Standards Act bars class actions in state courts brought by investors duped into "holding" their shares by deceitful statements by analysts and others. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit,* 126 S. Ct. 1503 (2006). As a consequence, the suit must be removed to the federal court, where, under federal antifraud jurisprudence, non purchasers or non sellers lack standing to sue.

A third development retarding the initiation of class action suits are legislative reforms introduced by the Private Securities Litigation Reform Act of 1995. As the committee is well aware, the PSLRA not only bars discovery until all pretrial motions by defendants have been

resolved, but also tests any allegation involving fraud by the requirement that the allegations be pled with particularity and also must establish a "strong inference" of fraud. One consequence of these developments, according to the work of Professor Stephen Choi of New York University, is to reduce the number of meritorious class actions that could be maintained but for the heightened pleading requirement and discovery bar introduced by the PSLRA. *See* Stephen J. Choi, The Evidence on Securities Class Actions, 57 Vand. L. Rev. 1465, 1472 (2005).

The heightened governance and financial reporting requirements, as well as judicial and statutory developments, summarized above, in combination, explain the dramatic change in dismissal rates following defendants' motions for summary judgment and motions to dismiss. A 2006 study by the National Economic Research Associates reports that the probability of dismissal pursuant to a pre-trial motion rate in the period 1993-1995 was 19.4 percent and climbed to 40.3 percent in the 2003-2005 period. *See* Ronald I. Miller, Todd Foster, & Elain Buckberg, Recent Trends in Shareholder Class Action Litigation: Beyond the Mega-Settlements, is Stabilization Ahead? 3 (NERA, April 2006). The high and apparently rising dismissal rate is not consistent with the thesis that baseless suits mature into extortionate settlements. Instead, the declining rates of filings support the view that doctrinal and legislative developments reviewed above are having a most sobering impact on decisions to prosecute securities class action settlements.

Understanding the above-described forces' contributions toward a decline in the number of securities class action filings should cause us pause in considering additional reforms at this time. Simply stated, we don't know what the right number of suits in any year is or should be. Rather than focus too much on that number, it is far wiser to focus, as the Congress did in the

Sarbanes-Oxley Act of 2002, on how best to strengthen the financial reporting process.

My co-author, Randall Thomas, John S. Beasley II Professor of Law and Business, Vanderbilt University Law School, and I have carried out a series of empirical studies of securities class action settlements. *See e.g.,* Cox & Thomas, SEC Enforcement Heuristics: An Empirical Inquiry, 53 Duke. L. J. 737 (2004); Cox & Thomas, Public and Private Enforcement of the Securities Laws: Have Things Changed Since Enron?, 80 Notre Dame L. Rev. 893 (2005); Does the Plaintiff Matter? Cox & Thomas, An Empirical Analysis of Lead Plaintiffs In Securities Class Actions, working paper (May 2006) Our data set now includes several hundred settlements dating from 1990 through spring of this year. At the committee's request, we would be delighted to provide copies of our published articles. Let it be sufficient to say that our work documents that most settlements involve significant sums of money, with the median settlement in the post-PSLRA era approaching $6 million (median settlements attracting institutions as lead plaintiffs yield settlements more than five times as large as settlements not involving institutional lead plaintiffs) and suits consistently reflect large provable losses per the economic model we use in our analysis. Our data clearly reflects that significant sums are recovered in securities class actions.

The chief disquiet arising from our work is the evidence we have gathered that financial institutions for a variety of reasons fail to submit claims in settled securities class actions. Our study of settlements prior to 2002 reveal that approximately 70 percent of the financial institutions with claims in settled securities class actions do <u>not</u> submit them. *See* Cox & Thomas, Letting Billions Slip Through Your Fingers: Empirical Evidence And Legal Implications Of The Failure Of Financial Institutions To Participate In Securities Class Action

Settlements, 58 Stan. L. Rev. 411 (2005); Cox & Thomas, Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?, 80 Wash. U. L. Q. 883 (2002). Our articles suggest means to easily remedy this problem. We believe our suggestions are worthy of this committee's and the SEC's attention since it would assure that those harmed by securities fraud equally participate in the settlements.

If investor protection and sparing American business needless expenses are the focus of this committee's efforts, it is doubtful that H.R. 5491 will achieve much toward that goal. The following identifies reasons for my less than wholehearted embrace of H.R. 5491. Indeed, it is quite likely that H.R. 5491 will have totally unintended consequences of actually increasing the defendants' cost of litigation.

II. Selection of Counsel

In re Cendant Corp. Securities Litigation, 264 F.3d 201 (3d Cir. 2001), held that selecting lead counsel via an auction was inconsistent with the lead plaintiff provision of the Private Securities Litigation Reform Act of 1995. In *Cendant*, the suit's lead plaintiff, a consortium of three of the country's largest pension funds, had originally negotiated a retainer agreement with lead counsel. The district court decided to disregard the choice made by the lead plaintiff and in turn the retainer agreement. The district court proceeded to conduct an auction among competing law firms whereby it ultimately decided that the best bid was that submitted by the same counsel as initially chosen by the lead plaintiff. After aggressively pursuing the case and negotiating a then record-breaking settlement, the district court awarded counsel fees pursuant to

the formula set forth in the winning bid submitted by the chosen law firm. The fees per that bid were $76 million greater than that provided in the initial agreement the lead plaintiff had negotiated per the retainer agreement. On appeal, the Third Circuit reversed the district court's use of an auction with the effect of restoring the fee award to that negotiated by the lead plaintiffs with class counsel. The Third Circuit's decision in *Cendant* represents the socially desirable focus, namely, the focus should first be on the adequacy of the plaintiff as a representative of the class. One measure of this is the fee arrangement the petitioning lead plaintiff has negotiated with counsel. *See e.g., Berger v. Compaq Computer Corp.*, 257 F.3d 475 (5th Cir. 2001)(PSLRA raises the standard of adequacy so that consideration of fee agreement negotiated with proposed lead counsel is relevant to determining if petitioner is the "most adequate" plaintiff). To this end, I would think insufficient consideration was given to this factor in *Herrott v. Cavanaugh,* 306 F.3d 726 (9th Cir. 2002), which rejected as lead plaintiff one whose fee agreement with counsel was one-half that negotiated by another petitioner whose losses were six times those of the hard-nosed petitioner.

Section 4 of H.R. 5491 would not only hamper lead plaintiffs negotiating retainer agreements such as occurred in *Cendant* but likely will retard the rising trend of financial institutions to petition to become lead plaintiffs. The empirical research I have conducted with Professor Randall Thomas documents the significant contributions to the settlement process when the lead plaintiff is a financial institution. Our data reflects that for every percentage change in provable losses suffered by the class, the presence of a financial institution as a lead plaintiff increases the settlement by 4 basis points. This number is statistically significant at traditional levels and when applied in the large market capitalization firms that attract financial

institutions yields a dollar settlement difference that is significant. Moreover, our own calculations do not take account, as does the work of Professor Michael Perino of St. Johns University Law School, of the contribution an institutional lead plaintiff makes by negotiating a fee retainer agreement with class counsel. Professor Perino's work, now being joined by our own, reflects that fees are significantly lower on average when the product of negotiation between the lead plaintiff and lead counsel. The district court decision in *Cendant* reflects what happens if courts were encouraged, as would be H.R. 5491's effect, to conduct auctions to select counsel.

Moreover, our research has informed us that institutions have clear preferences regarding who their counsel is so that their on-going participation, indeed monitoring, of the conduct of the suit, at all phases, is much more likely to occur if the institution perceives the class' counsel as one it has selected. A shotgun marriage to the lowest bidder is hardly likely to introduce the same dynamics into the relationship between the lead plaintiff and lead counsel. Multiple reasons for rejecting in most instances auctions is set forth in the "Third Circuit Task Force on the Selection of Class Counsel" (Final Report Jan. 2002). Academics, typically champions of market solutions, find that this market-based solution works poorly in the context of monitoring the conduct of securities class actions. *See* Jill Fisch, Lawyers on the Auction Block: Evaluating the Selection of Class Counsel by Auction, 102 Colum. L. Rev. 650 (2002).

Finally, there is no need for this legislation. Most circuits have not decided whether auctions are a permitted mechanism for selecting class counsel. Even the Third Circuit's decision in *Cendant* and its Task Force Report leave open the possibility of auctions in instances the judge believes appropriate. Thus, Section 4 of H.R. 5491 is unlikely to alter existing practices since it

merely reflects the present jurisprudence regarding the appropriateness of auctions as a means to select class counsel in a post-PSLRA lead plaintiff world. We find few instances of auctions being employed in this environment because there is little reason to expect, generally, that the mail order marriage between lead plaintiff and lead counsel contrived by the auction can rival that based upon thoughtful screening of potential law firms as is the practice followed by institutions. And, when an institution is not involved, the decisions are replete with opinions where the presiding court, as part of its identification of lead plaintiff, gives ample attention to the experience of counsel representing the non-institutional lead plaintiff.

There is one area where the research I have conducted with Randall Thomas does point to a question about counsel for the class action. The problem area are suits where the plaintiff is a single individual - as contrasted with a financial institution, an aggregation of individuals or an individual and an entity, such as a trust or partnership. When the designated plaintiff is an individual, our study of class action settlements indicate that the percentage of losses recovered by the class via the settlement declines as the losses suffered by the class increase. This appears to have no relationship to the attorney's fee structure; it appears to reflect the risk aversion of the attorney and the derivative suit plaintiff to pushing for a better settlement. This is a problem of incentives which is likely to be exacerbated by competitive bidding among attorneys. The answer to this problem is focusing more on the approval of the settlement which is not the focus of H.R. 5491.

III. Rule 11 Sanction: Redux

Section 2 of H.R. 5491 amends the existing provisions of the Securities Act and the

Securities Exchange Act to authorize defendants to move for Rule 11 sanctions against the plaintiff when the plaintiff has incurred an adverse "final judgment against a plaintiff on the basis of a motion to dismiss, motion for summary judgment, or a trial on the merits." This provision is not likely to be effective for several reasons.

First, the PSLRA introduced a modification to Rule 11 of the Federal Rules of Civil Procedure. The innovation of the PSLRA was to mandate at the final adjudication of any private securities case the judge is to make a finding regarding compliance by each party with Rule 11. The purpose behind the PSLRA's change was that there was ample evidence that defendants and their counsel rarely moved for Rule 11 sanctions. There were multiple reasons for this; one reason is that to so move would not bring the litigation to a close, but would instead invite on-going litigation and its related costs. And, the outcome of so moving was doubtful. The change proposed in H.R. 5491 is as problematic as was the pre-PSLRA Rule 11's operation in securities matters. H.R. 5491 does not repeal either the Securities Act's or the Securities Exchange Act's mandate that the court make a finding regarding whether the parties have satisfied Rule 11. Thus, the defendant's motion would have life in the very instance where the court has found that the plaintiff and plaintiff's counsel have satisfied Rule 11. Such a finding by the presiding court is not likely to encourage the defendant or defendant's counsel to move for sanctions notwithstanding the judge's finding.

Second, any inquiry will necessarily be an adversarial one and expensive at that. Hence, the defendants and defendant's counsel likely will discount heavily the uncertain benefits of so moving by the certain costs of that proceeding. Herein lies the wisdom of the contemporary PSLRA approach. By the PSLRA's amendments taking this decision out of the hands of the

defendant and defendant's counsel, it has made it possible that in the life of the PSLRA. Indeed, there have been fee awards pursuant to the mechanism set in motion by the PSLRA. Not to be overlooked here is the salutary effects of the lead plaintiff provision which, at least when an institution or other financial entity are involved, provides the suit with an active plaintiff.

There is an even broader concern with any fee shifting arrangement. An important component of our society is our commitment to provide all our citizens with "access to justice." We should be careful to assess the benefits and the costs of any provision that poses a threat to this important component of American society. The American rule has long set us aside from our European and even Asian neighbors where the loser pay rule dominates to the extent of choking off the vindication of private rights. Even businesses who might support H.R. 5491, when asserting their legal rights through litigation, are the beneficiaries of the American Rule. This is a rule that should know no class boundaries and should not be sacrificed in isolated pockets of the law as pleases those who enjoy access to the seats of power.

IV. Conflicts of Interest Disclosure

Section 3 of H.R. 5491 would expand the disclosures the lead plaintiff must make in connection with the suit. Specifically, the plaintiff is to identify "any direct or indirect payment, between such attorney and such plaintiff and between such attorney and any affiliated person of such attorney." Except for the use of the different verb tense, this language closely parallels that added by the PSLRA in amending both section 27(a)(1)(vi) and section 21D(a)(2)(vi) of the Securities Exchange Act which require a sworn certification that "the plaintiff will not accept any payment for serving as a representative party on behalf of the class beyond the plaintiff's pro rata

share of any recovery, except as ordered or approved by the court. . . ." Although there is considerable overlap between the affirmation now required by the PSLRA of lead plaintiffs and the disclosure proposed by H.R. 5491, the latter is more inclusive. It is my own opinion that Section 3 should be even more specific and focused than it is. For example, in our own empirical studies of securities class actions we have called for heightened scrutiny by the courts of possible pay-to-play behavior whereby plaintiff law firms might seek to secure institutional clients as lead plaintiffs via political contributions to those who oversee the financial institution. *See* Cox and Thomas, Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs In Securities Class Actions, working paper (May 2006). Rather than compel disclosure, our recommendation is that a lead plaintiff should not be selected absent demonstrating procedures and safeguards within its organization that fully insulate the decision to become a lead plaintiff from any political or other financial contributions that may be provided those affiliated with the financial institution.

It is my understanding that most federal judges do inquire what financial relations and understandings, if any, exist between the class action plaintiff and proposed class counsel. To the extent not all judges so inquire, H.R. 5491 provides a potentially valuable contribution. It may be wise that this apply more broadly to all class actions brought in the federal courts; this could as easily be accomplished through the Advisory Committee on Civil Rules who has responsibility for updating and improving the Federal Rules of Civil Procedure.

I express my gratitude for having this opportunity to share my comments on H.R. 5491 with you. You and your staff are most welcome to contact me should you believe I can assist you in your efforts in any way.

Statement Presented to the
Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises
of the
Committee on Financial Services
of the
United States House of Representatives

by

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Investor Protection: A Review of Plaintiffs' Attorney Abuses in Securities Litigation and Legislative Remedies

June 28, 2006
10 a.m.

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Thank you, Mr. Chairman, and members of this Subcommittee, for your kind invitation to testify today about abuses in securities class action litigation and on H.R. 5491, the proposed Securities Litigation Attorney Accountability and Transparency Act.

I serve as Director of the AEI Liability Project, and as a Resident Fellow at the American Enterprise Institute for Public Policy Research, but I am not testifying here on their behalf and the views that I am sharing today are my own.

The problem of abuses by plaintiffs' attorneys in securities class action litigation have come to the forefront because of the recent indictment of the Milberg Weiss law firm. But I am reminded of what Michael Kinsley once said: "The scandal isn't what's illegal; the scandal is what's legal." I, along with many academics, believe that the same is true with much securities class action litigation.

But while there are areas of securities class action reform that are unavoidably divisive, this bill should not be one of them. The small steps taken by this bill are uncontroversial means to reduce corruption in the securities litigation process, benefiting shareholders and plaintiffs' law firms that play by the rules. I would like to see Congress to take more decisive action to protect investors and the American public from problems created by earlier Congressional action and judicial interpretations of these statutes, but this bill is a step in the right direction.

I. Background

When Congress first passed the 1933 and 1934 Acts, they provided only for government enforcement; there was no explicit private right of action. Such a right was created by judicial fiat in a 1946 district court opinion, and accepted as a *fait accompli* without serious discussion by the Supreme Court in 1971.[1]

Securities class actions affect almost every element of American business. Between 1997 and 2005, there were 225 securities class actions brought against members of the Fortune 500, 43 of them against members of the Fortune 50.[2] From 1996 to 2005, securities class action settlements totaled $37 billion.[3]

Not all of those $37 billion in settlements reflect wrongdoing. As Justice Stevens noted about securities class actions in a unanimous Supreme Court decision in March, "Even weak cases brought under the Rule may have substantial settlement value... because

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[1] *Superintendent of Ins. of N. Y. v. Bankers Life & Casualty Co.*, 404 U. S. 6 (1971).
[2] PricewaterhouseCoopers 2005 Securities Litigation Study, released 2006, available at http://www.pwc.com/extweb/pwcpublications.nsf/docid/7999A70324592B738525715C0059A948.
[3] *Id.*

'[t]he very pendency of the lawsuit may frustrate or delay normal business activity.'"[4] The Supreme Court has also said that securities litigation "presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."[5]

As an example of the pressures on defendants from weak cases, one need only look at the recent WorldCom settlements, where questionable decisions by a single federal district court judge generated billions of dollars of settlements from deep-pocket entities only remotely related to the underlying fraud. Using a divide-and-conquer strategy that gave a discount to the first banks that settled, and using the risk of a bankrupting judgment, the plaintiffs were able to force seventeen defendants to settle for between pennies and twenty cents on the dollar rather; the plaintiffs' attorneys faced no risk litigating against the last defendants, because they were guaranteed a tremendous profit upon achieving the first settlement. If the case was about the merits, rather than about a quick windfall, it is hard to imagine why the plaintiffs were willing to settle for so little on the eve of trial. This problem is not unique to securities class actions. Seven years ago, plaintiffs' firms sued eight HMOs, alleging, without evidence, a wildly implausible conspiracy to cheat doctors in reimbursements. Because of the risk and harassment of multi-billion-dollar litigation, six insurers settled for hundreds of millions of dollars. Two had the courage to continue fighting, and won summary judgment throwing out the claims for lack of evidence. But the plaintiffs' lawyers are sanguine: they will receive $200 million for bringing a bogus case.[6]

It's worth noting that diversified investors are made worse off by securities litigation, because settlements from such lawsuits provide money to plaintiffs' left-hand pocket by taking it from their right-hand pocket, with a substantial commission to the plaintiffs' attorneys for facilitating the transaction. A prominent recent example of this is, once again, the WorldCom litigation. As Forbes magazine reported:

> "Judging by a plaintiff expert's own estimate of shareholder losses, New York's claim of a $317 million hit would entitle it to 1.1% of the kitty, or a mere $11 million .... [Comptroller Alan] Hevesi's suit cost New York's pension fund by deflating the value of its investments in the banks it sued. The Hevesi fund owns stakes in J.P. Morgan, Citigroup and BofA. These three banks took aftertax charges totaling $3.2 billion for WorldCom settlement costs. The fund's pro rata share of these losses, and those of smaller-fry defendants, totes up to $13 million."[7]

The New York State Common Retirement Fund lost money; its lawyers—who had donated generously to Hevesi—made more than $300 million. This is ironic given that

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[4] *Merrill Lynch v. Dabit*, No. 04-1371 (Mar. 21, 2006), quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740 (1975).
[5] *Blue Chip Stamps*, 421 U.S. at 739.
[6] Julie Kay, "HMO Suit Brings Big Payoffs to Lawyers but Leaves Unsettled Questions," *Daily Business Review* (Jun. 27, 2006).
[7] Neil Weinberg, "Cui bono?", *Forbes*, Apr. 25, 2005.

the lawsuits against the bystander banks accused the defendants of having conflicts of interest.

II. Abuses By The Plaintiffs' Bar In Securities Litigation: The Problem Of Kickbacks

Congress has long recognized the problem of abuses by the plaintiffs' bar in securities litigation. When Congress passed the Private Securities Litigation Reform Act (PSLRA) in 1995 with a two-thirds majority over a presidential veto, the House and Senate reports both noted that they wished to stop the problem of bounties paid to lead plaintiffs.[8] The Milberg Weiss[9] indictment handed down by the grand jury on May 18 is the most detailed accounting to date of illegal kickback allegations, but I would be tremendously surprised if the aberration in the Milberg Weiss indictment is that these are the only examples of illegal kickbacks, as opposed to the only examples of a law firm getting caught giving illegal kickbacks.

Milberg Weiss is the biggest player in securities class actions. By the Institute for Legal Reform's count from Securities Class Action Services data, Milberg Weiss has handled 43% of the hundreds of class action settlements between December 1995 (when the Private Securities Litigation Reform Act (PSLRA) went into effect) and August 2005, generating $1.7 **billion** in legal fees and expenses, several times that of its nearest competitor. Their website prominently features a Columbia Law professor who calls the firm "as dominant in their industry as IBM was in the 1960s and as Microsoft is today."[10]

To illustrate the problem of illegal kickbacks, I summarize the Milberg Weiss indictment from the government's complaint.

A. The Importance Of Named Plaintiffs In Class Actions

A firm like Milberg Weiss cannot simply file a class action complaint on its own. There must be a plaintiff named in the complaint who can allege damages, and can allege that he or she can represent the interests of the members of the class not directly participating in the lawsuit. The named plaintiff (and his attorneys) must demonstrate to the court's satisfaction, among other things, that: (a) the named plaintiff's claims are "typical" of the claims of the absent class members or shareholders; (b) the named plaintiff does not have a conflict of interest with the absent class members or shareholders; (c) the named plaintiff is not subject to unique defenses that could become the focus of the litigation to

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[8] *See* H.R. Conf. Rep. 104-369, at 32-33 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 731-32; S. Rep. No. 104-98, at 6 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 685.

[9] The full name of Milberg Weiss is Milberg Weiss Bershad & Schulman LLP. The firm has changed its name a couple of times over the years as partners, most notably William Lerach, have left: it was formerly known as Milberg Weiss Bershad Hynes & Lerach LLP and Milberg Weiss Bershad Specthrie & Lerach. I will refer to these entities as "Milberg Weiss" throughout this testimony. In 2004, William Lerach and several other attorneys split from Milberg Weiss to create what became Lerach Coughlin Stoia Geller Rudman & Robbins.

[10] John Coffee, Professor of Law Columbia University, *Financial Times,* May 3, 2004, noted at http://www.milbergweissjustice.com/whatotherssay_investigation.php

the detriment of the absent class members or shareholders; and (d) the named plaintiff and his attorneys will be able to fairly and adequately represent the interests of the absent class members or shareholders. If a court determines that all of the requirements of a class action are met, it will "certify" a defined class to be represented by the named plaintiff.

In many instances, there are multiple complaints filed by multiple plaintiffs represented by multiple attorneys seeking to represent the same class. In these cases, the lawyers and law firms compete to be appointed by the court as "lead counsel" or "co-lead counsel" for the class. The lead counsel typically has the power to run the case and divvy up the work (and resulting contingent fees) in the litigation.

To protect the due process rights of the absent class members who have no say in the conduct of the litigation, the named plaintiff has fiduciary duties to the class. A named plaintiff may not place his or her own interests above those of absent class members, and is required to disclose any fact that reasonably could affect his or her ability to fairly or adequately represent the interests of the absent class members or shareholders. Thus, any settlement may not favor the named plaintiff above other class members. While a named plaintiff may be entitled to reimbursement of his or her reasonable costs and expenses incurred in connection with the lawsuit or a court-approved bonus payment above and beyond the plaintiff's *pro rata* share of the settlement, all such payments must be disclosed to the class members, and the class members must have the opportunity to object.

Any class action settlement presents a conflict of interest between the attorneys and their class clients, and that is the fact that every dollar paid to the attorneys is a dollar that does not go to the class, and vice versa. For this reason among others, the named plaintiff and the court are meant to act as watchdogs and scrutinize proposed settlements to ensure that they are fair to the absent class members.

B. The Alleged Kickback Scheme

A kickback of attorneys' fees to the named plaintiff divorces the plaintiff's incentives from those of the class. With such an arrangement in place, the named plaintiff's incentive is to maximize not the recovery to the class, but the recovery to the attorneys. Moreover, undisclosed kickbacks to influence a fiduciary's conduct are illegal under New York law; both New York and California law further prohibit attorneys from agreeing to share fees with persons not licensed to practice law.

The indictment charges the Milberg Weiss firm; two leading "name" partners of the firm, David J. Bershad and Steven G. Schulman; Seymour M. Lazar, who allegedly received kickbacks; and Lazar's attorney, Paul T. Selzer, who allegedly acted as an intermediary. They are charged with, among other crimes, conspiracy, racketeering, money laundering, and obstruction of justice. The indictment charges only two Milberg Weiss partners; but lists three other senior partners as unnamed co-conspirators working in conjunction with

Bershad and Schulman, suggesting that these kickbacks are not a case of individual attorneys going off the reservation, but one of business as usual.

According to the indictment, Milberg Weiss paid kickbacks to at least three groups of named plaintiffs using a variety of intermediaries to conceal the payments. The government alleges $2.4 million of kickbacks to frequent plaintiff Seymour Lazar and his family; $2.5 million of kickbacks to frequent plaintiff Howard Vogel and his family; and $6.5 million of kickbacks to frequent plaintiff Steven Cooperman and his family and some of his colleagues. In these lawsuits alone, Milberg Weiss obtained more than $216.1 million in attorneys' fees.

The government alleges that the kickback payments were sometimes given in cash, laundered through casinos or just distributed from a safe in a credenza in named partner David Bershad's office. In other instances, Milberg Weiss would send payments to intermediary law firms, falsely characterize the payments in accounting and tax records, and then provide instructions to the intermediaries to directly or indirectly pay the named plaintiffs.

The indictment, over the course of over forty pages, meticulously identifies and traces each check and payment, each false statement given to the court, each false statement given in a deposition, over the course of the alleged kickback scheme.

For example, according to the indictment, and Vogel's plea agreement, on June 27, 2003, Milberg Weiss received its attorneys fees from the *Oxford Health* class action. Schulman then told Vogel to have his intermediary contact another Milberg Weiss senior attorney to arrange his payment. Vogel sent two memos to Schulman and "Partner A" in September 20 and October 15 submitting "material from 1997/1998 relating to my role as initiating plaintiff in the Oxford and Baan cases" and asking for a phone call to discuss the long-settled cases with his intermediary. Schulman told Vogel that Partner A would only meet the intermediary in person. That meeting occurred on November 10, and on December 18, 2003, Milberg Weiss paid Vogel's attorney two checks for $1.2 million, claiming that it was payment for attorneys' fees from two class action settlements; on January 8, 2004, the law firm wired $1.2 million to Vogel. Vogel admits that he falsely certified to the court that his claims were "typical of the claims of the members of the Class" and that he would not accept payment for serving as a class representative beyond his pro rata share of the settlement and reasonable costs and expenses.

Howard Vogel has pled guilty to one count of making a false declaration before a court, and admitted to receiving $2.5 million in kickbacks from Milberg Weiss. For example, in the *Oxford Health Plans* class action, Vogel owned fifty shares, lost $3000 from the alleged wrongful conduct by the corporate defendant, and collected a $1.1 million kickback. Vogel says he was told by a Milberg Weiss partner that his payment in that case was decreased because "Milberg Weiss would have other payment obligations in the case." Milberg Weiss was awarded $40 million in attorneys' fees in that case.

On May 22, Richard R. Purtich, identified in the indictment as "Cooperman Intermediary A," entered into a plea agreement admitting that "he and certain law firms with which he was associated received checks from Milberg Weiss totaling more than $3.5 million for the benefit of Cooperman" even though he and his law firms never made any referrals, performed any work, or did anything to earn the payments from Milberg Weiss.

Further indictments could be forthcoming. The *National Law Journal* also reports that federal prosecutors are in negotiations with Vogel's intermediary in the Oxford transaction, a Denver attorney.[11] If he agrees to testify, charges could be added against "Partner A."

Some have suggested that the moneys were just what they were recorded as, referral fees. But this seems implausible. Milberg Weiss is notably aggressive in doing business, to the point that other plaintiffs' firms complain about their conduct in recruiting plaintiffs. (In the WorldCom litigation, prominent plaintiffs' law firm Bernstein Litowitz complained that Milberg Weiss submitted misleading solicitations to WorldCom bondholders in an effort to steal those clients from the main class action; the federal district court agreed and ordered corrective communications.) Why would Milberg Weiss passively pay millions of dollars of referral fees for the same plaintiff for dozens and dozens of cases to firms doing nothing to contribute to the underlying securities litigation? Why not simply ask Mr. Vogel or Mr. Lazar to contact Milberg Weiss directly and leave out the intermediary, unless the intermediary was serving some other role? (We see from Mr. Vogel's 2003 memos that he was not shy about directly writing senior partners at Milberg.)

Milberg Weiss's scenario is implausible from the other direction. There are famous tales of "professional plaintiffs" like Vogel and Lazar who are used as lead plaintiffs for case after case after case; who are willing, despite only small injury from holding small stakes, to be deposed at length again and again; who are willing, despite the irrationality of the investment strategy, to hold broad portfolios of small amounts of hundreds of different stocks instead of purchasing cheaper index funds or engaging in less expensive diversification. In the words of Columbia law professor John Coffee, "One does not logically do this free"[12]—and the behavior is far more consistent with under-the-table payments than with an altruistic hobby that makes others rich.

C. The Problem Of Kickbacks

Some argue that no one is hurt by kickbacks. Other plaintiffs' firms who lost the opportunity to honestly represent plaintiffs and reap the rewards of doing so might argue otherwise. But, again, it is ironic that Milberg Weiss would suddenly suggest that kickbacks should be judged by their economic effect: the firm's website brags about its lawsuits over kickbacks in dozens of cases.

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[11] Amanda Bronstad, "Denver Lawyer Could Sharpen Focus on Weiss in Milberg Probe," *National Law Journal* (Jun. 19, 2006).
[12] John C. Coffee, Jr., "Milberg Weiss Indictment," *National Law Journal* (Jun. 19, 2006).

As Walter Olson notes, "Although there are many debatable cases, concealed payoffs to named plaintiffs in class actions aren't one of them: They're clearly improper under virtually any analysis."[13] As discussed above, named plaintiffs owe a duty to absent class members to place the interests of the class first. Instead, Milberg Weiss and its named plaintiffs were more concerned about divvying up the spoils between themselves, something the class and court surely would have wanted to know when deciding whether to approve the settlement. There is already a systematic problem in class action litigation where named plaintiffs fail to exercise sufficient oversight of their attorneys to protect the interests of the class. Those who defend kickbacks are arguing that it should be acceptable for law firms to completely buy off that oversight.

Indeed, plaintiffs' firms Cohen, Milstein, Hausfeld & Toll PLLC and Berger & Montague PC, arguing for the investigation of an attorney linked to the Milberg Weiss indictment, filed a brief stating "Far from generalized allegations of amorphous misconduct, the allegations of the indictment... go to the very core of a class counsel's duties to the class and the court."

D. Other Abuses By Plaintiffs' Firms

Milberg's website says about the indictment that the government's allegations "just a small number of these payments"—which perhaps suggests that more investigation is needed. And, indeed, there are press reports that indicate that what is alleged in the indictment is only the tip of the iceberg for wrongful conduct by the plaintiffs' bar.

The Recorder reports that there is an investigation over whether Milberg Weiss was also paying undisclosed kickbacks to one of its expert witnesses, John Torkelson, and whether the firm was laundering campaign contributions through Torkelson, who has already pled guilty to a scheme to defraud the U.S. Small Business Administration.[14]

A KPMG employee has testified that a lead plaintiff in a Milberg Weiss class action against KPMG told him that he and others agreed to become lead plaintiffs because "they would get more money."[15] U.S. District Judge Dennis Cavanaugh refused to delay the settlement fairness hearing to investigate the charges.[16] (The plaintiff in question denies that he is due any additional money.)

On June 19, two prominent securities firms, Cohen, Milstein, Hausfeld & Toll, PLLC, and Berger & Montague, P.C., filed a brief in the *GMH Communities Trust* litigation in Philadelphia seeking to remove Milberg Weiss spin-off Lerach Coughlin from lead-plaintiff status, making a series of allegations against William Lerach. The firms, against

[13] Walter Olson, "Inside Milberg's Credenza", *Wall Street Journal* (May 22, 2006).
[14] Justin Scheck, "Federal Prosecutors Put Pressure on Milberg Weiss' Star Expert", *The Recorder* (Jun. 9, 2006); Nathan Koppel, "Prosecutors Probe Milberg Payments To Witness", *Wall Street Journal* (Jun. 10, 2006).
[15] David Reilly, "KPMG Letter May Complicate Milberg Weiss-Led Class Action", *Wall Street Journal* (May 26, 2006).
[16] Anna Driver, "U.S. judge approves KPMG settlement with investors", Reuters (Jun. 3, 2006).

their own financial self-interest, withdrew the motion almost immediately after Lerach issued a scathing press release. One can only imagine what the reaction would be if Kerr-McGee and Halliburton withdrew from bidding on a government contract within hours of Enron criticizing them for seeking an investigation.

And just Thursday, the Chicago Tribune revealed that Milberg Weiss and Lerach Coughlin, which represented several Illinois union pension funds, paid more than $750,000 in undisclosed fees to the pension funds' attorney, William K. Cavanagh.[17] Federal law prohibits paying pension attorneys referral fees; Lerach Coughlin claims that the payments reflected work Cavanaugh did, but Cavanaugh's hours were not submitted to the courts approving Lerach Coughlin's settlements. Attorneys' fees in the affected cases totaled $44 million. The paper interviews a judge who approved one of the settlements:

> Richard H. Kyle of Minnesota, who presided over one of the cases in which Cavanagh received fees, said he, too, was unaware of Cavanagh's involvement in the case.
>
> "It seems to me if there are side deals like that where fees are going back to the general counsel, that's something I should be told," Kyle said. "The bottom line is I have to choose lead plaintiff and counsel based on whether they can fairly and adequately represent the entire class.
>
> "That kind of relationship would certainly lead me to ask a lot more questions, and very well could lead me to choose someone else to lead."[18]

None of these cases are mentioned in the indictment.

III. H.R. 5491: the Securities Litigation Attorney Accountability and Transparency Act

The Milberg Weiss indictment shines a small light on a small portion of a great problem of corruption in the plaintiffs' bar. The very fact of kickbacks exhibits that the PSLRA's attempt to impose market discipline in securities litigation has failed. If securities class action attorneys were facing market competition, there would be no windfall worth fighting for with millions of dollars in under-the-table payments, much less the risk of prosecution. I would argue that sweeping reform is needed. This bill is not that sweeping reform, but it presents some incremental reforms that improve the system for honest players on both sides of the table and therefore should be uncontroversial.

A. Section 2: Fee-shifting where a claim was not substantially justified

As noted above, there is a great imbalance in the current securities laws in that even a weak case has substantial settlement value because of the costs it can impose upon a

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[17] David Kidwell, "Illinois lawyer tied to indicted law firm", *Chicago Tribune* (Jun. 22, 2006).
[18] *Id.*

defendant unjustly accused. According to NERA Economic Consulting, over 39% of PSLRA cases are dismissed because the complaint is insufficient to meet PSLRA standards. Still other cases are resolved on summary judgment after extensive and expensive discovery. But a defendant unjustly accused has almost no recourse under current law; it bears its own costs, thus encouraging plaintiffs to file indiscriminately.

The United States is the only Western democracy that permits this sort of fundamental injustice. In every other country, the losing side in litigation is required to make the other side whole by compensating its litigation expenses. In securities cases, that requirement is entirely one-sided: defendants' pay winning plaintiffs' fees, but plaintiffs do not pay winning defendants' fees. As a result, many of the securities settlements—70% of securities settlements in 2004—are actually nuisance settlements of under $10 million,[19] an amount to settle that is cheaper than litigating. The plaintiffs' attorneys walk away with millions in what is effectively legalized extortion.

This bill is not a "loser pays" provision. A losing plaintiff will pay nothing if the defendant cannot prove that the case was not "substantially justified"; the defendant has the burden of persuasion. This is the same standard used in the fee-shifting under the Equal Access to Justice Act, 5 U.S.C. § 504, and for discovery disputes under the Federal Rule of Civil Procedure 37, so courts will not need to create new jurisprudence to resolve any such disputes. (This bill is narrower than those rules in that it specifies the winning party has to prove lack of substantial justification. In the context of Rule 37 and EAJA, it is the burden of the losing party to prove that its position was substantially justified.) Moreover, courts have two safety valves to prevent unjust awards: the court, before awarding reasonable attorneys' fees and expenses, must also find that "imposing fees and expenses on the plaintiffs' attorney would be just" and that "the cost of such fees and expenses to the defendant is substantially burdensome or unjust."

Such recourse for defendants, which corrects a fundamental unfairness in the status quo, will have no effect on plaintiffs who bring legitimate claims. The only cases it will affect are the nuisance cases brought to extort a small settlement; defendants can now credibly decide to fight a meritless case. The result will be fewer meritless cases brought harassing corporations and fewer unjust results when meritless cases are brought.

If anything, the provision does not go far enough. Attorneys' fees and costs are not the only costs experienced by defendants unjustly sued; this provision will leave defendants undercompensated. The problem is compounded by the discretionary nature of the award; there will be collateral litigation over whether the original litigation was "substantially justified," and I am concerned that the toothlessness of the discretionary fee-shifting in Federal Rule of Civil Procedure 11 will be duplicated here. Defendants do not get to avoid paying attorneys' fees by showing their defense was substantially justified. Fairness dictates a symmetry missing from the status quo, and that this bill only partially corrects.

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[19] NERA Economic Consulting, "Recent Trends In Shareholder Class Action Litigation: Bear Market Cases Bring Big Settlements" (2005).

B. Section 3: Disclosures regarding conflicts of interest

Current law already requires sworn certifications with the filing of the complaint.[20] The bill adds a requirement of disclosures of direct and indirect payments between attorneys and affiliated persons of the plaintiff. This is a minor addition whose main effect will be to make it more difficult to hide kickbacks through intermediaries. A law firm would not be able to claim that an ambiguous payment with an oral side-deal was really a legal one without first disclosing the ambiguous payment and encouraging judicial scrutiny.

Again, this should be uncontroversial: the sole economic effect will be a wealth transfer from dishonest plaintiffs' firms to plaintiffs' firms that play by the rules; from dishonest named representatives who receive kickbacks to class members and investors as a whole.

C. Section 4: Permitting auctions at lead counsel

Under the current law, "[t]he most adequate plaintiff shall, subject to the approval of the court, select and retain counsel to represent the class."[21] Innovative, creative judges like Jimmy Carter appointee Milton Shadur of the Northern District of Illinois and George H.W. Bush appointee Vaughn Walker of the Northern District of California have solicited bids at the beginning of litigation from several firms that compete for the right to represent the class as lead counsel.[22]

Auctions provide several advantages. *First*, they permit courts to exercise greater control over counsel quality, a prime goal of the PSLRA that has not been realized. *Second*, auctions lead to lower-priced representation. When a court appoints a law firm without setting the fees, the attorneys' incentive is to maximize their take. But if the law firm is selected by auction, attorneys compete to provide the lowest reasonable bid. In a contested battle for lead counsel, this is much more likely to lead to market pricing than an attempt to establish attorneys' fees after the case has settled. A final advantage is an obvious one in the wake of the Milberg Weiss indictment: auctions would end kickbacks, because there would be no surplus to be had.

Empirical research supports these theoretical contentions. Michael Perino, in a 2006 working paper,[23] found that auctions substantially reduced attorneys' fees, a finding duplicated by Judge Shadur's experience. Though the sample size was small, there was no question that the difference was statistically significant, with a predicted reduction in fees of 55%. This money, which amounts to hundreds of millions of dollars a year, could be going directly into investors' pockets instead of attorneys. It further suggests (consistent with the observation of illegal kickbacks) that class action attorneys are gouging at a price twice what a fair market competition would produce, the equivalent of

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[20] *E.g.*, 15 U.S.C. § 78u-4(a)(2).
[21] 15 U.S.C. § 78u-4(a)(3)(B)(v).
[22] *E.g., In re Oracle Securities Litig.*, 131 F.R.D. 688 (N.D. Cal. 1990); *In re Amino Acid Lysine Antitrust Litig.*, 918 F.Supp. 1190 (N.D. Ill. 1996).
[23] Michael Perino, "Markets and Monitors: The Impact of Competition and Experience on Attorneys' Fees in Securities Class Actions."

one's local service station charging six dollars a gallon for gasoline on a normal spring day in 2006 without extenuating circumstances. In the case of a service station, one can choose to buy gasoline somewhere else, or (like I have done since 2001) drive a fuel-efficient hybrid car. But unnamed class members have little recourse to limit fees obtained by plaintiffs' firms who did not agree to a market-based price at the front end.

But there is controversy over whether the PSLRA permits district courts to hold auctions. The Third Circuit, though it recognized that it had previously recommended the auction process in other class action contexts, has interpreted the statute to say that it does not.[24] As a result, courts rarely implement auctions and the benefits they provide to investors and to honest plaintiffs' law firms who lack political connections are rarely realized. No judge likes to be reversed, and the existence of the Third Circuit opinion makes most judges reluctant to experiment with auctions.

This section of the bill fixes the ambiguity in the law by making it clear that the securities laws permit competitive bidding to choose lead counsel. Courts need no longer worry that an order for an auction will be struck down. But the language in the bill is permissive. Thus, courts will have the freedom to attempt alternative approaches. Some judges will choose competitive bidding; others will adopt a traditional method; still others might come up with innovative hybrid solutions that none of us here have yet thought of. This judicial discretion will provide helpful data on how to best help investors when Congress next revisits the securities laws.

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[24] *In re Cendant Corp. Litig.*, 264 F.3d 201, 258 (3d Cir. 2001).

Securities Litigation Attorney Accountability and Transparency Act
Testimony of William Francis Galvin
Secretary of the Commonwealth of Massachusetts

As Secretary of the Commonwealth of Massachusetts, I am the chief securities regulator in Massachusetts. Among other provisions, my Office administers and enforces the Massachusetts Uniform Securities Act.

The work of my Securities Division includes the review of securities offerings, the licensing of securities professionals, and significant enforcement work. Enforcement cases brought by my office have addressed some of the most substantial and timely problems in the financial marketplace: false and misleading analyst reports from national brokerages, market timing of mutual fund shares, abusive practices in the sales of annuity products, and fraudulent conduct by investment advisers.

I must stress that the great majority of financial firms conduct an honest business, and most issuers of stock are not defrauding investors. However, my office has repeatedly seen that small investors are at a serious disadvantage when they deal with dishonest sellers of securities and dishonest companies. It is imperative that investors at all levels have effective remedies in cases when they are defrauded. Class action litigation has been an effective remedy especially for small investors.

My office also incorporates Massachusetts corporations and charters business entities in Massachusetts. I am very sympathetic to the needs of legitimate business people and their companies. But business corporations ultimately belong to their shareholders. Corporate executives and directors owe fiduciary obligations of care and loyalty to the corporation and its shareholders.

I speak today for the interests of investors. If investors are to defend themselves from misconduct and fraud by officers and directors, we must preserve their remedies under the securities laws. Ultimately, giving investors strong and effective remedies will help prevent misconduct by company managements. The way I see it the right to civil litigation is an essential part of the free market. It is a free market force that guarantees that there will be financial consequences for fraud and wrongdoing and it operates as a deterrent in the marketplace to continuing misconduct.

My Office has committed significant resources to enforcement. We are a strong cop on the beat. However, the resources of any regulatory agency will always be limited. Regulators cannot police the financial markets alone. Since the 1930's, investors' private rights to sue have also operated to police and deter investment fraud. Both of these tools are essential to maintaining the integrity of our financial markets.

We are concerned that provisions of the Securities Litigation Attorney Accountability and Transparency Act will stifle the ability of plaintiffs to obtain recourse when the securities laws are violated. While my office has returned more than twenty

million dollars directly to investors, I am still concerned that many times so-called "fair funds", or pooled compensation funds do not effectively reach defrauded investors. Civil actions offer a more precise remedy.

"Loser Pays" Provision. This provision may be seriously detrimental to the interests of retail investors because their attorneys will be required to take on great financial risk in a class action. This provision would reverse the longstanding "American rule" that each party in an action should be responsible for its costs, unless the action involves abuse of the legal process.

Potentially imposing a defendant's costs on a plaintiff will chill investors and their attorneys from pressing legitimate claims.

Litigation involves many uncertainties; if there is a risk that the costs of defense counsel may fall on plaintiff's counsel, lawyers and parties who cannot afford that risk exposure will back away from even meritorious investor suits.

I note that federal Rule 11 already requires that court filings not be made for any improper purpose and that the legal arguments be warranted and that a party violating those requirements will be subject to court sanctions including paying defendants costs and legal fees. The "loser pays" provision of the legislation may add very little value over the current court rules.

Conflict of Interest Disclosure. I have no comment on this section except to ask whether legislation that targets the practices of a particular law firm is the proper way to approach these issues. I note that the law firm in question is currently the subject of a federal indictment for the practices this section would address.

Court's Role in Selecting Counsel for the Plaintiff Class. It is not clear why this section is necessary, and it appears not to be advisable.

The Private Securities Litigation Reform Act of 1995 created a presumption that the investor with the largest financial stake in a case should serve as lead plaintiff, and that it should choose and negotiate with class counsel. This law has led to more institutional investors acting as lead plaintiffs in class actions, so these cases are often led by sophisticated plaintiffs with meaningful resources. If the proper party is acting as lead plaintiff, the selection of counsel should rest with them.

Section 4 of the bill goes beyond requiring that the court should simply approve or disapprove counsel for the plaintiffs; and it instead embroils the court in the selection of plaintiff's counsel. The legislation will allow the court to employ alternative means in the selection and retention of counsel for the plaintiff, including a competitive bidding process.

Clearly, a bidding process is not the best way to select counsel when significant issues are at stake in complex and technical litigation.

This provision also raises disturbing constitutional issues, including the right to be represented by counsel, freedom of association, and freedom of contract. In the end, it is simply common sense that if the proper lead plaintiff is in place, that plaintiff is in the best position to select its counsel.

I urge that this legislation should not be adopted. Even after the passage of the Sarbanes-Oxley Act, we continue to see disturbing examples of fraud in the financial markets. From the failure and bankruptcy of the Refco commodity firm just a few months after its IPO, to the unfolding stories relating to the backdating of executive stock options, there still fresh examples of fraud and misconduct in the financial marketplace. But there is often a common thread running through these scoundrels and that is the application of two sets of rules – one set for connected insiders which allow them to extract unjust profits from the marketplace and the other set of rules for average American investors that has them pay the price for the fraud of connected insiders.

Private suits play an important role in keeping companies honest. As successive Congresses have encouraged and often required American families to assume the risk of the marketplace for their pensions and other aspects of their financial future.

I urge you to protect, and not diminish, this important tool to fight fraud and abuse against investors.

TESTIMONY OF VAUGHN R WALKER

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON BANKING AND FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

JUNE 28, 2006

Mr Chairman and members of the subcommittee, my name is Vaughn R Walker. I am chief judge of the United States District Court, Northern District of California. The court is headquartered in San Francisco.

I am honored to be invited today to testify about proposed legislation amending the 1933 and 1934 federal securities statutes. Private securities class actions are a useful and valuable adjunct to enforcement of the securities laws by federal and state regulatory bodies. These actions help to protect investors from fraud and other abuses, redress injuries when investors have suffered from fraud and abuse and thereby promote vital capital markets which are essential to the economic health of the nation and, indeed, because of the prominence of the American economy, the world. In this, class actions, although private, perform essentially a public function. Class actions are essentially public in another sense, as well.

The class members on whose behalf class actions are brought and prosecuted do not initiate, maintain or control the litigation in the same way that members of the general public do not initiate, maintain or control litigation brought by public officials or agencies. By contrast, of course, individual litigation is brought by clients who have a personal relationship with their lawyers and who can make decisions about the conduct of the litigation, when and if to settle and all other aspects of the litigation. But in class actions, except for the named representative or lead plaintiff, there is no direct client involvement.

In this sense, therefore, class actions are in important respects privatized public law enforcement; it is as though the public agencies responsible for enforcement of the nation's securities laws have outsourced a part of their public responsibilities to private attorneys and parties. Such outsourcing or privatization makes sense in important ways because it conserves the resources of the public agencies. When the defendants are solvent and able to satisfy a damages judgment and the wrongdoing not so reprehensible as to warrant criminal prosecution, it makes sense for the public agencies to stand by and let private class actions do much of the work needed to enforce the securities laws. And, I hasten to add, a great many

of the lawyers who practice on the plaintiffs' side in class actions are extremely able and wholly honest in their work.

Because class actions perform an essentially public function, however, safeguards are needed to protect class members that are not needed in individual actions. Litigation by public agencies is subject to many checks and balances. The members of the Securities & Exchange Commission, for example, are appointed by the President, must answer to this subcommittee and the corresponding body of the Senate, must work with the various self-regulatory bodies and industry groups and so forth. All of this helps to ensure the integrity of enforcement by the Commission and to direct its enforcement endeavors so that they are vigorous, but not overbearing or counter-productive. Now, of course, not everyone agrees that the proper balance is struck at all times or maybe even at anytime, but oversight of the Commission helps to strike an appropriate balance of these important and legitimate countervailing interests.

With class actions, however, this balancing process is very limited, indeed. Few of the measures that guard against abuse when other public functions have been outsourced to private parties have been imposed on class actions. In the area of securities class actions, Congress recognized this problem and sought to ensure against abuses by enacting in 1995 the Private

Securities Litigation Reform Act. The theory underlying that legislation was that by putting control of securities litigation into the hands of the largest investor, abuses that Congress perceived in lawyer-driven securities class actions would be corralled. Unfortunately, events have not substantiated this theory.

Mention has been made here today of the recent indictment of the Milberg Weiss law firm and two of its partners. The factual recitals of the Milberg indictment tell of millions in illegal kickbacks to lead plaintiffs, misrepresentations to courts and breaches of fiduciary duties to investor class members.

An indictment, of course, is merely a charge of wrongdoing. The defendants in that case are entitled to a fair trial and the government may not be able to prove the facts alleged in the indictment or persuade the courts that those facts, if proved, constitute the crimes alleged. But the indictment is significant nonetheless. These allegations need not be proved true beyond a reasonable doubt for them to awaken Congress to the need to review the operation of securities class actions. Lawyers are and should be held to higher standard than merely that they have avoided criminal liability. Lawyers should avoid impropriety and even the appearance of impropriety in the

conduct of their profession. This should be especially true of class action lawyers who, after all, are exercising the public responsibilities that I have mentioned.

The allegations of the Milberg indictment carry even more impact because at least some of the alleged events occurred after the 1995 Reform Act took effect. Indeed, the largest kickback payment alleged in the Milberg indictment occurred in a case governed by the 1995 Reform Act.

Furthermore, on June 22, 2006, the Chicago Tribune broke a story raising serious questions about financial relationships between the general counsel of several large pension funds that had served as lead plaintiffs in four class actions and the law firms that had served as lead counsel.[1] According to the Tribune, the general counsel received over $750,000 in fees associated with four class actions in which pension funds he represented acted as lead plaintiff. No billing records substantiated the general counsel's work and his role was never disclosed to the judges presiding over those class actions. Notably, two of the judges who presided in those cases were quoted that the relationships of which they were not informed would have been an important consideration in selecting lead

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[1] David Kidwell, *Illinois Lawyer Tied to Indicted Law Firm*, Chi Trib C1 (June 22, 2006).

plaintiff and lead counsel. Again, regardless whether the Tribune story can be proved true in a court of law, its publication takes on special significance because a key premise of the 1995 Reform Act was that institutional investors would come forward to take charge of securities class actions.

Frankly, I am unsurprised by these unhappy developments. In my view, the 1995 Reform Act failed to require the elements essential to effective delegation of public responsibility to private parties and, in the case of securities class actions, for the protection of investors. These elements are: transparency, accountability and appropriate restraints on the ability to bring and maintain securities class actions.

TRANSPARENCY

The 1995 Reform Act attempted to place control of securities class actions in the hands of institutional investors who it was thought would be more responsible than the figurehead plaintiffs that had typically been named lead plaintiffs in securities class actions prior to the 1995 Reform Act. Congress took this idea from a law review article[2] that appeared while the

[2] Elliot J Weiss & John S Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L J 2053 (1995).

legislation was under consideration.[3] Many good things appear in law reviews. That doesn't mean that the ideas in law reviews should find their way into law, however. One of the co-authors of the article has told me that he had no idea that the idea of institutional investor lead plaintiffs would become a statutory command.

Originally, the authors thought this was an idea that courts should consider and experiment with to see if it worked. I believe that I was the first judge in the United States to try this idea in an actual case.[4] This was before the Reform Act took effect. It is, of course, one thing to suggest that courts try an approach to litigation and quite another to mandate it. After all if an idea from a law review or elsewhere doesn't work out in practice, it can be abandoned or altered in a way to make it work. But when mandated by statute, the idea is locked in and courts have little ability to alter or amend it. Enacting the lead plaintiff provisions of the federal securities statutes has not worked as, I think, Congress intended.

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[3] See H R Rep No 104-369, 104th Cong, 1st Sess 34 n 3 & 35 n 6 (1995), reprinted in 1995 USCCAN 733-34 (citing Weiss and Beckerman); S Rep No 104-98, 104th Cong, 1st Sess 11 n 32, reprinted in 1995 USCCAN 690 n 32 (stating that the Weiss and Beckerman article "provided the basis for the 'most adequate plaintiff' provision").

[4] See In re California Micro Devices Securities Litigation, 168 FRD 257 (ND Cal 1996).

First, despite Congress' clear desire to see that securities class actions are managed by institutional investors with the know-how and capability to monitor and control the lawyers who represent the class, studies have shown that this has not been the experience under the Reform Act. In a report to the President and Congress on the first year of practice under the Reform Act, the SEC found that institutional investors sought lead plaintiff status in only 8 out of 105 sample cases.[5] More recently, Professor John C Coffee, Jr, of Columbia Law School, reported studies showing institutional participation ranging between 18% and 35%.[6] While institutional investors have assumed lead plaintiff responsibilities in some prominent and widely publicized cases, this has too often been the exception rather than the rule. Lawyers still run many, if not most, securities class actions with little or no oversight by an actual client. If institutional investors are unwilling to come forward and serve as lead plaintiffs, the logical assumption is that these investors do not believe the case is worth the time and effort required for them to serve as lead plaintiff.

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[5] Securities & Exchange Comm'n Office of General Counsel, *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995* (April 1997), available at http://www.sec.gov/news/studies/lreform.txt.

[6] John C Coffee, Jr, *Milberg Weiss Indictment*, Nat'l L J 18 (June 19, 2006).

Second, the 1995 Reform Act has effectively called a halt to transparency and competition in the selection of class counsel in securities class actions. In 1990, I conducted a competitive selection of class counsel and it worked.[7] Although the practice was criticized by some lawyers and commentators, I continued the practice in several later cases and several other judges began to pick up on the idea and applied a number of variations and improvements.[8] In two court of appeals decisions, competitive selection of class counsel was held to be contrary to the lead plaintiff and lead counsel provisions of the 1995 Reform Act.[9] I cannot say that these decisions are incorrect interpretations of the 1995 Reform Act, but their consequence has been unfortunate.

There is no little irony in this. While judges were for a long time lax in monitoring the conduct of class counsel,

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[7] See In re Oracle Securities Litigation, 131 FRD 688 (ND Cal 1990).

[8] See, for example, In re Bank One Shareholders Class Actions, 96 F Supp 2d 780 (ND Ill 2000) (Shadur); In re Lucent Technologies, Inc, Securities Litigation, 194 FRD 137 (DNJ 2000) (Lechner); Sherleigh Associates v Windmere-Durable Holdings, Inc, 184 FRD 688 (SD Fla 1999) (Lenard); see also In re Auction Houses Antitrust Litigation, 197 FRD 71 (SDNY 2000) (Kaplan) (antitrust).

[9] In re Cendant Corp Litigation, 264 F3d 201 (3d Cir 2001); In re Cavanaugh, 306 F3d 726 (9th Cir 2002).

the influence of the bidding cases has begun to be felt.[10] The Advisory Committee Notes to Rule 23 of the Federal Rules of Civil Procedure now expressly provide that a court may consider the price of counsel's services in awarding lead counsel designation.[11] Furthermore, the cases in which a competitive selection is perhaps most suitable are open-market securities fraud cases. This suitability arises from the fact that, unlike many other cases, the event that discloses the possibility of wrongdoing is a publicly announced or revealed event. Further, the legal claims actionable in the case of open market securities fraud are well established and fairly standardized. Under the Third and Ninth Circuit's interpretations of the 1995 Reform Act, competition is essentially impossible.

Section 4 of HR 5491 attempts to correct this shortcoming of the 1995 Reform Act by enabling courts to conduct alternative means, including competitive bidding, of approving lead counsel. If anything, this provision could and should be made even stronger by providing that the court shall not permit a

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[10] A Third Circuit task force and the Federal Judicial Center studied the auction process. Third Circuit Task Force on the Selection of Class Counsel, *Final Report* (January 2002), available at http://www.ca3.uscourts.gov; Laural L Hooper & Marie Leary, *Auctioning the Role of Class Counsel in Class Action Cases: A Descriptive Study* (Federal Judicial Center 2001), available at http://www.fjc.gov.

[11] Federal Rule of Civil Procedure 23, Advisory Committee Notes, 2003 Amendments, subsection (e), paragraph (1)(C).

securities class action to proceed unless and until the lead plaintiff has demonstrated that the lead plaintiff has evaluated competing proposals for representation of the class.

A lead plaintiff's failure to shop around for legal services raises two concerns. First, it should cause the court to question whether lead counsel has been chosen based on the perceived value of his services as opposed to some improper inducement. In this regard, requiring a lead plaintiff to select lead counsel on a competitive basis has salutary effects similar to an auction conducted by the court. Second, a lead plaintiff's failure to shop the market for legal services suggests that the plaintiff, although he may have the most at stake, cannot adequately represent the interests of the class. A plaintiff that has not exercised a calculated judgment in selecting counsel cannot be expected to direct or supervise counsel in a meaningful way. Accordingly, a plaintiff's failure to select counsel through a competitive selection process should constitute evidence that can rebut the "most adequate plaintiff" presumption and allow the court to conduct such a process or dismiss the case.[12]

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[12] For an example of a court requiring the lead plaintiff to select counsel through a competitive selection process, see In re Network Associates, Inc, Securities Litigation, 76 F Supp 2d 1017 (ND Cal 1999) (Alsup).

Section 3 of HR 5491 also seeks to promote transparency in securities class actions. This provision would amend subsection (a) of section 27 and section 21D of the 1933 and 1934 acts, respectively, by requiring that each plaintiff and the plaintiff's attorney provide sworn certifications that identify conflicts of interest, "including any direct or indirect payment, between such attorney and such plaintiff and between such attorney and any affiliated person of such plaintiff." Disclosing conflicts of interest is, of course, essential to transparency in securities class actions. Yet as suggested by the Milberg indictment and the Chicago Tribune article, this kind of disclosure has been lacking. One can scarcely doubt that section 3 takes a step in the right direction by requiring plaintiffs and their lawyers to disclose conflicts of interest.

Beyond conflicts of interest, I suggest that section 3 should also require disclosure of any financial relationship between an attorney representing a plaintiff in the class action and the plaintiff, any attorney that represents the plaintiff in other matters (including the plaintiff's general counsel) or any person related to or affiliated with either the plaintiff or attorneys that represent the plaintiff in other matters. Although much of this is covered by section 3 as currently drafted, there simply is no reason not to draft the section as

broadly as possible. Furthermore, I suggest adding a provision that requires court approval for any payment by the plaintiff's attorney to the plaintiff, any attorney that represents the plaintiff in other matters (including the plaintiff's general counsel) or any person related to or affiliated with either the plaintiff or attorneys that represent the plaintiff in other matters.

ACCOUNTABILITY

This highlights another problem with the lead plaintiff provisions of the 1995 Reform Act: the most adequate plaintiff may not always be the class member with the largest stake in the outcome of the case. What matters is the willingness and ability of the lead plaintiff actually to lead the litigation and monitor class counsel. The total number of dollars at stake may not determine this. A class member with a smaller stake may have more of its net worth at stake and be more keenly interested in securing relief.

The 1995 Reform Act created a statutory presumption that the plaintiff with the "largest financial interest in the relief sought by the class" is the "most adequate plaintiff," assuming that this plaintiff satisfies certain requirements of Rule 23 of the Federal Rules of Civil Procedure. One question

left unanswered by the 1995 Reform Act was whether plaintiffs could be grouped and their financial interests aggregated for purposes of the statutory presumption. As amended by the 1995 Reform Act, section 27 and section 21D of the 1933 and 1934 acts, respectively, both provide that the court "shall appoint as lead plaintiff the member or members of the purported plaintiff class that the court determines to be most capable of adequately representing the interests of class members." Similarly, both sections elsewhere suggest that a "person or group of persons" may qualify as the "most adequate plaintiff."

Courts interpreting this language have reached different conclusions. Some courts have rightly found that aggregating plaintiffs is antithetical to the 1995 Reform Act's goal of taking lawyers out of the driver's seat.[13] At the other end of the spectrum, courts have appointed groups of unrelated plaintiffs to act as "co-lead" plaintiffs.[14] Courts in the middle have allowed aggregation only if some pre-existing relationship binds members of the group such that agency costs

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[13] See, for example, In re Donnkenny Inc Securities Litigation, 171 FRD 156 (SDNY 1997).

[14] See, for example, In re Oxford Health Plans, Inc, Securities Litigation, 182 FRD 42 (SDNY 1998).

and collective action problems are not likely to emerge.[15] Underlying this middle approach is the notion that a closely related group will, as a practical matter, act in unison.[16]

Aggregating unrelated plaintiffs presents several problems. First, the larger the group, the more difficult it is for group members to communicate with each other. In the same vein, it becomes more difficult for the group to act cohesively when making decisions about the conduct of the litigation and to coordinate supervision of the lawyers. Second, cobbling together unrelated plaintiffs to satisfy the "largest financial interest" criterion amounts to an end-run around the statutory presumption. All of this enables lawyers to run the show.

Significantly, in at least two of the class actions listed in the indictment against the Milberg Weiss firm were governed by the 1995 Reform Act, Milberg Weiss was able to inject itself into the litigation with a client or collection of clients who, individually, would not have met the criteria of the "most adequate plaintiff."[17] It is worth noting that one of these

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[15] See, for example, In re Telxon Corp Securities Litigation, 67 F Supp 2d 803 (ND Ohio 1999).

[16] Aronson v McKesson HBOC, Inc, 79 F Supp 2d 1146 (ND Cal 1999).

[17] See In re Baan Co Securities Litigation, 186 FRD 214 (DDC 1999); In re Oxford Health Plans, Inc, Securities Litigation, 182 FRD 42 (SDNY 1998).

cases, Oxford Health, involved the largest single kickback payment alleged in the Milberg indictment: $1.1 million.

One approach to the problem of aggregating plaintiffs would be to draw a bright line forbidding the practice of allowing more than one individual or entity to serve as lead plaintiff. This might be as simple as eliminating the existing phrases "or members" and "or group of persons" from clause (a)(3)(B)(I) and subclause (a)(3)(B)(iii)(I), respectively. Alternatively, the subcommittee might consider codifying the middle approach taken by courts, whereby only a small, closely knit group of individuals or entities with a pre-existing relationship can act as lead plaintiff. But in no event should separate groups of plaintiffs and their lawyers be permitted to act as "co-lead" plaintiffs and "co-lead" counsel in order to qualify for designation.

APPROPRIATE RESTRAINT

The 1995 Reform Act sought appropriate restraint on the bringing of securities class actions by imposing a heightened pleading requirement for complaints alleging securities law violations. Whether that requirement has reduced the number of filings or simply prolonged and complicated the pleading stage of securities actions is open to debate. But it is clear that

securities complaints are now distended, prolix and circumlocutory. More significantly, this prompts securities issuers to lard mounds of cautionary language in their securities offering documents with little, if any, additional informational value to investors. Section 2 of HR 5491 would amend subsection (c) of section 27 and section 21D of the 1933 and 1934 acts, and impose a more effective restraint.

Currently, paragraph (c)(1) requires the court to make findings regarding compliance by the parties and attorneys with Rule 11 of the Federal Rules of Civil Procedure, which proscribes filings that are legally or factually baseless or made for an improper purpose. Paragraph (c)(2) provides that the court shall impose sanctions for filings that violate Rule 11. Paragraph (c)(3) creates a rebuttable presumption that the appropriate sanction for improper filings is an award of attorney fees and expenses. Subsection (c) does "not in any way purport to alter the substantive standards for finding a violation of Rule 11, but functions merely to reduce courts' discretion in choosing whether to conduct the Rule 11 inquiry at all and whether and how to sanction a party once a violation is found."[18]

Section 2 of HR 5491 would amend subsection (c) by

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[18] Simon DeBartolo Group, LP v Richard A Jacobs Group, Inc, 186 F3d 157, 167 (2d Cir 1999).

adding new paragraph (c)(4) providing that upon motion by a defendant who has obtained final judgment against a plaintiff through a dispositive motion or a trial on the merits, the court shall determine whether (1) the plaintiff's position was "not substantially justified," (2) imposing defendant's fees and expenses upon the plaintiff's attorney would be just and (3) fees and expenses incurred by the defendant are "substantially burdensome or unjust." The defendant bears the burden of persuading the court that the plaintiff's position was not substantially justified. If the court finds these three conditions are satisfied, the court shall award the defendant fees and expenses to be paid by the plaintiff's attorney.

I would offer the following comments.

The subcommittee might wish to consider making the standard for an award of fees and expenses more objective than the rather elastic standards of Rule 11. The Rule 11 standards can change with judicial interpretations in cases not involving the securities laws. Furthermore, Rule 11 sanctions are closely tied to pleadings filed in court and have other limitations that make their imposition often impossible. Lead counsel's pleadings are only one aspect of securities litigation. It should be possible for a court to evaluate lead counsel's conduct of the litigation as a whole. A standard that would shift fees to lead

counsel in securities litigation if the court finds that the action or its conduct was not substantially justified would better serve the intent of this legislation.

Finally, conditioning a fee award upon a finding that it would be unjust or substantially burdensome for a defendant to bear its own fees and expenses does not further the purpose of the fee-shifting provision. Whether a particular frivolous class action is burdensome and therefore warrants an award of fees against the plaintiff's attorney simply should not depend on the depth of the defendant's pockets.

Once again, I am honored to have been invited to testify before the subcommittee. HR 5491 plainly seeks to promote transparency and accountability in securities class actions and protect the investing public. I hope my comments have been helpful to the subcommittee and would be pleased to answer your questions.

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June 27, 2006

Via Facsimile

Honorable Richard H. Baker
Chairman
Subcommittee on Capital Markets, Insurance,
and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

This law firm represents Milberg Weiss Bershad & Schulman LLP. We write in response to your recent invitation to the firm's founding partner, Melvyn I. Weiss, to testify on Wednesday, June 28, 2006, at a hearing now entitled "Investor Protection: A Review of Plaintiffs' Attorney Abuses in Securities Litigation and Legislative Remedies."[1]

Mr. Weiss has devoted the past 40 years of his professional career to protecting investors, consumers and others, such as victims of discrimination, environmental abuses and the Holocaust. Milberg Weiss is widely recognized as the leading defender of the rights of victims against corporate and other large scale wrongdoing. The firm, through the prosecution of class action lawsuits, has had unparalleled success in achieving recoveries for its clients in a wide variety of complex cases including, for example, the tobacco litigation, in which $12.5 billion was recovered for the cities and counties of California; the Holocaust cases, in which $6.25 billion was recovered for World War II victims of bank fraud, property theft and slave labor; the Drexel-Milken litigation, in which the firm worked with the FDIC and RTC to recover more than $2 billion for the United States government and investors; the Lucent Technologies case, in which $600 million was recovered for shareholders; the Nortel securities case, in which more than $2 billion is being recovered; the Raytheon securities litigation, in which more than $460 million was recovered for the New York State Common Retirement fund and other class members who were the victims of accounting fraud; and the life insurance marketing fraud cases, in which more than $15 billion has been recovered for policy holders.

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1 The hearing was originally titled "Protecting Investors: A Review of the Milberg Weiss Indictment and Ways to Prevent Securities Litigation Abuse."

In addition to achieving substantial monetary recoveries for their clients, lawyers at Milberg Weiss have been instrumental in developing landmark legal precedents that now govern complex class action litigation, such as the "fraud on the market doctrine" that applies in securities-fraud class actions. That doctrine has become a cornerstone of the SEC's enforcement efforts. As former SEC chairman Arthur Levitt affirmed in congressional testimony in the mid-1990s: "I have said in San Diego and elsewhere that fraud on the market is absolutely fundamental to the Commission's activities."[2]

Milberg Weiss has also pressed for and obtained significant reforms in corporate governance and has partnered with the Securities and Exchange Commission staff in ferreting out corporate fraud. The federal judge in the recent Rite-Aid corporate securities litigation observed that Milberg Weiss was "at least eighteen months ahead of the United States Department of Justice in ferreting out the conduct that ultimately resulted in the write-down of over $1.6 billion in previously reported Rite Aid earnings."[3]

Under ordinary circumstances, Mr. Weiss would welcome the opportunity to testify before the Congress, as he has done in the past, regarding the important issues confronting investors and the plaintiffs' bar that represents them. We have reluctantly concluded, however, that the hearings proposed for Wednesday are not intended to provide a forum to address these issues.

To the contrary, both the original title of the hearing and the committee's recent press release suggest that the hearing is driven by politics rather than substance. The press release speaks of preventing "frivolous lawsuits" manufactured by plaintiffs' attorneys for their own benefit – as if the tobacco industry and corporations such as Lucent and Raytheon would settle lawsuits for millions of dollars if they were in fact frivolous. The proposed legislation, the Securities Litigation Attorney Accountability and Transparency Act, was introduced just one week after the indictment was announced and, on its face, appears directed at Milberg Weiss. Furthermore, the invitation to Mr. Weiss requests his testimony not on that legislation but rather on the criminal indictment itself – an inappropriate topic for comment while the case is pending and a matter that does not seem to be within the jurisdiction of the subcommittee in any event. As far as we can determine, the majority has not sought the testimony of the Association of Trial Lawyers of America or any of the other prominent plaintiffs' firms. Rather, it appears that the indictment is unfortunately being used for political purposes, to tarnish Milberg Weiss in an

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[2] Legislative History of the Private Securities Litigation Reform Act of 1995, Vol. 2, Tab 5, "Hearings Before the Subcommittee on Telecommunications and Finance of the Committee on Commerce, House of Representatives," January 19 and February 10, 1995 (Testimony of Arthur Levitt, Chairman, Securities and Exchange Commission), at 212.

[3] *In re Rite Aid Corp. Sec. Litig.*, 269 F. Supp. 2d 603, 611 (E.D. Pa. 2003).

effort to restrict access to the courts for working Americans and thereby insulate corporations from scrutiny.

We do not believe it is appropriate or productive for Mr. Weiss to testify under these circumstances and accordingly must decline the subcommittee's invitation. Milberg Weiss remains committed to representing its clients zealously and to providing representation that reflects the high standards of the firm. It also looks forward to defending itself vigorously against the charges that have been made against it in the appropriate forum – the courts.

Sincerely,

William W. Taylor, III

cc: Honorable Paul E. Kanjorski

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June 22, 2006

The Honorable Richard H. Baker
Chairman
Subcommittee on Capital Markets, Insurance,
and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

We write to request a major change in the structure of the hearing announced for next Wednesday in the Capital Markets Subcommittee entitled "Protecting Investors: A Review of the Milberg Weiss Indictment and Ways to Prevent Securities Litigation Abuse." While securities litigation and abuses in that area are legitimate topics for a hearing, it is completely inappropriate to hold a hearing to review an indictment already obtained by the Department of Justice. Such a hearing opens the Committee to justifiable criticism for meddling in an on-going prosecution.

We therefore urge that the hearing be restructured to remove the indictment as a major subject.

BARNEY FRANK
Ranking Member
Committee on Financial Services

PAUL E. KANJORSKI
Ranking Member
Subcommittee on Capital Markets,
Insurance and Government Sponsored
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June 22, 2006

The Honorable Barney Frank
Ranking Member
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Frank:

I am in receipt of your letter regarding the upcoming Capital Markets Subcommittee hearing entitled "Protecting Investors: A Review of the Milberg Weiss Indictment and Ways to Prevent Securities Litigation Abuse." The Subcommittee hearing is being held not for the purpose of "meddling in an on-going prosecution," as you suggest in your letter, but to shine light on securities litigation abuses, such as those alleged in the recent indictment of one of the nation's foremost securities litigation firms, Milberg Weiss Bershad & Schulman LLP, and two of its named partners. I believe that you are aware that I have invited Mr. Melvyn Weiss, another of the law firm's named partners who is not under indictment, to appear before the Subcommittee. It is highly appropriate to invite Mr. Weiss as he has an obligation to respond to Members of this Subcommittee who are concerned that *the practices and actions as alleged in the indictment are commonplace in securities litigation practice.* Mr. Weiss is free to exercise his rights not to answer questions as he deems appropriate.

I concur with your statement that "securities litigation and abuses in that area are legitimate topics for a hearing." As originally planned, I will also be inviting witnesses to discuss the problems in the securities litigation industry and more specifically the reforms presented in the recently introduced H.R. 5491, the Securities Litigation Attorney Accountability and Transparency Act.

The hearing will take place as scheduled with the same focus and subject matter. However, in order to allay your concerns I would agree to the issuance of a revised hearing notice stating the hearing title as "Investor Protection: A Review of Plaintiffs' Attorney Abuses in Securities Litigation and Legislative Remedies."

Yours truly,

Richard H. Baker, Chairman
Subcommittee on Capital Markets,
Insurance and Government Sponsored
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Cc: Michael G. Oxley

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ROBERT U. FOSTER III
CHIEF OF STAFF

June 27, 2006

Honorable Richard H. Baker, Chairman
Subcommittee on Capital Markets,
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341Cannon House Office Building
Washington, DC 20515

Dear Mr. Chairman:

We were very disappointed to receive your response to our letter about the hearing you have scheduled for tomorrow. We continue to believe strongly that the hearing as you describe it is an inappropriate intrusion by the Legislative Branch into a pending criminal case. We repeat that we think a hearing on the legislation you have introduced is of course entirely legitimate, but intermingling that – attempting to give it more prominence apparently – by inquiring into a pending indictment and the issues specifically raised by that indictment is wholly inappropriate.

Indeed, your letter to us acknowledges that when you note that you "have invited Mr. Melvyn Weiss, another of the law firm's named partners who is not under indictment, to appear before the Subcommittee." That is, you implicitly note that you have not invited the two named partners who were personally indicted. But Mr. Weiss is a name partner of the firm that is under indictment, and you have invited him to speak on behalf of the firm – the entity that was indicted. And you note that you want to ask Mr. Weiss about "the practices and actions as alleged in the indictment," that is, you are convening this hearing specifically on the specifics of a pending criminal prosecution. This is a blatant violation of the separation of powers. A Congressional hearing on the precise issues involved in an indictment – specifically called in part for that purpose – is precisely "meddling in an ongoing prosecution," which you deny doing, even as you tell us that you plan to do exactly that.

In closing, you say, "to allay your concerns" you "agree to the issuance of a revised hearing notice." That is, you are prepared to be less explicit than you were initially about your intention to involve the Committee in the very heart of an ongoing criminal prosecution, but you also make clear that you do not intend to change any aspect of the proceeding. It may be that you regret having been quite so explicit about your intention at the outset, but simply being less explicit about your intention to inquire of Mr. Weiss about "the practices and actions as alleged in the indictment," does not cure the grave harm this hearing would do to the principle of a fair trial. We again request that you refocus the hearing – not simply change the title – so that we are inquiring into what you believe to be abuses in the securities field, without focusing on the specifics of the indictment, and without seeking to pressure the head of the firm that is under indictment to come and testify as a representative of the indicted entity.

BARNEY FRANK

PAUL E. KANJORSKI

STATEMENT FOR THE RECORD OF DAMON A. SILVERS
ASSOCIATE GENERAL COUNSEL
AMERICAN FEDERATION OF LABOR AND
CONGRESS OF INDUSTRIAL ORGANIZATIONS
Before the
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES
UNITED STATES HOUSE OF REPRESENTATIVES
June 28, 2006

In the American legal system, the parties get to pick their own lawyers and generally pay their own costs. Even Ken Lay got to pick his own lawyer. H.R. 5491 would deprive investors of those basic rights—and not when they have done anything wrong, but when they have been the victims of securities fraud by corporate management. Of course the bill imposes no burdens whatsoever on the actual perpetrators of securities fraud. The bill seeks to hide what it is really doing by saying plaintiffs' lawyers will have to pay and not investors, when anyone with the slightest familiarity with economics can see that the result of the provision will be that plaintiffs' law firms will increase their fees for bringing corporate fraud cases to compensate for the punitive burden of H.R.5491.

Institutional investors have recovered billions of dollars from those who committed corporate fraud at companies like Enron and Worldcom over the last five years, and have fundamentally changed the balance of power between plaintiffs' lawyers and their clients since the passage of the Private Securities Litigation Reform Act. H.R.5491 would punish institutional investors and other victims of corporate fraud for having the nerve to seek redress in the courts. H.R. 5491 will both protect perpetrators of corporate fraud and increase legal fees to plaintiffs' lawyers, both at the expense of workers' retirement funds. H.R. 5491 is a fine vehicle for political fundraising from CEO's, but it doesn't pass the laugh test as public policy.

Consumer Federation of America

June 27, 2006

The Honorable Richard H. Baker
Chairman
Subcommittee on Capital Markets,
Insurance, and Government Sponsored
Enterprises
Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Paul E. Kanjorski
Ranking Member
Subcommittee on Capital Markets,
Insurance, and Government Sponsored
Enterprises
Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Baker and Ranking Member Kanjorski:

We are writing to express Consumer Federation of America's opposition to H.R. 5491, the Securities Litigation Attorney Accountability and Transparency Act, which we understand is to be a subject of tomorrow's subcommittee hearing on attorney abuses in securities litigation. While we believe a comprehensive look at how to protect investors in securities litigation lawsuits could be beneficial, this legislation does not appear to be based on such an analysis. Instead, in an overly hasty response to a single case of alleged wrong-doing, it would adopt radical new changes with no evidence that these changes are needed or would benefit investors.

CFA strongly opposes Section 2 of the bill on the grounds that its loser pays provision would be likely to chill meritorious as well as frivolous lawsuits. Plaintiffs attorneys who take cases on a contingent fee basis already face significant financial costs if they fail to prevail in court. Adding a new threat that they could be forced to pay the defendant's cost if a judge determines that their case was "not substantially justified" could raise the risks to a level that only those firms with the deepest pockets – the Milberg Weiss Bershad & Shulmans of the world, in fact – would be able to take on the risk. This is particularly true since the term "not substantially justified" is vague and undefined, seems to include even cases that have met today's heightened pleading standards and survived a motion to dismiss, and could be interpreted very differently by different judges.

Furthermore, this provision seems to suggest that the provisions adopted as part of the Private Securities Litigation Reform Act to screen out meritless cases have not been effective. In fact, however, the research we have seen suggests that PSLRA both reduced the number and changed the nature of securities class action lawsuits filed in its wake. Some have even concluded that its provisions did more than screen out frivolous cases, but also prevented certain types of meritorious cases from being brought. We would hope that Congress would have a better basis for action that could discourage legitimate cases from being brought than alleged wrong-doing at a single law firm.

CFA also opposes Section 4 of the bill, which would strip plaintiffs of their right to chose their own lead counsel. Allowing judges to impose a competitive bidding process suggests that costs are the only relevant factor to consider when selecting counsel and that judges are better able than investors to determine what is in their best interests. Under the worst case scenario, investors could be forced to accept representation by a lower cost firm that lacks the expertise and experience of other available counsel and could lose their case as a result. The law already gives judges authority to approve lead counsel. It seems paternalistic at best to further shift this responsibility away from those whose financial well-being is at stake. Again, we ask, how can alleged wrong-doing at a single law firm justify such a radical legislative response?

CFA has no objection to the concept behind Section 3 of the bill, which requires disclosures of conflicts of interest between plaintiffs and attorneys. If the Subcommittee has reason to believe that abuses of the type alleged in the Justice Department's prosecution of Milberg Weiss Bershad & Schulman are widespread and thus in need of a legislative solution, a requirement that lead plaintiffs and attorneys sign sworn certifications regarding conflicts of interest seems to be a reasonable response. We are concerned, however, that this provision of the legislation is vaguely written. Rather than referring to lead plaintiffs, for example, it refers to "each plaintiff." Who does that encompass within a class action lawsuit? Also, what constitutes a "conflict of interest" that must be disclosed? Without some guidance on this point, plaintiffs and their attorneys may find it difficult if not impossible to know what information to include in these sworn certifications.

Ten years ago, Congress adopted sweeping changes to the rules governing securities class action lawsuits. The wave of fraud that has swept the markets in recent years has provided a testing ground for that new system. If the subcommittee is truly concerned with protecting investors in securities litigation, it would seem appropriate to look first at whether defrauded investors are able to recover their losses under the current system. Questions that we believe deserve attention are: whether the move to a system of proportionate liability and the lack of aiding and abetting liability significantly reduced recoveries for defrauded investors, whether the heightened pleading standards and discovery stay of the PSLRA prevented meritorious cases from getting a hearing, and whether the broad safe harbor for forward-looking statements has contributed to the flood of unreliable and inaccurate information from public companies.

These are the types of issues we would urge Congress to consider before it rushes ahead with a hasty and ill-considered bill based on little if any evidence that the abuses it purports to address are widespread or that its proposed remedies would benefit investors rather than the perpetrators of securities fraud. Thank you for your attention to our concerns.

Respectfully submitted,

Barbara Roper
Director of Investor Protection
Consumer Federation of America

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