NLWJC - Kagan
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Securities Litigation Reform [1]

Securities Litigation Reform

Bruce —
A short memo by NEC standards, supporting limited preemption of state securities law
Elena

MEMORANDUM TO NEC PRINCIPALS

FROM: Mozelle W. Thompson
Ellen Seidman

SUBJECT: Extension of the Private Securities Legislation Reform Act of 1995 to State Securities Class Action Suits

ACTION FORCING EVENT

In May, the President was asked by a bipartisan group of over 75 members of Congress and by representatives of the high-technology industry to support the enactment of uniform federal standards for securities fraud class actions. Since then, two bills have been introduced in the House that seek to amend the Private Securities Litigation Reform Act of 1995 to establish such standards by preemption of state law. Consumer groups have indicated strong opposition to such legislation, as have state regulators.

On Thursday, July 24, the Securities Subcommittee of the Senate Banking Committee, chaired by Senator Gramm, will hold a hearing on the issue at which the SEC will testify. Both on the Hill and among private sector parties interested in this issue, the approaching hearings have intensified inquiries about where the Administration is on the legislation, although no Executive Branch agency so far has been asked to testify.

The NEC established an interagency working group to consider the policy issues and make recommendations to the President. This memorandum outlines the working group's views and provides options for action.

DISCUSSION

The Private Securities Litigation Reform Act of 1995

In December 1995, Congress passed, over the President's veto, the Private Securities Litigation Reform Act (the "Reform Act"), which revised both substantive and procedural law governing private actions under the federal securities laws. Among other things, the Reform Act (1) created a safe harbor for forward-looking statements; (2) heightened the pleading standards for claims of fraud; (3) created a stay of discovery pending a defendant's motion to dismiss; (4) limited the exposure of certain defendants by establishing proportionate liability, rather than joint and several liability, for parties not found to have "knowingly" committed violations; and (5) required courts to assess whether all parties complied with Rule 11 of the

Federal Rules of Civil Procedure, prohibiting the filing of frivolous legal motions.

In his veto message, the President indicated his objection to three provisions of the Reform Act that would "erect procedural barriers... [and] keep wrongly injured persons from having their day in court": (1) the heightened pleading standards; (2) the breadth of safe harbor for forward-looking statements, as suggested in the language of the Conference Report; and (3) the Rule 11 sanctions, which were seen as too close to a "loser pays" standard.

In response to the passage of the Reform Act over his veto, the President requested the SEC to undertake a year-long study and provide advice on the impact of the Reform Act on the effectiveness of the securities laws and on investor protection. In its April 1997 report, the SEC concluded it was too early to determine the full impact of the Reform Act. In particular, the SEC found that judicial interpretations of the new pleading standards varied and that there had been only one decision on the application of Rule 11.

The SEC did find, however, that there had been a significant increase in securities class actions filed in state courts, particularly in California, a finding consistent with an industry-sponsored study by Stanford professor Joseph Grundfest. The SEC study also indicated that since passage of the Reform Act, public companies had failed to avail themselves of the "safe harbor" for forward-looking statements.

Studies reported in the Wall Street Journal on July 9, 1997 indicate that federal securities lawsuits are back up to their pre-Reform Act levels, and that state suits are way down from their 1996 levels. The Journal states that "the filings are back up because federal courts haven't been as inhospitable to shareholder suits as proponents of the new law had hoped."1 Wall Street Journal (July 9, 1997, page B11)

Interaction between Federal and State Securities Laws

Over the last sixty years, federal securities laws have worked in tandem with state corporate law, securities law and the common law of fraud, to contribute to public confidence in our capital markets. State law has traditionally provided a remedy for those defrauded in face-to-face transactions, and certain types of corporate actions that may involve actively traded securities (such as proxy contests, mergers and tender offers) are tried in state, not federal court.

On the other hand, until the passage of the Reform Act, large class actions alleging securities fraud in connection with securities traded in national markets were generally brought in federal court, under federal law. The reasons for this include: provisions for strict liability of issuers and underwriters in certain situations; the ability to include plaintiffs from many states in a single action; the lack of need to

prove reliance by each plaintiff on misstatements or omissions; and the expertise of the federal courts, particularly in the Second and Ninth Circuits.
Proponents of the Reform Act argued that the federal system had gone awry, and that the high tech industry, accountants, lawyers and securities firms were being unfairly targeted in meritless class-action shareholder suits. They argued the litigation burdened the cost of raising capital and stifled growth and productivity. The Reform Act was intended to reduce this burden.

The high-tech industry and Congressional supporters assert that the industry has not obtained the relief intended by the Reform Act because of the trend toward state court actions. They are also concerned that plaintiff-friendly changes could be adopted in state law (such as proposed Proposition 211 in California, which the President publicly opposed) that will make the Reform Act even less effective. Therefore, to restore the federal/state balance -- but with the benefit of the Reform Act's provisions in federal court -- they argue that a single national standard of liability should be effected through preemption of state securities laws for private class action fraud actions. During the 1996 election campaign, while Proposition 211 was being considered in California, the President indicated some sympathy with this position.

Congressional Proposals

In May, two bills were introduced in the House that would preempt certain securities fraud actions filed in state courts. H.R.1689, introduced by Representatives Eshoo (D-CA) and White (R-WA), would preempt class action securities fraud suits (with more than 25 plaintiffs) based on state law if any of the company's securities were traded on a national exchange or the Nasdaq National Market System during the period of the alleged fraud. No such action could be brought, in either state or federal court, based on state common or statutory law. The Eshoo/White bill has over 75 co-sponsors, of both parties.

H.R. 1653, introduced by Representative Campbell (R-CA), is virtually identical to the Eshoo/White bill with two exceptions. The Campbell bill preempts all suits, not just class actions. On the other hand, the bill more narrowly defines "covered security" to apply only if the security *at issue* (rather than any of the company's securities) was traded on a national exchange or the National Market System. This bill has no additional sponsors; it appears the high tech community has decided the Eshoo/White bill is more likely to pass.2

ISSUES RAISED BY EXPANDING THE REFORM ACT

As a whole, and with some exceptions, the members of the NEC working group are inclined to believe that proponents of **wholesale** preemption of state securities fraud actions (or even state securities fraud class actions) for nationally-traded securities have not yet made an effective case for such action. However, the group discussed three areas in which limited, though significant, preemptive relief may be appropriate to enhance the likelihood that the benefits of the Reform Act will be realized:

- protecting the federal discovery stay from an "end run" using state actions;
- expanding the applicability of the safe harbor for forward-looking statements; and
- limiting state suits that do not require the plaintiff to demonstrate individual reliance on the defendants' misstatements or omissions.

These could form the core of a carefully drawn statute that creates national uniformity for claims truly related to national market actions while leaving state law intact for its traditional purposes.

In addition, the Administration may want to use this opportunity to revisit some of the issues raised during consideration of the Reform Act, such as the length of the federal statute of limitations. It is quite possible, however, that a decision to revisit any of these issues -- even in combination with support for some preemption -- would be taken as an indication that the Administration was not in fact supportive of the high tech community's interests.

Discovery Stay: The Reform Act provided for a stay of discovery during the pendency of motions to dismiss unless discovery is necessary to preserve evidence or prevent undue prejudice. Since the passage of the Reform Act, many state class action suits have been filed parallel to identical federal actions. Prior to the Reform Act, parallel suits were unusual. Although it is too soon to have conclusive evidence of discovery practices in these state actions, a strong inference is that state jurisdiction in these suits is being used to obtain discovery for use in the parallel federal court action. This lack of effectiveness of the federal discovery stay is a central complaint of the proponents of a national standard. While there may be potential constitutional (Tenth Amendment) issues in requiring state courts to respect the federal discovery stay, both the Justice Department and the SEC believe it is possible to craft such a statute.3

Safe Harbor: The Reform Act established a safe harbor from liability under the federal securities fraud laws for forward-looking statements that were not known to be false when made or that were accompanied by "meaningful" cautionary statements. Such a safe harbor is not generally found in state law. The President's veto message on the Reform Act noted that it was appropriate to modify federal securities law to "ensure that companies can make reasonable statements and future projections without getting sued every time earnings turn out to be lower than expected..." But the President took issue with the language of the Conference Report that "weaken[ed] the cautionary language that the bill itself provides."

The SEC's report on the impact of the Reform Act suggested that the lack of case law or regulation on what constitutes "meaningful" cautionary statements, rather than the potential for state court litigation, might be the primary inhibition to the wider use of the safe harbor. However, the goal of the safe harbor would probably be enhanced by making it universally applicable -- in state as well as federal courts.

Reliance: Most large federal securities fraud class action suits -- the type of litigation that generates the most concern in the business community -- rely on the theory of "fraud on the market." This doctrine allows plaintiffs to bring fraud actions under the federal securities laws alleging that misinformation or omissions of material fact caused securities sold in the market to be mispriced, resulting in damage to the plaintiffs, regardless of whether each plaintiff had personal knowledge of and relied on the misinformation or the omission. This makes large class actions far more feasible than doctrines, such as common law fraud, that require individual proof of reliance.

Because until recently there has been little incentive to file these kinds of suits in state, rather than federal court, most states do not have definitive court rulings on whether fraud on the market is a permissible theory of liability. There are no state law cases allowing fraud on the market -- rather than individual reliance -- as the basis for a state common law fraud suit. Four states -- Colorado, Arizona, Texas and Montana -- explicitly allow blue sky statutory fraud suits without proof of individual reliance (the functional equivalent of fraud on the market). The California Supreme Court has ruled that reliance is required for a common law fraud action, but stated in dicta that it would **not** be required for a statutory securities law action -- with the result that California plaintiffs are bringing statutory blue sky fraud actions without alleging individual reliance on the assumption that the Supreme Court will uphold them. It is unclear whether other states, if the issue is raised through post-Reform Act cases moved to state court, would follow California.

Given the uncertainties of state law, but the fact that state law generally requires individual reliance, federal preemption of state cases not requiring reliance would limit large state securities fraud class actions. This could be accomplished today without overruling current state law outside of Colorado, Arizona, Texas, Montana, and probably California.

Heightened Pleading Standards: The Reform Act adopts the Second Circuit's standard that plaintiffs must plead with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind. The President in his veto message indicated that this standard -- the toughest adopted by any Court of Appeals -- would be acceptable, but that the Conference Report's virtual direction to impose an even tougher pleading standard was inappropriate. The SEC's report indicates that most courts have applied the Second Circuit standard, notwithstanding the language of the Conference Report. However, in In re Silicon Graphics, Inc. Securities Litigation, 1997 WL 285057 (ND Cal, May 23, 1997), the

District Court held that allegations of non-deliberate "recklessness" would be insufficient to satisfy the new standard. Preemption of state court suits would make it more difficult for plaintiffs to bring law suits against reckless violators, particularly if Silicon Graphics becomes the Ninth Circuit or national standard.4 An attempt to overrule Silicon Graphics by statute would be vigorously opposed by the high tech community.

Aiding and Abetting: A Supreme Court case decided while the Reform Act was being considered (Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994)) eliminated private liability for aiding and abetting a securities law violation under the federal securities law. Attempts by the Administration and others to convince Congress to overrule the case in the Reform Act were not successful. About 20 states (including California) recognize private civil liability for aiding and abetting as a statutory blue sky violation.5 Preempting state fraud actions would effectively prevent statutory aiding and abetting claims in those states, as well as common law fraud aiding and abetting claims in all other states. An attempt to restore federal private aiding and abetting liability would likely meet strong objection not only from the high tech community but also from lawyers and accountants.

Statute of Limitations: In 1991, the Supreme Court limited the statute of limitation for federal private actions for securities fraud (Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991)) to a "one/three" standard -- one year after learning of facts that should put plaintiff on notice of the fraud, but no more than three years after the conduct. During the debate on the Reform Act, the Administration supported a longer statute of limitations. However, the Reform Act did not overrule Lampf. Preemption of state court suits would remove the ability to bring state court actions on the expiration of the shorter federal statute of limitations in the 31 states, including California, that currently have longer statutes. This may be an area in which an attempt to move federal law in a direction more friendly to plaintiffs would be feasible.

OPTIONS

1. Do not support legislative action at present

The Administration could choose not to comment on the proposed legislation -- or could oppose it -- accepting the recommendation of SEC Chairman Levitt that we allow case law implementing the Reform Act to develop. We could also make the point that to the extent these suits have shifted back from state to federal court in recent months, action to preempt state law might be both unnecessary and misdirected.

If we took this position, however, members of the high tech community would reiterate their claim that the President had committed to supporting some degree of federalization of the law in this area in his comments on California's Proposition 211. They have clearly indicated they would regard failure to support some preemption as a policy reversal and betrayal. On the other hand, consumer groups as well as state regulators would applaud our action.

2. Support the Eshoo/White or Campbell proposals

The Eshoo/White bill would move large securities fraud class actions into federal courts, but would continue to allow small aggregate actions (under 25 plaintiffs) to be brought in state court under either statutory or common law. The Campbell bill has a broader scope in that it impacts all lawsuits, not just class actions. Enactment of either bill would undoubtedly reduce the number of securities fraud suits brought in state court or under state law, thereby driving them back into federal court where the provisions of the Reform Act apply.

However, as noted above, the breadth of the bills, particularly the Campbell bill, could result in many types of actions traditionally, and successfully, brought in state courts (such as common law fraud cases based on actual reliance and actions alleging fraud in the course of a tender offer or proxy fight) being forced into federal court. In some cases, such as misrepresentations in intra-state private placements, there may not be the interstate commerce predicate for federal jurisdiction. It is possible that defrauded investors in these cases may find themselves without any remedy at all.

3. Propose legislation either as a stand-alone or to modify the Eshoo/White or Campbell bills

Neither the Eshoo/White nor the Campbell bill appear sufficiently well targeted to respond to what we perceive to be the primary issues that may deserve attention. Moreover, they are overbroad and completely pro-defendant. It is arguable that in providing something more to defendants in protection against state court actions, it might be useful to tilt the balance back somewhat in federal court. A carefully drawn statute that creates national uniformity for claims truly related to national market actions while leaving state law intact for its traditional purposes could serve all parties.

A package consisting of the following might be a useful counter-proposal:

- Preempt state law liability for statements that meet the federal safe harbor standards;
- Apply the discovery stay to securities fraud suits brought in state court;
- Preempt state securities fraud actions that do not require proof of individual reliance; and
- Increase the federal statute of limitations to the earlier of three years after

discovery or five years after the act.

While it is highly unlikely that such a package would fully satisfy either the high-tech community or opponents of any preemption, it responds to the concerns that have been documented, encourages further use of the safe harbor, and balances enhanced restrictions on plaintiffs' actions in state court with respect to clearly national issues with some degree of enhanced (or restored) plaintiffs' rights in federal court.

Securities Litigation Reform

NASCAT

NATIONAL ASSOCIATION OF SECURITIES AND COMMERCIAL LAW ATTORNEYS

July 18, 1997

Elena Kagan
Deputy Assistant to the President for Domestic Policy
The White House
Washington, DC 20502

Dear Ms. Kagan:

In light of next week's Senate Securities Subcommittee oversight hearing on the Private Securities Litigation Reform Act of 1995 (PSLRA), the National Association of Securities and Commercial Law Attorneys (NASCAT) urges that the Clinton Administration proceed cautiously as it considers proposals to preempt private rights of action under state securities laws. We strongly oppose any legislative initiatives that would further jeopardize defrauded investors' ability to recover their losses.

Representatives of the high-tech, securities and accounting industries who advocate federal preemption of state securities laws argue that they need additional legislation to protect them from the "onslaught" of shareholder class action suits filed in state court. These hyperbolic claims provide little justification for imprudent intrusion on state securities laws. Even at its height in 1996, the number of shareholder class actions filed in state court numbered less than 100, out of some 15 million civil cases filed in state courts each year. In the five years previous, only some 35 to 55 securities class actions were filed in state court annually.

Recent studies already indicate a reversal of the 1996 aberration. According to a study by National Economic Research Associates, Inc. (NERA), "[T]here has been a slowdown in state court filings: the 19 filings [January] through April [1997]...project to a total of 57 filings for this year, approximating the 1991 to 1995 average." NERA termed the 1996 numbers "transient." (Enclosed is a copy of the *Wall Street Journal* article summarizing the studies, as well as copies of the studies' findings.)

317 MASSACHUSETTS AVE., N.E. • SUITE 300 • WASHINGTON, DC 20002
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Furthermore, preemption proponents seek to nullify many state laws that provide greater investor protections not found in the new federal law, including a longer statute of limitations and aiding and abetting liability.

Finally, we stress our fundamental opposition to federal preemption of state securities laws based on the current reality that **it is not clear that there will be any means for defrauded investors to recover stolen money under federal law after passage of the PSLRA.** It will take years to assess PSLRA's impact as the courts struggle to interpret its provisions. Even Stanford University law professor and preemption proponent Professor Joseph Grundfest stated last week, "The law is very much in flux."

Unfortunately, several federal district courts already have issued rulings so restrictive that they threaten almost all private enforcement. In the first of those decisions, *Silicon Graphics,* the court held that reckless wrongdoers are no longer liable to their victims under PSLRA. The Securities and Exchange Commission (SEC) took the extraordinary step of entering the case to file a brief in the district court to protest the result. Preemption of state remedies under such circumstances could leave investors with no ability to protect themselves against fraud.

As you know, an impressive array of consumer and investor advocates also oppose the current attempt to federally preempt investor protections provided under existing state securities laws. These groups are the National League of Cities, U.S. Conference of Mayors, National Association of Counties, National Association of County Treasurers and Finance Officers, Government Finance Officers Association, the Municipal Treasurers Association, the American Association of Retired Persons, Citizen Action, Consumer Federation of America, Consumers Union, Public Citizen's Congress Watch, and the U.S. Public Interest Research Group.

Bottom line, preemption proponents seek eradication of a 60-year system of dual enforcement that has served the country well since the Depression -- based on a mere 19 state courts filings, at a time when it is not certain that sufficient protections exist for investors under the new federal law. We encourage you to heed the recommendation of SEC Chairman Arthur Levitt, who counseled, "[I]t is too early to assess with confidence many important effects of the [Private Securities Litigation] Reform Act and therefore, on this basis, it is premature to propose legislative changes. The one-year time frame has not allowed for sufficient practical experience with the Reform Act's key provisions, or for many court decisions (particularly appellate court decisions) interpreting those provisions."

At a minimum, Congress should await conclusive evidence of the impact of both the PSLRA and the 1996 National Securities Markets Improvement Act, bills which have created a more difficult environment for defrauded investors and reduced regulator oversight of the industry.

We look forward to working with you over the coming months as Congress seeks to evaluate the impact of the Private Securities Litigation Reform Act and to chart a course for the future of private securities litigation.

Sincerely,

Mern Horan

Mern Horan
Executive Director

Enclosure

UPDATE ON SECURITIES CLASS ACTION FILINGS IN STATE AND FEDERAL COURTS

Media Coverage

Securities Class Action Lawsuits Make Comeback in Federal Court (Wall Street Journal, July 9, 1997)

National Economic Research Associates, Inc
New York, New York

Federal Class Action Filings Rise to Pre-Reform Levels as State Filings Fall

Securities Class Action Clearinghouse, Stanford University
Professor Joseph Grundfest (Preemption Proponent)

Federal Litigation Box Score
State Court Class Actions

Wilson Sonsini Goodrich & Rosati (Securities Defense Firm)
Palo Alto, California

Summary of study on Motions to Dismiss under the PSLRA

Securities Class-Action Lawsuits Make Comeback in Federal Court

By DEAN STARKMAN
Staff Reporter of THE WALL STREET JOURNAL

The number of securities-fraud class-action suits filed in federal court this year has climbed back to the levels of the early 1990s, despite a 1995 law aimed at curbing such suits, two new studies show.

The studies indicate that plaintiffs lawyers have returned to federal court after adjusting to higher pleading standards and other hurdles presented by the Private Securities Litigation Reform Act, passed over a presidential veto in December 1995. Meanwhile, the number of shareholder suits filed in state courts is down sharply this year, after spiking last year, the studies show.

"The plaintiffs lawyers have figured out that it's not so bad to file in federal court, and there's no significant advantage to filing in state court," says Vinita Juneja, a vice president of National Economic Research Associates Inc., a White Plains, N.Y., consulting firm that studied both federal and state court filings.

The group found that 78 suits were filed in federal court through May, compared with 47 last year. In state courts, it found that 19 shareholder class actions were filed through April, down from 40 in the same period last year.

In its study, the Securities Class Action Clearinghouse, a research project run by Stanford University law school, found that 83 securities-fraud suits were filed this year in federal court through July 3. If the filings continue at that rate, there will be 166 suits filed this year. That's roughly the same number as in the early 1990s, when business groups lobbied Congress to make it harder for shareholders to bring "meritless" suits in federal court. Back then, the number of shareholder suits filed in federal court averaged about 178 a year.

Last year, the number of suits filed in federal court dropped to about 123, as more suits were filed in state court. Observers also attributed the decline to a rush by lawyers to file federal claims in late 1995 before the law went into effect.

Both groups say the filings are back up because federal courts haven't been as inhospitable to shareholder suits as proponents of the new law had hoped.

In 17 rulings since the law went into effect, federal judges have dismissed six cases outright and three others with the provision that plaintiffs could refile if they added more information to their complaints, according to a separate study by the Palo Alto, Calif., firm of Wilson Sonsini Goodrich & Rosati, which defends high-tech firms. Judges, however, allowed at least part of eight other cases to go forward, the study found.

"The law is still very much in a state of flux," says Joseph A. Grundfest, a Stanford University law professor and former member of the Securities and Exchange Commission.

The first federal appeals-court ruling on the new law is expected in a widely watched case involving Silicon Graphics Inc., a maker of interactive computer systems in Mountain View, Calif., now before the federal appeals court in San Francisco. In May, a federal district judge in San Francisco threw out a shareholder-fraud suit against the firm, ruling, among other things, that the plaintiffs weren't specific enough in their allegations that corporate insiders who sold their stock at the end of 1995 knew that sales wouldn't meet company forecasts.

William S. Lerach, a leading plaintiffs lawyer with Milberg Weiss Bershad Hynes & Lerach, who is handling the case, says the decision, if upheld, "will mortally wound private enforcement of federal securities laws."

Boris Feldman, a Wilson Sonsini lawyer who defends high-tech companies, says that until higher-court rulings are handed down, it's too early to tell if the new law will ultimately discourage shareholder suits. "Certainly, the plaintiffs lawyers haven't become demoralized and started selling life insurance," he says. "They're a very resilient bar."

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Consulting Economists

NATIONAL ECONOMIC RESEARCH ASSOCIATES, INC.
1166 AVENUE OF THE AMERICAS
NEW YORK, NEW YORK 10036
TEL: 212.345.3000
FAX: 212.345.4650

FEDERAL SHAREHOLDER CLASS ACTION FILINGS RISE TO PRE-REFORM ACT LEVELS AS STATE FILINGS FALL

NERA Analyzes First Five Months of 1997

An analysis of recent shareholder class action filings reveals a reversal of 1996 trends. As documented by NERA and others, federal shareholder class actions fell last year following passage of the Private Securities Litigation Reform Act of 1995.[1] At the same time, however, there was an extraordinary increase in state filings. In a new analysis through May of this year, the 1996 trends are found to have been transient: federal class actions are *up* significantly and state class actions are *down* from 1996 levels. In both cases, the five-month rate is about the same as occurred in the five years prior to the Reform Act.

"These results are consistent with anecdotal evidence reported by plaintiffs' attorneys who recently have been more upbeat in their response to the Act, believing that they are bringing stronger cases resulting in larger recoveries," notes Dr. Frederick Dunbar, NERA Senior Vice President.

Table 1 summarizes federal court filings. NERA's prior research showed that there was an apparent acceleration in federal filings in December 1995 to avoid being subject to the Reform Act, followed by a lull in filings for January to March 1996. The next six months' 1996 filings were at a lower rate than in earlier years but not by a statistically significant amount when adjustments were made to reflect the effect of the bullish stock market on reducing the number of securities lawsuits. The total number of filings for 1996 (123) lagged that of 1995 (163) and the annual average from 1991 to 1995 (179). However, this year, an apparent return to the federal courts has occurred, with 78 filings to date projecting to a total of 187 federal filings for all of this year.

[1] See NERA's "Recent Trends IV: What Explains Filings and Settlements in Shareholder Class Actions" ("Recent Trends IV").

Table 2 summarizes state court filings. The 110 state court filings in 1996 is more than double the annual average from 1991 to 1995 (52) and exceeds the second highest year, 1994, by more than 50 percent. However, this year, there has been a slowdown in state court filings: the 19 filings through April (May data may be incomplete due to the greater lag in reporting state filings) project to a total of 57 filings for this year, approximating the 1991 to 1995 average.

A first-ever NERA empirical analysis of settlements of cases filed after passage of the Reform Act finds that, on average, they are over 40 percent higher than pre-Reform Act settlements, although this result is not statistically significant. This analysis included five cases for which (at least preliminary) settlement values are available and which meet (or appear to meet) the conditions described in Recent Trends IV. For this small sample of cases, investor losses were calculated and combined with NERA's sample of earlier investor losses cases. Then, multiple regression analysis was used (see Recent Trends IV) to attempt to quantify the effect of the Reform Act on settlements.

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For further information contact:

Todd S. Foster
(212) 345-3000
todd_foster@nera.com

or

Frederick C. Dunbar
(212)345-3000
fred_dunbar@nera.com

or

Denise N. Martin
(212) 345-3000
denise_martin@nera.com

or

Vinita M. Juneja
(914) 448-4000
vinita_juneja@nera.com

Summary of Federal Court Filings of Security Class Action Suits

Filings from:	1991	1992	1993	1994	1995	1996	1997	1991 to 1997
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
January to May	70	71	66	96	69	47	78	497
January to December	156	193	159	222	163	123	187*	1203*
Monthly Average	13	16	13	19	14	10	16	14

* Based upon extrapolation using January to May 1997 data.

Summary of State Court Filings of Security Class Action Suits

Filings from:	1991	1992	1993	1994	1995	1996	1997	1991 to 1997
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(8)
January to May	21	15	14	28	23	53	21	175
January to December	49	34	47	72	57	110	57*	426*
Monthly Average	4	3	4	6	5	9	4	5

* Based upon extrapolation using January to April 1997 data.

SECURITIES CLASS ACTION CLEARINGHOUSE

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- .Complaints
- .Summaries
- .Briefs
- .Settlements
- .State Courts
- .Gateways
- .'95 Act Text
- .E-mail Registration
- .Search
- .Your Comments

Federal Litigation Box Score 22 Dec. 1995 to 28 May 1997	1996	1997	Total
Companies sued in federal court	109	71	180
Federal complaints on line	75	14	89
Companies sued in California	25	16	41
Most frequently sued industry	High-Tech		High-Tech
Most active district court	S.D. N.Y.	S.D. Fla.	
Percentage alleging accounting fraud	59%*		59%*
Percentage alleging insider sales during class period	55%*		55%*

Clearinghouse Main Page

Last Updated 28 May 1997

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* These figures are based on a sample of 65 complaints filed during 1996.

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SECURITIES CLASS ACTION CLEARINGHOUSE

State Court Class Actions

Filed Since Enactment of the
Private Securities Litigation Reform Act of 1995

[Alabama] [Arizona][California][Colorado][Connecticut][Delaware]
[Florida][Georgia][Illinois][Maryland][Montana][Nevada]
[New Jersey][New Mexico][New York][Ohio][Texas]

Arranged by state, and then alphabetically by company

State	Company	Date Filed	Court	Allegations and Notes
Alabama				
Alabama	AmSouth	~4/22/96		Defrauding customers into cashin in CDs and putting them into uninsured mutual funds; federal action filed
Arizona				
Arizona	Microtest	9/29/96	Maricopa County	Improper revenue recognition; insider sales
Arizona	Orthologic	6/24/96	Maricopa County	Failure to disclose FDA warning letter, insider sales; federal action filed
California				
California	3Com Corporation	3/24/97	Santa Clara County	Violations of California law; misrepresentations; insider tradin
California	20th Century Industries	1/17/96	Los Angeles County	Sale of portion of the company

California	Access HealthNet	12/19/96	Orange County	Federal action filed
California	Adobe Systems	2/6/96	Santa Clara County	Failure to disclose declining business and unsuccessful integration of merged company
California	Brooktree Corp.	5/6/96	Santa Diego County	Misleading new product statement
California	CellNet Data Systems, Inc.	10/31/96	San Mateo County	
California	Cinergi Pictures Entertainment, Inc.	5/13/96	Los Angeles County	Misrepresentations and omission in connection with stock offering
California	Circon Corporation	5/28/96	Santa Barbara County	False & misleading statements about merger; insider sales
California	Cirrus Logic	2/21/96	Alameda County	Misrepresentations concerning anticipated financial results; inadequate reserves for inventory
California	Citadel Holding	10/--/96	Los Angeles County	
California	Communications and Entertainment Corporation	3/25/96	Los Angeles County	Financial treatment of disposition of subsidiary; federal action filed
California	Comparator Systems Corporation	5/13/96	Orange County	Market manipulation
California	DSP Communications, Inc.	5/12/97	Santa Clara County	Misleading statements about orde rates, prospects for earnings growth; insider trading
California	Dean Witter	9/9/96	Los Angeles County	Fraud in sale of "managed futures" funds; parallel N.Y. stat court action
California	Diamond Multimedia Systems, Inc.	6/27/96	Santa Clara County	Misleading statements about business, products, earnings growth and financial statements; insider sales; federal action filed
California	Digital Link Corp.	4/22/96	Santa Clara County	False financials, failed product development, insider sales
California	Discreet Logic, Inc.	5/29/96	Santa Francisco County	Misleading forecasts and new product reports; insider sales; federal action filed
California	FileNet Corporation	12/20/96	Orange County	Misleading forward looking statements concerning product demand and sales; insider sales
				Improper accounting for mergers and acquisition costs, improperly recognized revenue, and failure t

California	Fritz Companies, Inc.	7/29/96	San Francisco County	establish adequate allowance for doubtful accounts receivable; insider sales; federal action filed
California	Growth Hotel Investors	2/28/96	Los Angeles County	Misrepresentations in connection with sale of limited partnership interests
California	Helmstar Group Inc.	5/-/96	Riverside County	Misrepresentations concerning ta status of interest on bonds
California	IMP, Inc.	9/17/96	Santa Clara County	Misrepresentations and omission concerning product demand and forecasted earnings; insider sales; federal action filed
California	Insignia Solutions plc	4/9/96	Santa Clara County	Misrepresentation about business sales force, new software product earnings growth, and ability to continue to achieve profitable growth; permitted public offering of ADRs, insider sales
California	Manhattan Bagel Company, Inc.	8/7/96	Los Angeles County	Restated financial results; federal action filed
California	Mossimo Inc.	1/24/97	Orange County	
California	Nellcor Puritan Bennett Inc.	5/3/96	Alameda County	False and misleading statements about merger; insider sales
California	Network Computing Devices, Inc.	4/10/96	Santa Clara County	Misstatements re company, operating results to prospects, insider sales, underwriter sued; federal action filed
California	Oak Technology, Inc.	6/7/96	Santa Clara County	False financials, failed product development, insider sales; underwriter sued; federal action filed
California	Oakley, Inc.	12/26/96	Orange County	Misrepresentations and omission in connection with secondary offerings; insider sales
California	Paracelsus Healthcare Corporation	10/11/96	Los Angeles County	False and misleading statements i connection with acquisition and offerings of equity and debt securities; possible restated financials; federal action filed
California	Paradigm Technology	8/13/96	Santa Clara County	

California	Pearce International Systems, Inc.	3/--/96	San Francisco County	
California	Performance Development, Inc.	2/2/96	Los Angeles County	Misrepresentations in connection with sale of limited partnership interests
California	Prism Solutions, Inc.	3/6/97	Santa Clara County	Misrepresentations and omission in connection with IPO
California	Proxima Corporation	8/27/96	San Diego County	Misleading earnings forecasts an product statements; insider sales; federal action filed
California	Pyramid Breweries, Inc.	9/3/96	San Diego County	Misrepresentations and omission in connection with IPO; insider sales; Pyramid changed its name from Hart Brewery
California	Quality Systems	4/4/97	Orange County	Misrepresentations that company was effectively competing and wa enjoying strong demand for its products; insider trading
California	Quantum Corporation	8/28/96	Santa Clara County	Misleading earnings forecasts an product statements; insider sales; federal action filed
California	Quarterdeck Corp.	12/3/96	Los Angeles County	Misleading product statements; violations of GAAP; insider sales
California	Read-Rite Corporation	12/11/96	Santa Clara County	Misleading product statements; insider sales
California	Shiva Corporation	1/17/97	Los Angeles County	
California	Silicon Graphics	3/29/96	Santa Clara County	Misleading forecasts of quarterly earnings; federal action filed
California	Storm Technology, Inc.	3/14/97	Santa Clara County	Misrepresentations and omission re ability to manufacture product low sales; insider trading
California	StorMedia, Inc.	9/18/96	Santa Clara County	Misrepresentations concerning product demand; insider sales
California	Symantec	3/18/96	Santa Cruz County	Misrepresented earnings forecasts insider sales; Federal action filed
California	SyQuest Technology	3/25/96	Alameda County	Failure to take adequate inventor reserves; misrepresentations concerning prospects for product; federal action filed
California	TCSI Corp.	11/4/96	Alameda County	False and misleading revenue an earnings forecasts; insider sales through secondary offerings

California	Veterinary Centers of America	4/3/97	Los Angeles County	Misrepresentations re animal hospitals, laboratories and pet foo operations and success in integrating acquisitions; insider trading
California	VanStar Corporation	7/7/97	Santa Clara County	Misrepresentations in connection with IPO; insider trading
California	Wiz Technology, Inc.	3/5/97	Orange County	False financial statements
California	Yes! Entertainment Corp.	Unknown	Alameda County	Misrepresentations re sales and products
Colorado				
Colorado	DII Group, Inc.	6/9/97	Boulder County	Misrepresentations re decline in revenues
Colorado	Tele Communications, Inc.	2/25/97	Arapahoe	
Connecticut				
Connecticut	Northeast Utilities	12/5/96	Hartford	Misrepresentations and omissions concerning operation and business prospects of nuclear power plant
Delaware				
Delaware	General Nutrition Companies, Inc.	8/5/96	Chancery Court	Misrepresentations and omissions in public offerings insider sales; federal action filed
Delaware	Lehman Brothers	3/7/96	Chancery Court	Misrepresentations and omissions in connection wit sale of partnership units
Florida				
Florida	Atico Records, Inc.	4/15/97	Fort Myers	Misrepresentations or omissions in offering documents; misleading oral presentations
Florida	Barnett Banks	9/16/96	Hillsborough County	Sale of securities by unregistered branch offices
Georgia				

Georgia	ADAM Software, Inc.	4/25/96	Fulton County	Violations of 1993 Act in connection with IPO
Georgia	ValuJet	6/21/96	Fulton County	federal action filed
Illinois				
Illinois	Cerion Technologies, Inc.	8/2/96	Cook County	False and misleading statements about significant customer relationships and future trends
Maryland				
Maryland	Lehman Brothers	2/6/96	Baltimore	Misrepresentations and omissions in connection wit sale of partnership units
Maryland	Mid Atlantic Medical Services, Inc.	11/12/96	Montgomery County	Misrepresentations and omissions concerning revenues, costs, margins an loss ratios; insider sales
Maryland	Oxford Tax Exempt Fund	1/23/96	Montgomery County	Misrepresentations or omissions in connection wit restructuring plan
Montana				
Montana	Semitool	2/21/96	Flatahead County	False and misleading forecasts; insider sales
Nevada				
Nevada	Stratosphere Corporation	8/16/96	Clark County	Misrepresentations about prospects and operations of casinos; insider sales; federal action filed
New Jersey				
New Jersey	I-Stat	6/19/96	Mercer County	Misrepresentations/omission re business, sales, earnings and products
New Jersey	John Hancock Realty Income Fund, LP	2/ /96	Essex County	Misrepresentations and omissions in connection wit sale of limited partnership interests
	Lehman Brothers/			

New Jersey	American Express/ Smith Barney	8/30/96	Union County	
New Mexico				
New Mexico	Horizon/CMS Healthcare	3/21/96	Bernalillo County	Federal action filed
New Mexico	Solv-Ex Corporation	10/28/96	Albuquerque	Artificial inflation of stock during time period by misrepresenting the busines reserves, existing technologies and the overall value of company; unlawful distribution of private placements with related entities and individuals; federal action filed
New York				
New York	Advanced Voice Technologies Inc.	12/5/96	Supreme Court	Misrepresentations and omissions in connection wit IPO
New York	Bennett Funding Group, Inc.	4/12/96	New York County	1933 Act violation (sale of unregistered securities); misrepresentations/omission in sales of securities to publi federal action filed
New York	Com/Tech Communication Technologies Inc.	12/5/96	Supreme Court	Misrepresentations and omissions in connection wit IPO
New York	Datapax Computer Systems, Inc.		Supreme Court	Failure to disclose adverse information relating to sale and earnings in a timely fashion
New York	Dean Witter Reynolds, Inc.	9/19/96	Supreme Court	Fraud in sale of "managed futures" funds; parallel California state court actio
New York	Lehman Brothers	2/29/96	Supreme Court, New	Misrepresentations and omissions in connection wit

			York County	sale of limited partnership interests
New York	Simware, Inc.	5/21/96	New York County	Misrepresentations/omission in connection with/IPOs; underwriter sued as well
Ohio				
Ohio	Compuserve/H&R Block	7/--/96	Franklin County	Federal action filed
Texas				
Texas	Amre, Inc. (Certain officers and directors sued)	4/9/97	Tarrant	Misrepresentations re financial results, future prospects; insider sale
Texas	FoxMeyer Health Corp.			Federal action filed
Texas	Nutrition for Life International, Inc.	8/23/96	Harris County	Failure to disclose regulator concerns and past convictions of company's largest distributor; federal action filed
Texas	Physician Reliance Network, Inc.	9/18/96	Nueces County	Misrepresentations and omissions concerning billin practices and relationship with Texas Oncology, P.A.; federal action filed
Texas	Pier 1 Imports	1/24/96	Tarrant County	Dissemination of false and misleading information concerning company's financial condition in violation of Texas Securitie Act
Texas	ProNet, Inc.	7/3/96	Dallas County	False and misleading statements in IPO; underwriter sued; federal action filed

Securities Class

Action Clearinghouse
Last updated July 9 1997

Motions to Dismiss: Summary

- 17 Decisions
  - » 6 granted with prejudice
  - » 3 granted with leave to amend
  - » 2 granted in part
  - » 6 denied as to main defendant
    - – But auditors dismissed with prejudice in one

Motions to Dismiss (1)

Alliance Semiconductor	Granted w/ amend
Aprogenex (not class)	Granted in part
Bollinger Industries	Denied
Chantal Pharmaceutical	Denied
Discreet Logic	Granted in part
Eagle Finance	Granted w/ amend
Ernst Home Centers	Granted
Firefox Communications	Granted

Motions to Dismiss (2)

FTP Software	Denied
Hart Brewing	Granted
Midcom Communications	Granted w/ amend
Norwood v. Converse (not class)	Granted
NuMed Home Health	Granted
Page v. Derrickson (not class)	Denied
Proxima	Denied
Silicon Graphics	Granted
Wellcare Management	Denied (granted re auditors)

Securities Litigation Reform

TALKING POINT
REGARDING SECURITIES LITIGATION LEGISLATION

Background

At the urging of a number of Silicon Valley companies, Congresswoman Anna Eshoo has introduced legislation to preempt private securities fraud class actions brought under state law. Only "nationally marketed" securities would be covered by this preemption measure.

You likely will be asked whether you have decided whether the Administration will support the Eshoo bill. An interagency group has been meeting under the auspices of the NEC and Counsel's Office to develop a recommendation to you. The group is reviewing the evidence and studies on national uniform standards; there is weight on both sides. Among the recent studies is a report from the SEC, which you requested, that concludes that it is premature to consider further federal legislation on securities litigation.

The interagency group is considering not only the option of taking a position for or against the bill, but also intermediate options, short of supporting the bill, that could stake out a position in favor of some preemption to achieve some measure of uniformity among the states in litigation standards. But the bill is not moving at the moment; no hearings have been scheduled in the House yet and no bill has been introduced in the Senate. Thus, there is no urgency in the sense of legislative scheduling to your announcing a position now.

Suggested Talking Point:

- The issue of national uniform standards for securities fraud class actions is an important issue and we are continuing to look at it carefully as I said we would do in my letter responding to Congressowman Eshoo. We have benefited from your thoughtful input in that process. We are not on a specific timetable to complete the review. We will watch the legislation carefully as the process unfolds.

Prepared by Wallman 3/21/97, updated 6/17/97

Fili: Securities reform

Reuben L. Musgrave Jr. 04/17/97 09:12:30 AM

Record Type: Record

To: See the distribution list at the bottom of this message

cc: Tracy F. Sisser/WHO/EOP

Subject: Re: draft letter on securities litigation

Here's the edit you requested.

****

Dear <salutation>,

Thank you for your letter of March 14 ~~on~~ concerning legislation to create national uniform standards for ~~some~~ certain types of securities litigation. The new regime put in place by the Private Securities Litigation Reform Act is still ~~unfolding~~ in its infancy, and one of the issues that will need to be considered as we gain experience with the Act is how its provisions affect the roles of state and federal courts in private securities fraud litigation.

The Securities and Exchange Commission has just released a report ~~I asked them to prepare for me and for Congress~~ that I requested, assessing the ~~impact~~ effects of last year's legislation -- particularly the impact of its "safe harbor" provisions. ~~, including not only issues relating to litigation, but also the impact of the "safe harbor" for forward looking statements on information available to investors. Other studies also have been done.~~ We will be reviewing the SEC study and other reports and data to assess the need for further legislation. We look forward to working with you on this important issue.

****

Please fee free to call me (ext 6-5518) if you have questions.

Thanks.

Message Sent To:

James A. Dorskind/WHO/EOP
Kathleen M. Wallman/WHO/EOP
Bruce R. Lindsey/WHO/EOP
Elena Kagan/OPD/EOP
Ellen S. Seidman/OPD/EOP

Ani. OK.

Securities Reform

Reuben L. Musgrave Jr. 04/17/97 05:42:54 PM

Record Type: Record

To: Kathleen M. Wallman/WHO/EOP, Ellen S. Seidman/OPD/EOP, Bruce R. Lindsey/WHO/EOP, Elena Kagan/OPD/EOP

cc: James A. Dorskind/WHO/EOP, Tracy F. Sisser/WHO/EOP
Subject: Securities Litigation

Ellen was the only one who got back to me on this, and she recommended one change: instead of "particularly the impact of its "safe harbor" provisions," it should say, "including the Act's impact on litigation, investor protection and information made available to investors." And for style reasons, we would add a comma after "investor protection." Otherwise, we think the statement is OK with Ellen's edit. Thanks.

Securities Reform

Reuben L. Musgrave Jr. 04/18/97 10:21:39 AM

Record Type: Record

To: Ellen S. Seidman/OPD/EOP, Kathleen M. Wallman/WHO/EOP, Elena Kagan/OPD/EOP

cc: James A. Dorskind/WHO/EOP, Tracy F. Sisser/WHO/EOP, Bruce R. Lindsey/WHO/EOP
Subject: Re: Reply to signers of securities litigation letter

Bruce Lindsey has one change to recommend, as shown below:

The Securities and Exchange Commission has just released a report that I requested, assessing the effects of last year's legislation, including the Act's impact on litigation, investor protection, and information made available to investors. We will be reviewing the SEC study and other reports and data to assess the need for further ~~legislation~~ **action.** We look forward to working with you on this important issue.

Thanks.

Securities Litigation Reform

Why Congress Should Not Preempt
State Laws Against Securities Fraud

1. Talking Points & Supporting Materials

2. Consumer Groups Joint Letter To Congress

3. Government Finance Officers Association Resolution Opposing Federal Preemption

4. "SEC Submits Amicus Brief Urging 10(b) Recklessness Standard" *(Securities Regulation & Law Report*, 2/7/97)

5. "The Mob on Wall Street" (*Business Week*, December 16, 1997)

6. State Opponents to 1995 Private Securities Litigation Reform Act (H.R. 1058)

1. Talking Points & Supporting Materials

Why the Government Should Not Subvert State Investor Protection Laws.

* Tens of millions of hard working Americans investing for their retirement, either directly or through their pension plans, need all the protection against investment fraud that they can get. This issue is especially critical given recent proposals to privatize at least a portion of Social Security. Strong investor protection promotes both investor confidence in the marketplace and capital formation. State investor protection laws are part of a dual state and federal enforcement system that has served the country since the Depression. Before Congress passed laws to stop abuses that caused the 1929 crash, states enacted their own laws to protect against financial schemes. Under state laws, each year investors nationwide recover millions of dollars stolen through fraud. When Congress twice made sweeping deregulatory changes to the federal investment protection laws in the past two years, both times it wisely left intact state laws to recover investment fraud damages.

* Subverting state investor protection laws would needlessly expose the retirement savings of millions of Americans to fraud. Because of loopholes in federal law, state law sometimes provides the only way to hold the guilty responsible for repaying defrauded investors. Under federal law, (1) investors who do not discover the fraud for three years -- a frequent occurrence in retirement investments -- cannot recover their losses; and (2) "aiders and abettors" (i.e., those who substantially assist a fraud, but are not the primary violators) are not legally required to pay back their victims, no matter how deeply they are implicated. Under current federal law, the seniors Charles Keating bilked out of their retirement savings would recover only six cents on the dollar, rather than the 65 cents they received.

* It is too soon after passage of the Private Securities Litigation Reform Act to pass yet another measure further restricting the rights of defrauded investors. Because it will take several years to determine if there is adequate federal protection for investors, preemption threatens to leave investors with no ability to protect themselves against fraud. There have been extremely few interpretations of the 1995 law restricting private damage suits, none by any appellate court. One federal district court has issued such a ruling so restrictive that it threatens all private enforcement and triggered the SEC to file a brief protesting the ruling.

* There is no need for any federal action. Proponents of subverting state investor protection laws are complaining about a mere handful of state cases, representing an infinitesimally small percentage of all state court filings. In these cases, state judges are free to adopt practices that protect defendants against any overreaching. Clearly, states should be allowed to design their own investor protection laws. For example, California, which appears to be at the center of the debate, has recently formed a high-level legislative commission under the leadership of the Senate President to study whether changes to California law are needed. Arizona has already enacted legislation to bring its law more into conformance with federal law. Contrary to claims by proponents of subverting state investor protection laws, there are no securities fraud ballot propositions on the horizon.

* The wise and prudent decision is to preserve investor protections. As consumer leaders, state regulators and government finance officers have pointed out, the stakes are extremely high. Inadvertently exposing the life savings of hundreds of millions of Americans to fraud could have a catastrophic effect on the U.S. economy, as history conclusively proves.

February 18, 1997

WSJ 2·18·97 A6

Former CEO Of Centennial Faces Charges

By Jon G. Auerbach
And Laura Johannes
Staff Reporters of The Wall Street Journal

Federal authorities charged the former chief executive of Centennial Technologies Inc. with unlawful insider trading and a fraudulent scheme to overstate results.

After his arrest by Federal Bureau of Investigation agents at home in Beverly, Mass., on Friday, Emanuel Pinez was being held pending a bail hearing this morning in U.S. District Court in Boston.

The arrest climaxed an eventful week for Centennial, a maker of computer memory cards whose stock more than quintupled to be the top performer on the New York Stock Exchange last year, but came crashing down as its board and authorities closed in on Mr. Pinez's alleged scheme. Centennial's shares, which peaked at $58.25 last month and last changed hands at $16.50 on Feb. 10, haven't traded since the company fired Mr. Pinez and disclosed possible improprieties.

Robert L. Ullmann, Mr. Pinez's attorney, said his client "vehemently denies any criminal wrongdoing.... He wants to solve Centennial's problems, not run away from them."

In its complaint filed in Boston, the U.S. attorney accused Mr. Pinez, age 58, of falsely boosting recorded revenues by using his own funds to book orders and misrepresenting his academic credentials. The U.S. attorney also said inventories were falsely inflated.

Separately, the Securities and Exchange Commission charged that in advance of his dismissal and the accounting inquiry, Mr. Pinez purchased and sold over 4,400 options contracts that would rise in value if the stock plunged. The SEC said in a complaint, also filed in federal court in Boston, that Mr. Pinez was hiding Centennial's true financial status at the time of his transactions. The SEC wants a freeze on Mr. Pinez's assets and financial penalties, which could be triple any illicit profits.

According to the SEC complaint, Mr. Pinez purchased about 2,000 put-option contracts and sold about 2,400 call-option contracts betting that Centennial's stock would close below $20 prior to the expiration on the options on March 21.

The SEC said Mr. Pinez already had a profit of about $450,000 in premiums received from call-option buyers. Juan Marcelino, the SEC's regional director in Boston, said he did not know the profit Mr. Pinez had made on the put options.

The complaint filed by the U.S. Attorney says that Mr. Pinez admitted to the company's board that he had advanced personal money to customers to pay for goods. In order to raise this money, Mr. Pinez used his Centennial stock, as well as funds he had borrowed on margin on his accounts, the complaint said.

If convicted, Mr. Pinez could face a maximum of five years in jail plus a $5,000 fine on each count of securities fraud. The number of counts he is charged with will be determined when he is indicted sometime within the next 30 days, said a spokeswoman for the U.S. Attorney.

The Billerica, Mass., company's accounting inquiry centers on past results and its second quarter ended Dec. 31, when it reported sales of $31.7 million and earnings of $3.5 million, or 19 cents a share. For the year-earlier quarter, it reported sales of $8.5 million and earnings of $996,000, or 15 cents a share.

HOECHST AG

Roussel Uclaf, a French unit of Germany's Hoechst AG, said its 1996 net profit rose 90% to 1.93 billion French francs ($339.5 million) from 1.02 billion francs in 1995. Excluding exceptional items, the pharmaceutical group's net profit rose 11% to 1.61 billion francs from 1.45 billion francs in 1995. Sales in 1996 rose 3.8% to 17.1 billion francs from 16.6 billion francs in 1995. Broken down by division, health-care sales rose 6.8% in 1996, while fine-chemicals sales fell 5.4%. Sales from the animal-health division, which was transferred to Roussel Uclaf in July, totaled 521 million francs. In late 1996 and early 1997, Hoescht, a chemical and drug company, bought all shares outstanding in the French unit.

THE NATIONAL LAW JOURNAL Monday, January 27, 1997

Can a New Prop. 211 Be Avoided?

Lawyers seek pre-emption of state securities litigation.

BY KAREN DONOVAN
NATIONAL LAW JOURNAL STAFF REPORTER

HERE WE go again.

It's been barely a year since the Private Securities Litigation Reform Act of 1995 took effect, and corporate America is back at Congress' door, asking for more relief from plaintiffs' lawyers.

This time around, businesses—and especially high-tech companies—want federal lawmakers to amend the litigation reform statute, which placed stiff limits on federal class actions, to block shareholder suits filed in state courts.

Benjamin M. Vandegrift, of the Washington, D.C., office of San Francisco's Pillsbury Madison & Sutro L.L.P., who represents an underwriter of high-tech stocks, has drafted a proposed amendment for U.S. Rep. Tom Campbell, R-Calif. Mr. Campbell, whose district contains many of the Silicon Valley companies that gripe about frivolous shareholder suits, has made passage of an amendment a priority for the 106th Congress, which begins in February.

The draft bill would block state lawsuits seeking more than $5 million in damages for losses in securities traded on national exchanges.

The recent fight over Proposition 211, a California ballot proposal that critics claimed would have made an end-run on the federal law and turned the state into a haven for class actions, was closely watched by Congress. But Proposition 211 went down in flames in November, and Melvyn I. Weiss, of New York's Milberg Weiss Bershad Hynes & Lerach L.L.P., claims pre-emption will shield a business's questionable practices: "All they are doing is getting greedy; they just don't want any exposure."

But defense lawyers aren't just trying to avoid another political fight over a 211-type measure. They complain that plaintiffs' lawyers are ducking a limit of the reform act by filing the same complaint in state and federal court, and then seeking discovery in the state action that would be denied in the federal case.

The pre-emption issue may prove to be a nonstarter on Capitol Hill. "Unless there's clear evidence that plaintiffs are using state law to undermine the goals of the law, Congress isn't going to have the stomach to revisit the issue again," said Robert J. Giuffra Jr., of New York's Sullivan & Cromwell, a key player in the previous fight as chief counsel of the Senate Banking Committee.

Worcester, Massachusetts Telegram & Gazette (January 16, 1997)

Rep. Kennedy Wants To Close Loophole
Proposal Aimed At 'Frivolous' Securities Suits
By John M. Biers
States News Service

WASHINGTON -- Backed by technology companies, Rep. Joseph P. Kennedy, II is developing legislation to strengthen a 1995 law intended to stop "frivolous" securities lawsuits.

The 1996 securities law, which New England technology companies vigorously supported, stiffened the requirements for stockholders attempting to sue companies for fraud for providing inaccurate projections to retain investors.

Kennedy wants to close an apparent loophole in the 1995 law that he fears could leave high-tech firms vulnerable to litigation in state courts, even though there is little indication the problem exists and the proposal faces strong opposition.

RUSH OF LAWSUITS

The Massachusetts Democrat says the 1996 law has caused a rush in state courts of lawsuits that could not meet the new federal requirements. His staff points to a National Economic Research Associates report which found that state suits doubled since enactment of the law.

NERA is a consulting firm that assists companies in securities litigation; most of its clients are defendants in lawsuits.

Kennedy has also pointed to a 1996 California ballot initiative as impetus for the bill. Though it was resoundingly defeated, Proposition 211 would have effectively replaced the federal law with a lower standard.

In a November letter to fellow congressmen, Kennedy said proponents of the looser standard were planning campaigns in other states. They would lead to "nuisance and predatory shareholder lawsuits," which could cost thousands of jobs. "The simplest solution to this threat is federal preemption," he wrote.

Kennedy will introduce the legislation later this year. He is working with a bipartisan group of lawmakers, including conservative Rep. C. Christopher Cox, R-Calif., a Kennedy aide said.

LOOSER STANDARDS

Howard Foley, president of the Massachusetts High Technology Council, said the bill would ensure that local companies could not be sued by residents of other states with looser standards. Virtually all major Massachusetts companies were sued under the old law, Foley said.

The total cost of the California campaign was more than $45 million, the costliest referendum in California history. Some Massachusetts companies spent thousands to help defeat the proposal.

Foley concedes there is little evidence of the problem Kennedy describes. Kennedy's bill is largely "preventative," . . . said Foley, whose organization has heard only a few anecdotes about companies being sued in state courts.

Although Kennedy's scenario has been viewed as a "potential problem," there is "no clear evidence" of an increase in state lawsuits, said Harvard Law School professor Howell Jackson, who specializes in securities litigation. The Securities and Exchange Commission has no data yet on the effect of the new federal law.

LONG FIGHT

Further, Kennedy's bill could face a long fight on Capitol Hill. The 1995 law was opposed by many congressional Democrats, as well as consumers, senior citizens and trial lawyer groups.

Securities regulators also are likely to oppose the legislation. Massachusetts Secretary of State William F. Galvin, who oversees securities litigation, said he was waiting to see the final version of the bill, but opposes its overall aim.

"It is something that would not be in the best interest of the consumer," he said. "This is not good legislation."

2. Consumer Groups Joint Letter To Congress

Citizen Action
Consumer Federation of America
Consumers Union
Public Citizen's Congress Watch

January 31, 1997

Members of the U.S. Senate
Senate Office Building
Washington, D.C. 20510

Dear Senator:

As the 105th Congress turns to its legislative agenda, we write to let you know of the high priority our organizations place on preserving and enhancing federal and state securities laws designed to protect investors. We are concerned that discussions at the start of this Congress have focused instead on initiatives that could seriously erode investor protections.

Millions of middle-income Americans have come to rely on investments to build their retirement nest eggs, finance the education of their children, and save for major purchases, such as a home. The result is that Americans today have more money invested in stocks than they have on deposit in commercial banks. Fidelity Investments has estimated that roughly half the money flowing into its stock mutual funds is being invested through 401(k) plans. And initiatives are under discussion that would increase the already substantial role securities play in how we save for retirement by privatizing some portion of Social Security.

At the same time, study after study has found that most investors lack even the most basic knowledge necessary to make sound investment decisions. This lack of investment knowledge, the resulting dependence on sometimes unscrupulous financial professionals, and the absence of timely and understandable disclosure leaves many Americans ready victims for securities fraud and abuse.

As you lay out your agenda for the new Congress, we urge you to consider what additional protections may be necessary to better safeguard the investments on which so many Americans now depend. For example, we believe individuals need clearer, more complete, and more timely disclosure about the investments they buy and the financial professionals who advise them.

Also, any proposal to expand bank powers should provide adequate consumer protections and close the loophole that exempts banks from investor protection rules.

We are concerned, however, that legislation potentially damaging to investors is being given serious consideration. Representatives Tom Campbell and Joseph Kennedy already have announced their intention to introduce bills that would deprive many defrauded investors of their right to challenge securities fraud in state court. Others have suggested a further scaling back of state securities regulation and elimination of the requirement that brokers make only suitable recommendations to institutional investors, such as charities, pension funds, and state and local governments.

These proposals come on the heels of two bills enacted in the last Congress that encompass the most significant rewriting of our nation's securities laws in more than 50 years. Between them, H.R. 1058 and H.R. 3005 set a higher threshold for access to federal court for securities fraud lawsuits and reduced public oversight of the securities industry. Only time will tell whether this experiment benefits investors by reinvigorating the economy, as proponents pledged, or brings on a new round of securities fraud, as our organizations fear. Common sense dictates, however, that these laws be given a chance to take effect, and their implications for average investors be carefully studied, before new deregulatory initiatives are enacted.

These are important issues that affect the financial well-being of millions of middle-income Americans. We encourage you, therefore, to seek out a diversity of viewpoints as you consider any legislative initiatives that may be made with respect to our federal or state securities laws. And we strongly urge you to oppose any initiative that would erode investor protection and support initiatives to strengthen investor protection. Our organizations will be happy to work with you in this endeavor. You may contact Barbara Roper of Consumer Federation of America at 719/543-9468.

Sincerely,

Richard Vuernick
Director, Legal Policy
Citizen Action

Mary Griffin
Insurance Counsel
Consumers Union

Barbara Roper
Director, Investor Protection
Consumer Federation of American

Frank Clemente
Director
Public Citizen's Congress Watch

3. Government Finance Officers Association Resolution Opposing Federal Preemption

GOVERNMENT FINANCE OFFICERS ASSOCIATION

Policy Statement

Preemption of State Investor Protection Laws

Background

The Constitution assigns certain responsibilities to the federal government and preserves state prerogatives in other areas. In some cases, federal and state governments share responsibilities. However, the role of the federal government has not been as regulator of state or local government financial or securities policies. Such intervention or preemption of the legitimate role of state authorities would be a drastic departure from the principles of federalism and would be an encroachment on state sovereignty.

One area in which federal and state governments share responsibility is the protection of public funds invested in the securities markets. Investor protection includes the enactment and enforcement of securities regulation as well as an assurance of meaningful access to the judicial system to provide effective remedies against those who violate state or federal securities laws or common law fiduciary responsibilities.

State and local governments participate in the securities markets both as investors of pension funds and temporary cash balances as well as issuers of municipal debt. They therefore have an interest in preserving well-established investor rights as well as protecting themselves from unwarranted and expensive litigation. States protect their public funds through the enactment of state investment statutes and state securities laws that are designed to respond to specific identifiable state needs, and by permitting private rights of action under securities and contract law or common law trust principles.

Recent changes in the federal securities laws have erected substantial new hurdles for both access to federal courts and the remedies available for aggrieved investors by imposing stringent pleading requirements, restricting discovery, eliminating joint and several liability, and permitting a safe harbor for forward looking statements. In many cases, state private rights of action now remain the only method of obtaining recovery for defrauded investors by permitting liability for aiding and abetting wrongdoing, joint and several liability, and reasonable statutes of limitations for the filing of claims. In addition, many causes of action do not depend on an alleged violation of state or federal securities laws but on state contractual or common law fiduciary violations long recognized as state prerogatives.

GFOA Position

GFOA believes that state laws and access to state courts serve as deterrents to securities and contract law and fiduciary duty violations. GFOA supports the rights of states to protect public investors, and opposes federal efforts to preempt state laws regulating investments and securities transactions, as well as those designed to preempt contractual rights and other common law protections for public investors and their taxpayers. In addition, GFOA opposes federal efforts to further limit access or remedies provided by state courts for defrauded public investors seeking recovery.

Approved by Committee on Cash Management and Committee on Governmental Debt and Fiscal Policy
January 28, 1997

4. "SEC Submits Amicus Brief Urging 10(b) Recklessness Standard" *(Securities Regulation & Law Report*, 2/7/97)

Antifraud

SEC Submits Amicus Brief Urging § 10(b) Recklessness Standard

Securities and Exchange Commission General Counsel Richard Walker announced Feb. 4 that his agency has submitted to the U.S. District Court for the Northern District of California an amicus curiae brief urging that reckless misconduct will support antifraud liability, even under the 1995 Private Securities Litigation Reform Act's heightened pleading standards (*In re Silicon Graphics Inc. Securities Litigation*, DC NCalif, Lead Case No. C 96-0393 FMS, 1/31/97).

"Such a standard is needed to protect investors and the securities markets from fraudulent conduct and to protect the integrity of the disclosure process," the agency asserted.

No Change In Definition

In a release, Walker explained that last fall, the court dismissed the securities fraud plaintiffs' original complaint with leave to amend. It found, among other matters, that the complaint did not meet the Reform Act's strict pleading standards.

According to the SEC's brief, the court—in considering the defendants' first dismissal motion—concluded that new Section 21D(b)(2) of the 1934 Securities Exchange Act "required the plaintiffs to allege specific facts that constitute circumstantial evidence of 'conscious behavior' by defendants and that plaintiffs must create a strong inference of 'knowing' misrepresentation on the part of the defendants. Allegations of reckless behavior, the Court held, would not suffice."

In its brief, the commission pointed out that Section 21D(b)(2) merely requires a plaintiff to "state with particularity facts giving rise to a strong inference that the defendants acted with the required state of mind." The Reform Act "made no change in the definition of scienter under the federal securities laws," except in connection with certain forward-looking statements, the agency emphasized. As such, it asserted, "recklessness continues to satisfy the scienter requirement for a private action" under Section 10(b) and Rule 10b-5.

In addition, the commission told the court that it "has consistently supported a recklessness standard" for '34 Act Section 10(b) liability in both SEC and private actions under the federal securities laws. It maintained that this standard "discourages deliberate ignorance and also prevents defendants from escaping liability simply because of the difficulty of proving knowledge or conscious intent on the basis of the circumstantial evidence frequently used in securities fraud cases. A retreat from the recklessness standard would greatly erode the deterrent effect of Section 10(b) actions," the commission asserted.

Finally, the commission argued, in the past 21 years, every court of appeals to consider the requisite state of mind in Section 10(b) actions—including the U.S. Court of Appeals for the Ninth Circuit—"ha[s] held that recklessness is sufficient to establish liability under Section 10(b) and Rule 10b-5." A hearing on the defendants' motion to dismiss the amended complaint has been scheduled for March 21, Walker noted.

5. "The Mob on Wall Street" (*Business Week*, December 16, 1997)

THE PAYOFF FROM LOW INFLATION / JAPAN: A NEW RECESSION?

BusinessWeek

DECEMBER 16, 1996
A PUBLICATION OF THE McGRAW-HILL COMPANIES
$3.50

Two men appeared at the office of the CEO of a small Manhattan brokerage. They took him for a walk. One of the men stuck a gun in his ribs. 'From now on,' he was told, 'you'll be retailing all of our stock.'

THE MOB ON WALL STREET

AN INSIDE LOOK AT HOW ORGANIZED [CRI]ME INFLUENCES THE MARKET

BY GARY WEISS PAGE 92

THE MOB ON WALL STREET

A three-month investigation reveals that organized crime has made shocking inroads into the small-cap stock market

BY GARY WEISS

ILLUSTRATIONS BY RICHARD MERKIN

Cover Story

In the world of multimedia components, Phoenix-based SC&T International Inc. has carved out a small but significant niche. SC&T's products have won raves in the trade press, but working capital has not always been easy to come by. So in December, 1995, the company brought in Sovereign Equity Management Corp., a Boca Raton (Fla.) brokerage, to manage an initial public offering. "We thought they were a solid second- or third-tier investment bank," says SC&T Chief Executive James L. Copeland.

But there was much about Sovereign that was known to only a very few. There were, for example, the early investors, introduced by Sovereign, who had provided inventory financing for SC&T. Most shared the same post office box in the Bahamas. "I had absolutely no idea of who those people were," says Copeland. He asked Sovereign. "I was told, 'Who gives a s—. It's clean money.'" The early investors cashed out, at the offering price of $5, some 1.575 million shares that they acquired at about $1.33 a share—a gain of some $5.8 million.

By mid-June, SC&T was trading at $8 or better. But for SC&T shareholders who did not sell by then, the stock was an unmitigated disaster. Sovereign, which had handled over 60% of SC&T's trades early in the year, sharply reduced its support of the stock. Without the backing of Sovereign and its 75-odd brokers, SC&T's shares plummeted—to $2 in July, $1 in September, and lately, pennies. The company's capital-raising ability is in tatters. Laments Copeland: "We're in the crapper."

A routine case of a hot stock that went frigid. Or was it? Copeland didn't know it, but there was a man who kept a very close eye on SC&T and is alleged by Wall Street sources to have profited handsomely in the IPO—allegedly by being one of the lucky few who sold shares through a Bahamian shell company. His name is Philip Abramo, and he has been identified in court documents as a ranking member, or *capo*, in the New Jersey-based DeCavalcante organized crime family.

James Copeland didn't know it. Nobody at SC&T could have dreamed it. But the almost unimaginable had come true: Copeland had put his company in the hands of the Mob.

Today, the stock market is confronting a vexing problem that, so far, the industry and regulators have seemed reluctant to face—or even acknowledge. Call it what you will: organized crime, the Mafia, wiseguys. They are the stuff of tabloids and gangster movies. To most investors, they would seem to have as much to do with Wall Street as the other side of the moon.

But in the canyons of lower Manhattan, one can find members of organized crime, their friends and associates. How large a presence? No one—least of all regulators and law enforcement—seems to know. The Street's ranking reputed underworld chieftain, Abramo, is described by sources familiar with his activities as controlling at least four brokerages through front men and exerting influence upon still more firms. Until recently, Abramo had an office in the heart of the financial district, around the corner from the regional office of an organization that might just as well be on Venus as far as the Mob is concerned—the National Association of Securities

Three men appeared at the office of a dealer in small-cap stocks. One of the men carried a gun. The trader was roughed up. His company stopped trading the stock

Dealers, the self-regulatory organization that oversees the small-stock business.

A three-month investigation by BUSINESS WEEK reveals that substantial elements of the small-cap market have been turned into a veritable Mob franchise, under the very noses of regulators and law enforcement. And that is a daunting prospect for every investor who buys small-cap stocks and every small company whose stock trades on the NASDAQ market and over the counter. For the Mob makes money in various ways, ranging from exploiting IPOs to extortion to getting a "piece of the action" from traders and brokerage firms. But its chief means of livelihood is ripping off investors by the time-tested method of driving share prices upward—and dumping them on the public through aggressive cold-calling.

Cover Story

In its inquiry, BUSINESS WEEK reviewed a mountain of documentation and interviewed traders, brokerage executives, investors, regulators, law-enforcement officials, and prosecutors. It also interviewed present and former associates of the Wall Street Mob contingent. Virtually all spoke on condition of anonymity, with several Street sources fearing severe physical harm—even death—if their identities became known. One, a former broker at a Mob-run brokerage, says he discussed entering the federal Witness Protection Program after hearing that his life might be in danger. A short-seller in the Southwest, alarmed by threats, carries a gun.

Traders who run afoul of the Mob often get menacing calls. One short-seller in the Southwest, alarmed by threats, packs his own piece

Among BUSINESS WEEK's findings:

- The Mob has established a network of stock promoters, securities dealers, and the all-important "boiler rooms"—a crucial part of Mob manipulation schemes—that sell stocks nationwide through hard-sell cold-calling. The brokerages are located mainly in the New York area and in Florida, with the heart of their operations in the vicinity of lower Broad Street in downtown Manhattan.
- Four organized crime families as well as elements of the Russian Mob directly own or control, through front men, perhaps two dozen brokerage firms that make markets in hundreds of stocks. Other securities dealers and traders are believed to pay extortion money or "tribute" to the Mob as just another cost of doing business on the Street.
- Traders and brokers have been subjected in recent months to increasing levels of violent "persuasion" and punishment—threats and beatings. Among the firms that have been subject to Mob intimidation, sources say, is the premier market maker in NASDAQ stocks—Herzog, Heine, Geduld Inc.
- Using offshore accounts in the Bahamas and elsewhere, the Mob has engineered lucrative schemes involving low-priced stock under Regulation S of the securities laws. Organized crime members profit from the runup in such stocks and also from short-selling the stocks on the way down. They also take advantage of the very wide spreads between the bid and ask prices of the stock issues controlled by their confederates.
- The Mob's activities seem confined almost exclusively to stocks traded in the over-the-counter "bulletin board" and NASDAQ small-cap markets. By contrast, New York Stock Exchange and American Stock Exchange issues and firms apparently have been free of Mob exploitation.
- Wall Street has become so lucrative for the Mob that it is allegedly a major source of income for high-level members of organized crime—few of whom have ever been publicly identified as having ties to the Street. Abramo, who may well be the most active reputed mobster on the Street, has remained completely out of the public eye—even staying active on the Street after his recent conviction for tax evasion.
- Mob-related activities on the Street are the subject of inquiries by the FBI and the office of Manhattan District Attorney Robert M. Morgenthau, which is described by one source as having received numerous complaints concerning mobsters on the Street. (Officials at both agencies and the New York Police Dept. did not respond to repeated requests for comment.)

Only small NASDAQ and OTC stocks appear to have been ex

■ Overall, the response of regulators and law enforcement to Mob penetration of Wall Street has been mixed at best. Market sources say complaints of Mob coercion have often been ignored by law enforcement. Although an NASD spokesman says the agency would vigorously pursue reports of Mob infiltration, two top NASD officials told BUSINESS WEEK that they have no knowledge of Mob penetration of member firms. Asked to discuss such allegations, another high NASD official declined, saying: "I'd rather you not tell me about it."

■ The Hanover, Sterling & Co. penny-stock firm, which left 12,000 investors in the lurch when it went out of business in early 1995, is alleged by people close to the firm to have been under the control of members of the Genovese organized crime family. Sources say other Mob factions engaged in aggressive short-selling of stocks brought public by Hanover.

■ Federal investigators are said to be probing extortion attempts by Mob-linked short-sellers who had been associated with the now-defunct Stratton Oakmont penny-stock firm.

Mob manipulation has affected the markets in a wide range of stocks. Among those identified by BUSINESS WEEK are Affinity Entertainment, Celebrity Entertainment, Beachport Entertainment, Crystal Broadcasting, First Colonial Ventures, Global Spill Management, Hollywood Productions, Innovative Medical Services, International Nursing Services, Novatek International, Osicom Technologies, ReClaim, SC&T, Solv-Ex, and TJT. Officials of the companies deny any knowledge of Mob involvement in the trading of their stocks, and there is no evidence that company managements have been in league with stock manipulators. These stocks were allegedly run up by Mob-linked brokers, who sometimes used force or threats to curtail short-selling in the stocks. When support by allegedly Mob-linked brokerages ended, the stocks often suffered precipitous declines—sometimes abetted, traders say, by Mob-linked short-sellers. The stocks have generally fared poorly (table, page 99).

Not all of the stocks were recent IPOs, and they were often taken public by perfectly legitimate underwriters. International Nursing, for example, went public at $23 in 1994 and was trading at $8 in early 1996 before falling back to pennies. Short-sellers who attempted to sell the shares earlier this year were warned off—in one instance by a Mob member—market sources assert. International Nursing Chairman John Yeros denies knowledge of manipulation of the stock.

What this all adds up to is a shocking tale of criminal infiltration abetted by widespread fear and silence—and official inaction. While firms and brokerage executives who strive to keep far afield of the Mob often complain of NASD inaction, rarely do such people feel strongly enough to share their views with regulators or law enforcement. Instead, they engage in self-defense. One major brokerage, which often executes trades for small-cap market makers, keeps mammoth intelligence files—to steer clear of Mob-run brokers. A major accounting firm keeps an organized-crime expert on the payroll. His duties include preventing his firm from doing business with brokerages linked to organized crime and the Russian Mob.

In the pages that follow are the results of BUSINESS WEEK's investigation.

THE BOX

At about 3 o'clock in the afternoon of Sept. 25, 1996, three men appeared on the 28th floor of 120 Broadway, Manhattan. They walked into the offices of Sharpe Capital Inc., a dealer in over-the-counter stocks. They were burly. "Like lumberjacks," said an eyewitness soon after. A gun was in the belt of one of the men.

The confidential police report of the incident (Complaint No. 10530, First Precinct) reads as follows:

"At that point they asked the victim what he was trading in. Then they slapped him in the head and stated again, 'What the f— are you trading in.' Then he slapped the victim in the head again."

A witness recalls one of the men saying: "Don't f— with our stock." The stock: Crystal Broadcasting Inc. After the men left, Sharpe stopped trading in Crystal Broadcasting.

To the New York Police Dept., the incident at Sharpe was about as serious as a scuffle over a parking space. A police source says that the assault, categorized as a low-grade misdemeanor at best, is considered closed and is not being investigated because the victim was not seriously hurt, no gun was displayed—even though one was observed—and the per-

HOW THE MOB MAKES MONEY ON WALL STREET

TRADING SCAMS

THE BOX Mob-affiliated traders control the market for a stock and its price by trading it among themselves—enforcing their control through bribery, violence, and intimidation. They then unload the stock on the public at an inflated price and, sometimes, sell it short to profit when the shares go bust.

REGULATION S Through offshore accounts, Mob members illegally buy cheap stock issued under Regulation S of the securities laws—supposedly reserved only for foreign investors. The cheap stock is sold on the open market at vast, riskless markups.

FLIPPING Mobsters, through front men, quickly unload, at inflated prices, stocks that are the subject of hot IPOs issued by firms they control.

BROKERAGE SCAMS

HIDDEN OWNERSHIP Through front men who have no criminal records, the Mob controls, or has hidden ownership stakes in, at least two dozen NASDAQ brokerage firms.

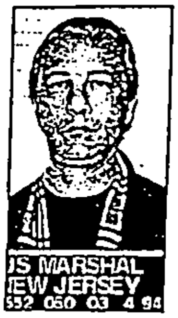
TRIBUTE Mob members get kickbacks from brokerages for protecting them from shakedown attempts by other mobsters.

EXTORTION Mobsters, working with short-selling confederates, demand payments in return for not shorting the stocks issued by penny-stock and microcap brokerages.

DATA: BUSINESS WEEK

xploited. Shares are driven up—then dumped on the public

IN THE SHADOWS OF THE SMALL-CAP MARKET



PHIL ABRAMO Abramo is described by sources as controlling at least four brokerage firms and is identified in court documents as a *capo* in the DeCavalcante organized crime family. He recently pleaded guilty to one count of tax evasion, for which he faces one year in prison. He is scheduled to report on Jan 7.

THOMAS QUINN The multinational stock honcho allegedly has ties to Phil Abramo. Quinn was sued by the SEC for securities fraud in 1989 and owes massive civil penalties.

DOMINICK "BLACK DOM" DINASSIO He controls broker Euro-Atlantic, say Street sources. A short-seller told police Dinassio threatened him for trading a Euro-Atlantic stock.

ALPHONSE "ALLIE SHADES" MALANGONE To law enforcement, Malangone is an alleged loan shark, gambler, and longtime power behind Mob control of New York's Fulton Fish Market. To Wall Streeters, he is a sophisticated trader who is an expert at working the spreads—getting in at the bid price and exiting at the ask price.

ALAN LONGO Malangone's right-hand man is described by sources as a heavy gambler who, along with Malangone, maintained control of the now-defunct penny-stock firm of Hanover Sterling through their links to Roy Ageloff.

JOHN "SONNY" FRANZESE Sources say Franzese joined the Mob's rush to the stock market after his 1994 parole from a 50-year term for bank robbery. The 77-year-old kingpin was recently found to have violated the terms of his parole and was ordered back to prison.

ROY AGELOFF Sources say he's the power behind PCM Securities. He allegedly "persuaded" a trader to drop a stock by inviting him to his office, where the trader was beaten.

JOHN GOTTI JR. The reputed New York Mob boss would have profited nicely from an IPO of an Italian ice maker. The canceled offering's shares traded high the first day.

PHOTOGRAPH BY ANDY UZZLE/NEW YORK POST (JOHN FRANZESE)

petrators were unknown. (However, one witness ruefully notes, police did nothing to ascertain their identity—such as examine a security-camera surveillance tape.) Sharpe's CEO, Lawrence Hoes, declined to discuss the matter.

But BUSINESS WEEK learned that the assault at Sharpe was not an isolated incident. Rather, it was part of a systematic pattern of intimidation. By eliminating competing market makers and allowing only cooperating brokers to bid on stocks, the result is a kind of rigged auction—with the prices where desired, and the spreads between bid and ask prices kept as wide as possible. In Street parlance, this process of rigging the market in a stock is known as "boxing" a stock. It is part of the lexicon of the Mob's dominion on Wall Street (page 99).

Cover Story

The box is the heart of most stock-manipulation schemes. In the case of Crystal, the trader at Sharpe was suspected of "cracking the spread." According to market sources who were familiar with the trading in Crystal that day, Sharpe was blamed, in effect, for doing what a market maker is supposed to do—get the best possible price for its customers and keeping the spreads as narrow as possible. During the day, Crystal traded as low as 4, well below the 5¼ closing price of the day before, and the spreads narrowed as well, to a relatively reasonable 4⅜ bid and 4⅝ ask. Sharpe was blamed for that benign—to most people—market action.

In the weeks following the Sharpe incident, Crystal shares were trading at the kind of spreads that can only happen when the market is tightly controlled. If you buy it from a dealer, you pay the ask price, $3.50. But when you sell it, you get the bid—56.2¢. (Crystal's president, Joseph Newman, said he had no knowledge of coercion of market makers in his stock.)

Sometimes the maneuvering involved in creating and exploiting the box can be as subtle as a bison in a china shop. One West Coast investor, who requested anonymity, says that brokers at a small New York firm, Monitor Investment Group, convinced him that two small-cap stocks—International Nursing Services and Beachport Entertainment—were about to be pushed upward. Says the investor: "They said they had a handle on all this stock. They said they'd run it up and get me out of it in a week."

So sometime around last New Year's Day, he bought warrants and a big block of the stock—100,000 shares of International Nursing and 85,000 of Beachport. When he tried to sell, he says, his brokers flatly refused. The shares, which had started heading southward almost from the moment he bought them, plummeted. They're now worth one-fifth of what he paid. Monitor Chairman William F. Palla denies the firm was involved in stock manipulation but concedes a broker may have promised a runup but not really meant it.

Sometimes, of course, thinly traded stocks can be run down by aggressive short sellers, and the Mob is alleged by Street sources to have profited from that as well. One target of investigators, sources say, is a coterie of brokers formerly associated with the defunct penny-stock brokerage of Stratton Oakmont. Sources familiar with the investigation say that authorities are exploring charges that some of these brokers, after Stratton's demise, may have extorted money from their former colleagues in the business—allegedly threatening to short-sell stocks underwritten by those firms. According to sources, the Stratton brokers allegedly shared their profits with a member of a New York crime family.

Among the trading being investigated, sources say, are stocks underwritten by a penny-stock firm called State Street Capital Markets. Stocks brought public by the New York-based firm—Fun Tyme Concepts, U.S. Bridge of N.Y., and Cable & Co. Worldwide—were pummeled in the market last August, and trading in the stocks is allegedly being probed. At the time, State Street maintained that its shares were victimized by concerted short-selling. State Street officials did not return phone calls, and Stratton officials could not be reached for comment.

"YOU'VE MADE A FRIEND"

First Colonial Ventures Ltd. is a minor venture-capital firm whose stock trades on the OTC bulletin board—so small that it is not required to file more than token disclosures with the Securities & Exchange Commission. But for market makers in small-cap stocks, First Colonial looms huge. It is an object lesson: When the Mob speaks, market makers obey.

The incidents took place early in October, one week after the assault at Sharpe. First came a beating. A trader at Naib Trading Corp. in Fort Lauderdale was summoned to the office of a man by the name of Roy Ageloff. The trader has told associates that Ageloff had beaten him once before with a nail-pierced baseball bat. This time, he said, Ageloff left the room. Then a 400-pound hoodlum knocked him down and kicked him while he was on the floor. The message: Stay away from First Colonial.

The trader at Naib was not the only one to suffer "persuasion" over First Colonial. Sources say that four other firms were approached with warnings to cease trading in the stock. To be sure, it was not a total success. There was one rebuff: A market maker in the little town of Hurst, Tex., Anthony Elgindy of Key West Securities Inc., says he ignored warnings that traders who did not comply would soon be "facing the ceiling"—and has received numerous threatening phone calls since then. But at two other market makers, the intimidation worked. They ceased making a market in First Colonial.

The market makers dropping the stock were William V. Frankel & Co. in Jersey City, N.J., and the biggest name in NASDAQ stocks: Herzog, Heine, Geduld. Sources say traders at both firms quit trading the stock after receiving menacing visits at their offices. "We decided we shouldn't get involved in a stock like that," says Herzog's head trader, Irwin Geduld. Was anyone at his firm threatened? "We weren't," said Geduld. "Someone else was." (A Frankel trader, who declined to give his name, says: "We have no comment whatsoever about First Colonial Ventures.") Even a brokerage that was not a market maker, D. L. Cromwell Investments Inc. in Boca Raton, received a visit from a thug, a source says. The visitor left after demanding, and being shown, proof that the firm was not a short-seller in the stock. Cromwell officials declined comment.

Sources say that traders who caved in to coercion later received expensive bottles of liquor with a note that read: "You've made a friend." But the market makers who dropped First Colonial were making no new pals among investors. Since the incident, the ask price paid by the public for buying First Colonial stock has climbed—from a low of \$1.13 on Oct. 2 to as high as \$4.13 in recent trading. But the bid price that the public gets when selling the stock back to the Street has been far less buoyant. The bid promptly rose from a low of 87¢ on Oct. 2 to \$1.50 and has stayed at about that level, even as the ask price has skyrocketed to al-

MOBSPEAK: A GLOSSARY

CHOP STOCK A thinly traded stock with a very wide bid-ask spread

VIG The ultrawide bid-ask spread commonly found in Mob-dominated stocks

HOUSE STOCKS Stocks sold aggressively to the public by the firms that control them

BOXING (AS IN "BOXING A STOCK") Controlling the market for a stock by trades among cooperating brokerages

PARKING Buying a stock for a customer by "mistake," as part of a scheme to hike the price and control the market in a stock

MOB-EXPLOITED STOCKS: MOST HAVE SUFFERED

These stocks have been identified by BUSINESS WEEK. The companies say they know of no Mob stock-rigging.

	52-WEEK HIGH	PRICE 12/3/96
AFFINITY ENTERTAINMENT Produces feature and TV films	10	2 1/32
BEACHPORT ENTERTAINMENT Entertainment production company	6	1 1/2
CELEBRITY ENTERTAINMENT Operates theme park in Florida	3 11/32	3/16
CRYSTAL BROADCASTING Runs and acquires radio stations	6 1/2	9/16
FIRST COLONIAL VENTURES Miscellaneous holdings	8 3/4	3 7/8
GLOBAL SPILL MANAGEMENT Environmental contractor	11 23/32	1/4
HOLLYWOOD PRODUCTIONS Motion picture producer	11 1/2	8
INNOVATIVE MEDICAL SERVICES Makes water-purification system	7 3/4	4
INTERNATIONAL NURSING SERVICES Health-care services	8 3/4	1 1/16
MAMA TISH'S* Makes Italian ices	NA	NA
NOVATEK INTERNATIONAL Makes diagnostic devices	13 3/4	[illegible]
OSICOM TECHNOLOGIES Fiber-optic products	20 1/2	8 1/4
RECLAIM Builds solid-waste treatment plants	42 1/2	[illegible]
SC&T Makes multimedia peripherals	9	5/32
SOLV-EX Extracts oil from oil sands	38	13 5/8
TJT Tire repair and reconditioning	9 5/8	5 1/4

*Initial public offer was withdrawn, November, 1996.

DATA: BLOOMBERG FINANCIAL MARKETS, BUSINESS WEEK

Abramo is "educated, sounds sincere. He's gotten all these wiseguys to work together," says one source

most three times that figure. (On Oct. 4, according to a letter sent to market makers obtained by BUSINESS WEEK, the NASD launched an inquiry into the dropping of First Colonial stock by market makers. The NASD declined comment on the investigation.)

Who was behind the wave of intimidation over First Colonial? NASDAQ trading figures point toward a New York-based firm called PCM Securities Ltd. PCM was the largest market maker in First Colonial in September, with 48% of the trades. By October, however, this rose to 75%. PCM completely dominated the market in First Colonial.

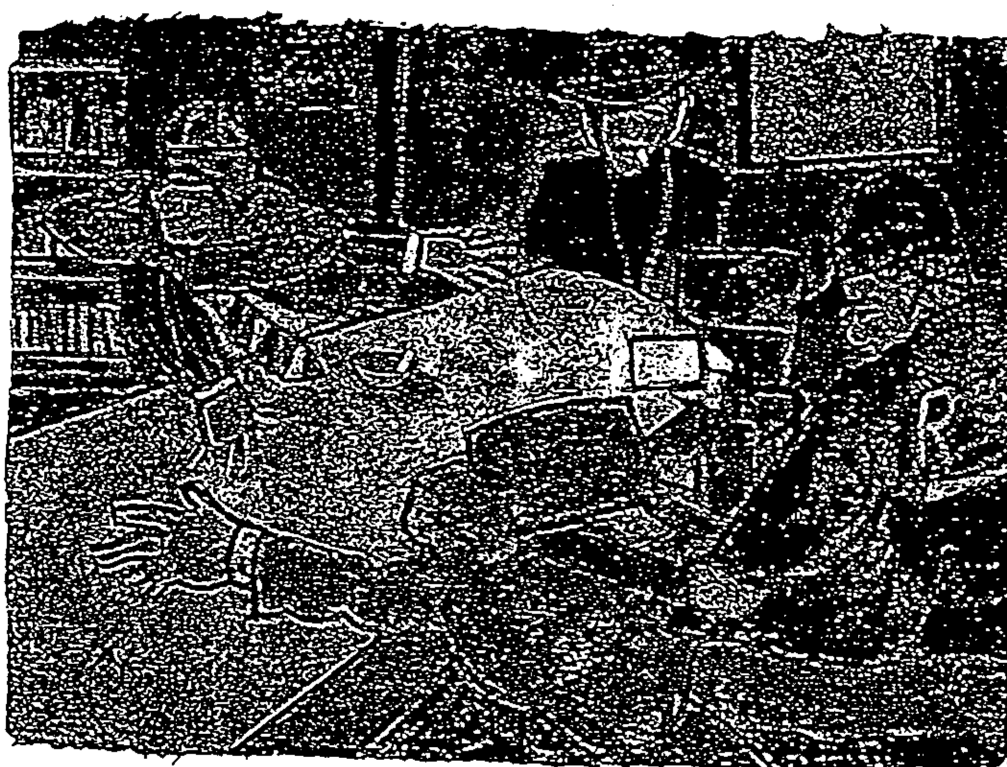
Although he is not listed in NASD records as a control person or even as an employee of PCM—or of any other brokerage—Street sources say that the power behind PCM is the 37-year-old Ageloff. He did not respond to numerous messages left at PCM's office in Boca Raton. An employee there said Ageloff nowadays spends most of his time there, punctuated by frequent visits to New York. Asked about Ageloff, Steven Edelson, PCM's principal, denied that Ageloff has any role in the firm and says he has met him only once. Edelson had no comment on its trading in First Colonial, and First Colonial President Murray Goldenberg said he was "shocked" to hear reports of intimidation of market makers.

A TALE OF TWO MARKETS

Even though NASD records show Ageloff has not been officially associated with any brokerage firm over the past two years, he is a widely known figure in small-cap stock circles. Why would market makers drop a stock just because Ageloff tells them—even when he is not accompanied by "persuasion"? Street sources say the fear he inspires is justified: The force that drives Ageloff, they maintain, is a 59-year-old man who, on official record at least, has never set foot on Wall Street. He is Alphonse Malangone, otherwise known as "Allie Shades," and his few appearances in the public record pertain almost exclusively to another market—the Fulton Fish Market.

Cover Story

"Allie Shades" Malangone is the Zelig of the Mob's Wall Street coterie. For years, he has been observed by investigators in lower Manhattan, ensconced in the twin worlds of the Fulton Fish Market and the stock market. To law enforcement he is an alleged loan shark and gambler, a longtime power behind Mob control of the Fulton market, and he is described in court proceedings by federal and state law enforcement officials as a *capo* in the Genovese crime family.



Whistle-blowers at Mob-dominated firms are rare, but a former broker at Monitor Investment alleges in a federal lawsuit that he was beaten with a chair at the brokerage

But to the very few Wall Streeters who know him, he is a sophisticated market player who is an expert at "working the spreads"—getting in at the bid price and exiting at the ask price, with the help of cooperative traders. "He's very smart, very articulate," says one investigator. "When you hear him on the wire, he would couch what he would say in gambling phrases" to mislead investigators.

Investigators are not fooled, but despite close surveillance and wiretaps dating back to the 1980s and perhaps before, they have been unable to make a case against Malangone and other reputed Fulton market mobsters for their suspected activities on Wall Street. One longtime Malangone-watcher recalls that the Fulton market was believed by law-enforcement authorities in the early '80s to be a clearinghouse for stolen bonds. But nothing was ever proven.

Investigators thought they were on to something, finally, in 1985. They had in their sights two big fish, so to speak—Malangone and Vincent Romano, also identified in court papers as an alleged Genovese family member who was suspected of involvement in the Fulton market. Malangone and Romano were probed by federal and local authorities for their alleged manipulation of a pharmaceutical company stock, Nu-Med Inc., a company that later declared bankruptcy. Investigators believed that the two men had a position in Nu-Med shares. The investigation was never made public, for authorities couldn't build a case against Malangone and Romano. Efforts to reach the two men were unsuccessful.

Cover Story

Sources on Wall Street say that Malangone was a behind-the-scenes player in the biggest penny-stock fiasco of recent years: Hanover Sterling. According to sources, Malangone controlled Hanover through his right-hand man, Alan Longo, who has been identified by federal authorities in court filings as a member of the Genovese family. Longo, who is described by acquaintances as a heavy gambler, is said by sources to have worked directly with Ageloff in Hanover and other market ventures.

Ageloff—in concert with his alleged Mob contacts—is believed by market sources to have been the hidden control person at Hanover. It went out of business in early 1995 and resulted in the demise of the firm that it cleared through, Adler, Coleman & Co. An attorney for the trustee in the Adler Coleman bankruptcy, Mitchell A. Lowenthal, says that his firm, Cleary, Gottlieb, Steen & Hamilton, has discovered evidence that 65% of Hanover's profits were shared by Ageloff and another Hanover official. Efforts to reach Hanover execs were unsuccessful.

> An alleged Mob loan shark and gambler is said to have been a behind-the-scenes player in one of the biggest penny-stock fiascos in recent years: Hanover Sterling

Street sources say that the Mob was involved in both sides of the Hanover-Adler imbroglio. The Malangone-Longo-Ageloff faction, they say, profited from the runup in Hanover stocks, while other mobsters allegedly sold short the Hanover stocks and pushed their prices downward—to the chagrin of the Malangone faction. This internecine dispute, sources close to Hanover say, was eventually resolved without bloodshed, but only after some tense meetings between Mob factions. Lowenthal says that his firm's investigation has shown that "Ageloff and some of the shorts were all connected [to the Mob] in one way or the other," but nothing was proven.

According to people close to the Hanover Sterling machinations, the Mob was represented on the short side through Falcon Trading Group and Sovereign Equity Management Corp. And those brokerages, sources say, are controlled by the alleged SC&T profiteer—a silver-haired, 51-year-old resident of northern New Jersey named Philip C. Abramo.

Abramo's name has never surfaced in any of the thousands of pages of deposition testimony taken by the adversaries in the Hanover-Adler Coleman legal warfare. Nor have his recent legal troubles—a federal fraud indictment—resulted in exposure of his Street ties or alleged Mob membership. Abramo's stunning success at avoiding publicity has helped make him the most active reputed Mob honcho on Wall Street. "He is educated. He sounds sincere," says one source. "He's gotten all these wiseguys to work together."

THE "CONSULTANT"

In court records and corporate filings, Philip Abramo gives his business address as 176 Saddle River Road, South Hackensack, N.J. The address applies to not one but several buildings, forming a kind of cul de sac on a dreary street in an industrial town in northern New Jersey. It is a quiet area. A cemetery is next door. Faded lettering shows that one of the buildings was once used many years ago to process meat. Today they house an auto-body shop, a construction company, and other little offices with ambiguous names.

Listed in no official records is another address for Phil Abramo—one that is far more apropos for a man who is a hidden power in the brokerage industry. Until a couple of months ago, sources say, Abramo maintained an office on the 14th floor of 90 Broad St. in lower Manhattan, directly adjoining the New York office of Sovereign Equity Management. A door linked the two offices, and it was always open. "I knew him as a stock promoter who always had stock deals. We hired brokers who were friends of his," says one Sovereign employee who requested anonymity. Sovereign CEO Glen T. Vittor denies that Abramo had any role in the firm.

But sources describe his role as central—as the hidden control person behind Sovereign, a prominent name in the micro-cap stock business, its sister firm Falcon Trading, and two other firms that are major penny-stock brokers and market makers, Toluca Pacific Securities Corp. and Greenway Capital Corp. He is also described by Street sources as controlling other dealers in small-cap stocks through brokers and traders owing allegiance to him.

On paper, Abramo is respectability personified. Over the past decade he has been listed as president or top shareholder of four publicly held investment companies. He is married, with a grown daughter. He has been a "restaurant consultant," auto dealer, and construction company operator. He has had four years of college and may even have training as an accountant.

But inquiries about Abramo bring far from routine reactions. At Greenway Capital, President John Margiotta is asked if he knows Abramo. Margiotta replies: "Who?" and hangs up the phone. A person answering the phone at Greenway, moments later, says that Margiotta is "very busy" and "not in the office." Toluca Pacific President Paul Fiorini, when asked about reports of Abramo's control of his firm, calls them a "total farce." He says he owns 100% of the firm and goes on to say: "Who is this person? I don't want my name associated with this. I don't know this person. I don't know Phil Abramo."

The reason for the reticence is understandable. According to federal court records in recent tax-evasion proceedings against Abramo in Newark, the Saddle River (N.J.) resident lists his occupation as "consultant." But elsewhere in the court file, the FBI gives a different version of his livelihood.

Cover Story

In 1994, in an affidavit filed with the court in a bail hearing, the FBI identified him as a frequent visitor to reputed New York Mob boss John Gotti prior to his imprisonment in 1992, and alleged that Abramo held the rank of *capo* in the New Jersey organized crime family once headed by Sam "the Plumber" DeCavalcante. But sources say that since then, Abramo has risen in the ranks to No. 2 in that crime family—underboss.

Abramo is easily the highest-ranking reputed mobster to be engaged full-time in Wall Street activities. His lawyer, Harvey Weissbard, declined comment on Abramo's alleged ties to organized crime. Asked about Abramo's possible role on Wall Street, Weissbard said he had "no information of which I can respond one way or the other, and I doubt if I did know one way or the other that I would respond."

Little is known about Abramo's early life, such as which college he attended. Except for a conviction for possession of stolen property in 1971 and another in 1973 for conspiracy to distribute heroin—which yielded him a seven-year prison sentence—he has stayed out of the limelight. Even when he was indicted in 1994 in New Jersey for allegedly swindling 300 people nationwide out of $1 million—they were sold phony "lines of credit"—he received no publicity and continued to work on the Street.

Indeed, by the time he was indicted in the credit-line scheme, Abramo already had a lengthy, ostensibly legitimate track record. In the late 1980s Abramo founded publicly-held investment companies with names such as Cambridge Investment Service Corp. and American Acquisition Corp. (SEC filings by these companies show they did little but file papers with the SEC.) According to papers filed by Abramo with the SEC for the investment companies, Abramo was a "restaurant consultant to Northern Roses Inc. (Miami, Fla.)," during 1982, and "was also a restaurant consultant to Bagel Nosh Inc. (1983 and 1984—New York, N. Y.)." Abramo's Bagel Nosh connection is significant, because the company was brought public by Thomas J. Quinn.

Quinn was one of the most prominent figures in the penny-stock world, but his association with Abramo has never been made public, although regulators have long suspected it. When Quinn was jailed in France in 1988 for securities fraud, investigators say, Abramo's name was prominently displayed in a notebook that was seized from him. Calls in 1995 from Quinn's telephone to Abramo's unlisted home phone number also appeared in phone records that were recently subpoenaed by investigators seeking Quinn's assets. (He was successfully sued by the SEC for securities fraud in 1989 and owes millions of dollars in civil penalties.) Indeed, Abramo was subpoenaed to testify before the SEC in 1989 during a probe of Quinn, but he invoked his Fifth Amendment privilege against self-incrimination. Efforts to reach Quinn for comment were unsuccessful.

The Quinn-Abramo connection could become significant in the months ahead because of an ongoing federal grand jury probe in California into possible irregularities in the trading in Solv-Ex Corp., an Albuquerque-based company that claims to have a process for retrieving oil from tar sands. (Solv-Ex officials denied knowledge of any trading irregularities and claimed that a private investigator's report, which they refused to release, indicated there was no manipulation.) According to sources close to the grand jury probe, Abramo and Quinn are among those who have been a subject of the investigation.

Three men invited the head of a penny-stock brokerage for a walk. One of the men stuck a gun in his ribs. "From now on," he was told, "you're retailing our stocks"

Today, Abramo faces a one-year prison term for tax evasion. It was a plea bargain—the guilty plea to tax evasion in return for dropping of the loan-scheme charges. He is scheduled to report to prison on Jan. 7. While he may well handle his Street interests while incarcerated, in some quarters there is concern that his departure will mean an increase in violence.

The level of violence is becoming worrisome. Early in November, a broker at a New York-area brokerage was severely beaten, his arm broken, in the lobby of the firm. As so often happens in such situations, he did not notify the police. His offense: He moved from a Mob-controlled firm, taking his customers with him, and dared to sell their stocks. Sell pressure on stocks is just what the Mob despises (unless, of course, they are short). It can sour a deal—and the often immense profits that can come with it.

THE DEAL

Mama Tish's International Foods is a Chicago-based company that makes Italian ices. But when it went public last month, it was red-hot. The IPO went for $5, but on the first day of trading, the shares moved as high as $9.75—a sure sign of "flipping," in which favored investors cash out of the stock immediately.

Cover Story

Alas, the Mama Tish IPO was canceled—wiping out all the trades—when the underwriter, a Long Island firm called Landmark International Equities, got into a heated dispute with the firm that clears its trades. The company and underwriter were disappointed—and so were some people who hate to be disapppointed.

Even before the deal began, traders began receiving phone calls warning them not to short the IPO, which might have driven down prices. According to Wall Street sources, among the people who would have profited heavily from the Mama Tish IPO is John Gotti Jr., reputed acting boss of the Gambino family and son of the imprisoned Gambino crime family chieftain. According to Wall Street sources, "Junior" Gotti is the hidden owner or control person of one of the brokerages—other than Landmark—that was active in the Mama Tish deal. Had the deal gone through, any Gotti people involved in the deal would have profited handsomely from the 80% difference between the offering price and the trading price of the shares. Gotti was unreachable for comment. A company official said he did not know of any Mob involvement in the IPO.

> "Junior" Gotti, reputed acting boss of the Gambino crime family, is said to be the hidden owner of a brokerage active in the recent failed IPO of Mama Tish, a Chicago food outfit

If "Junior" Gotti represents the younger generation of reputed mobsters on the Street, the older generation would be epitomized by John "Sonny" Franzese. Franzese has been described by law-enforcement authorities for decades as an influential, feared mobster who allegedly was the former underboss of the Colombo crime family. Sources say Franzese joined the Mob's rush to the stock market after his release on parole from a 50-year term for bank robbery in 1994. According to sources, the 77-year-old reputed Mob elder described himself to associates earlier this year as controlling, through a confederate, Monitor Investment Group, whose brokers allegedly ripped off the West Coast investor by promising a guaranteed runup. Monitor chairman William F. Palla denies that Franzese or organized crime has ever played any role in the firm.

Monitor, which ceased active operations last June, is described by former employees as a center for widespread stock manipulation—specifically involving boxing of International Nursing Services, Beachport Entertainment, and Innovative Medical Services. Officials of the three companies say they were unaware of any irregularities in the trading of their stocks. International Nursing Chairman John Yeros, however, concedes he felt something was amiss at Monitor when he attended a presentation the brokerage sponsored for International Nursing at a downtown hotel—and found that Monitor had hired a hooker to "service" the brokers in attendance. Palla says he heard of the "hooker incident" but denies Monitor retained that person.

If Franzese in fact became involved in the penny-stock business, it would be a potent sign of the lure of the penny-stock business to the Mob. But like Abramo, Franzese may have to cool his interest in the market for a while. He was recently found to have violated the terms of his parole and was ordered back to prison.

THE FUTURE

There are plenty of young mobsters ready to take the place of any old-timers who might fail victim to any future law-enforcement crackdown. One Brooklyn-based prosecutor, a specialist in the Mob, observes that "there are a lot of wannabes getting jobs on the Street, working in these places, cold-calling." That might explain why there seems to be no shortage of people willing to carry guns into brokerage houses and beat up traders in front of witnesses, or telephone threats to traders.

One reputed up-and-comer in the Street's Mob contingent is Dominick "Black Dom" Dinassio, who is said by Street and law-enforcement sources to hold sway over Euro-Atlantic Securities, a Manhattan brokerage that is active in penny stocks. According to a source in the Manhattan District Attorney's office, Dinassio is allegedly an associate in the Colombo crime family.

Law-enforcement sources say that Dinassio has lately been observed in the company of Longo, Malangone's longtime partner. Sources say a short-seller who was active in shorting Hanover stocks, John Fiero, told police recently that Dinassio threatened him for his trades in one stock brought public by Euro-Atlantic, Hollywood Productions Inc. Fiero refused comment and company officials did not return phone calls. Contacted at Euro-Atlantic's office in lower Manhattan, Dinassio declined to discuss his role at the firm. Asked about the allegations that he was connected to organized crime, he replied: "What? I think you're crazy, buddy. I'll talk to you later," and hung up. Euro-Atlantic officials did not return phone calls.

Although whistle-blowers in Mob-run firms are rare, the increasing violence is beginning to enter the public record. At Monitor, the firm Franzese allegedly claimed to control, an incident last January led to a rarity in this world—a lawsuit. In a suit filed in U.S. District Court in Manhattan, former broker Robert Grant contends that he was "maliciously and violently struck, battered, beaten, pummelled, pushed, punched, and attacked" by Monitor employees at the instigation of Palla and another manager. At one point, the suit says, Grant was beaten with a chair. The lawsuit does not say so, but witnesses say that another broker was also viciously assaulted. Neither Grant nor the other broker would comment, and Palla says he was in Philadelphia at the time of the incident, which he describes as a "fight." One witness says Monitor management suspected that the two brokers may have been short-selling Monitor's favorite stocks.

Some of the most violent, crudest elements to come to the Street are part of its fastest-growing contingent—the Russian Mob, based in the Brighton Beach section of Brooklyn. "Over the past couple of years, they've put people in the [brokerages], kids with clean records, and they're washing money legitimately," says one law-enforcement official who is intimately familiar with Russian organized crime. The offspring of two major Russian mob figures, he notes, have been active on Wall Street.

The Mob's fascination with Wall Street is understandable, for they have had little to fear from law enforcement or regulators. If the authorities, finally, act against Mob members who are active on the Street, it will be the first such prosecution since 1973, when three major Mob figures were imprisoned for securities fraud. At the time, the Mobsters were vanquished because one of their confederates became a government witness. "It's practically impossible to prosecute these people unless you have a turncoat, somebody who can walk you through all those transactions," notes Ira Lee Sorkin, a former SEC regional director who was involved in the 1970s prosecutions. So long as the Street continues to keep silent on the Mob in its midst, organized crime will continue to be the silent partner of the financial markets.

DID THE NASD LOOK THE OTHER WAY?

He was the head of a penny-stock brokerage that has had its share of regulatory problems. This, he has told friends, is what happened to him early in 1996: Two men appeared at his midtown Manhattan office. They went for a walk. One man stuck a revolver in his ribs. "From now on," he was told, "you're retailing our stocks."

According to sources, this man's brokerage did not retail the two mobsters' stocks. Nor did he contact regulators or the National Association of Securities Dealers. Instead, he got in touch with the only power that seemed to make sense: a protector in the Mob. Somehow, the problem was straightened out. Asked about the incident by BUSINESS WEEK, he responds: "I don't want to get involved."

If this penny-stock exec showed a less than civic-minded attitude toward law enforcement, it's understandable—particularly if the allegations of a 57-year-old former NASD official, Massood Gilani, prove valid. Gilani worked in the Special Investigations Unit of the NASD's New York office, checking complaints of improprieties and reporting them to his superiors for further action. He paints a picture of widespread indifference toward customer complaints that might have been a tip-off of Mob infiltration of Hanover Sterling & Co.

From 1992, when Gilani started working at the NASD in New York, until late 1995, when he left, there was disturbing talk in the hallways of the agency's New York office. "The rumor was that some of these firms were run by the Mafia—the word was that some of them, including Hanover Sterling, were used to launder drug money," he says.

Gilani says he received an unusually large volume of complaints about Hanover from customers, most involving unauthorized trades—something Gilani suspected might have indicated stock "parking." "They were definitely pushing the stocks up, and it definitely looked like parking," says Gilani. From October, 1993, to June, 1994, he says in the suit, there were at least 31 customer complaints against Hanover, almost all alleging unauthorized trading. Among the complaints, he says, were several against Roy Ageloff, who Gilani says was widely known at the NASD to be the power behind the firm.

MASSOOD GILANI: *The ex-NASD examiner suggested a wider probe into Hanover*

Sources have told BUSINESS WEEK that Ageloff has ties to the Genovese crime family.

Gilani says he suggested that a wider investigation be conducted by enforcement and market surveillance. The response: "I was told to mind my own business." At one point, he was told by a supervisor very bluntly that "[the brokerages] pay your paycheck. You don't bite the hand that feeds you."

NASD officials note that they took action against Hanover Sterling—but not until after Hanover went out of business. Gilani says that he urged the NASD to act long before the company folded—in time, perhaps, for regulators to act before its failure brought down the company's clearing firm, Adler Coleman.

Gilani is hardly an impartial source. He was fired by NASD in 1995, and he's suing for racial discrimination. (NASD officials decline comment on the suit.) Still, his comments regarding the NASD's handling of Hanover Sterling are damning.

To be sure, Gilani hardly had much clout at the NASD, since he was in the doghouse much of the time. One lawyer pursuing his suit, Aegis J. Frumento of Singer Zamansky LLP in New York, notes that the Iranian-born Gilani "agitated a great deal on discrimination and employment policies." Gilani feels he was ignored because of the "corporate culture at the NASD." And if his tale of indifference proves correct, it would seem that the NASD is a far cry from being the Eliot Ness of Wall Street.

By Gary Weiss in New York

MASSACHUSETTS OPPONENTS TO H.R. 1058/S. 240

AFSCME Council 93, Executive Director Joseph M. Vonavita
American Geriatric Resource (AGR), Executive Director Lawrence Osterweil
Augustinians of the Assumption, Brighton
Barnstable County, Treasurer Mary J. LeClair
Barnstable County Retirement Association, Chairman/Treasurer Mary J. LeClair, Elected Member C. Randall Sherman, and Council Member Elinor E. Slade
Berkshire County Commission, Chairman Paul R. Babeu and Commissioners Ronald E. Kitterman and William "Smitty" Pignatelli
Berkshire County Retirement System, Chairman Peter G. Arlos, Elected Board Member Patricia M. Hudelston, Advisory Board Member Patricia D. Carlino, Executive Secretary Barbara A. Flynn, Head Administrative Clerk John H. Staelens, Jr., and Principal Clerk Michael D. McKeever (resolution)
Boston College, Senior Vice President Dr. James P. McIntyre
Citizen Action of Massachusetts, Director Edward Kelly
Citizens for Participation in Political Action (CPPAX), Issue Organizer Julia Carpenter
City of Attleboro Contributory Retirement Board, Chairman Gary S. Sagar and Appointed Member Richard V. Boucher
City of Boston, Mayor Thomas M. Menino
City of Brockton Retirement Board, Chairman William G. Harris
City of Cambridge, Treasurer James Maloney
City of Cambridge Retirement Board, Appointed Member & Chairman Joseph E. Connarton, Elected Board Member Sheila Tobin, and Ex-officio Board Member James Lindstron (resolution)
City of Chicopee Contributory Retirement System, Board Member and City Auditor Norman J. Ritchott, Director Ruth Corridan, Elected Member Timothy O'Shea and Accountant Susana Baltazar
City of Everett Retirement Board, Executive Director Ann M. Fournier and Appointed Member Robert D. Crowley
City of Fall River Board of Retirement, Chairman Joseph C. Almeida, City Auditor/Member Ex-Officio Raymond L. Reynolds and Appointed Member Gregory A. Brilhante
City of Fitchburg, Auditor/Finance Director Richard N. Sarasin
City of Gardner Retirement Board, Chairman Charlotte M. Noponen
City of Gloucester Retirement Board, Chairman Douglas A. MacArthur, Ex-officio Member Joseph T. Pratt and Elected Member Leland G.Ryan
City of Haverhill, Auditor William J. Klueber
City of Haverhill Board of Retirement, Chairman Vaughn E. Guertin
City of Holyoke Retirement Board, Chairman Joseph L. Whalen, Accountant Laurie Moran, Administrative Assistant Anita Barett, and Office Manager Healean Glidden
City of Lawrence Retirement Board, Chairman Richard F. Gosselin, Appointed Member Carl Knightly and Elected Member John A. Neilon, Jr.
City of Leominster Retirement Board, Administrative Secretary A. Nancy Person

City of Lynn Retirement Board, Ex Officio Member John E. Pace and Executive Secretary Barbara L. Belliveau

City of Medford Retirement Board, Chairman Thomas M. Curtis, Executive Secretary Gilda Antolini, Senior Clerk Tina Rapatano and Bookkeeper/Analyst Dora LoConte

City of New Bedford Contributory Retirement System, Elected Member Edward J. Wiley

City of Newburyport Retirement Board, Chairman Nolan R. Morris, Jr.

City of Northampton Retirement Board, Chairman Michael J. Lyons

City of Peabody, Mayor Peter Torigian, Treasurer Thomas J. Durkin, III, City Collector Donald G. Johnson and Assistant Treasurer/Collector Linda Cavallon

City of Pittsfield Retirement Board, Chairman Gerard E. Miller

City of Quincy Retirement Board, Chairman Robert E. Foy III, and Elected Board Member George McCray

City of Salem, Treasurer/Collector Robert H. Nagle

City of Salem Retirement Board, Member Robert H. Nagle

City of Somerville Retirement Board, Elected Member John M. Memory

City of Springfield Retirement Board, Elected Member Cornelius E. Sullivan

City of Taunton Contributory Retirement System, Chairman Richard T. Avila, Appointed Member Peter H. Corr, Ex-Officio, Member Ann Marie Hebert and Executive Secretary Paul J. Slivinski

City of Westfield Contributory Retirement Board, Chairman Kevin J. Regan, Appointed Member William D. Leahy and Administrative Assistant Lynda Cavanaugh

City of Woburn Retirement Board, Elected Member Denis P. Devine

Essex County Board of Commissioners, Chairman Christopher T. Casey and Commissioners John V. O'Brien and Marguerite P. Kane

Essex County Retirement Board, Chairman-Treasurer Katherine O'Leary and Elected Member Regina C. Mielcarz

Franklin County Retirement Board, Chairman Carolyn Olsen and Executive Secretary Cheryl S. Jobb

Fraternal Order of Police, Greater Boston Lodge, President Michael Giannetti

Greater Lawrence Sanitary District Employee's Retirement System, Chairman Roderick A. Rainville and Member Mark J. Lundy

Hampshire County Commissioners Executive Committee, Chairman Michael V. O'Brien and Legislative, Charter, and Code Committee Chairman Vincent J. O'Connor

Industrial Cooperative Association (ICA) Group, Director James Megson

International Brotherhood of Teamsters Local 25, Recording Secretary Richard Reardon

International Brotherhood of Teamsters Local 122, Secretary Treasurer John Murphy

International Brotherhood of Teamsters Local 504, Secretary Treasurer Dave Robbins

International Union of Operating Engineers Local 877, President and Business Agent Richard Draper

Massachusetts Association of Contributory Retirement Systems, Inc., President Robert Drew, Vice President George F. McCray and Executive Assistant/Conference Planner John E. Murphy

Massachusetts Association of County Commissioners, President Robert Stone

Massachusetts Collectors and Treasurers Association, Executive Director Aldo F. Luca
Massachusetts Consumers' Coalition, Chairman Paul J. Schlaver
Massachusetts Government Finance Officers Association, President John A. Lafleche
Massachusetts Jobs with Justice, Director Rand Wilson
Massachusetts Municipal Association, Accounting/Finance Director Ruth Stevens
Massachusetts Municipal Management Association, President John D. Petrin
Massachusetts Municipal Auditors' and Accountants' Association, President Mary E. Thompson
Massachusetts Port Authority Retirement Board, Ex-Officio Member Secretary/Treasurer George A. O'Brien, Appointed Member James P. Costello and Elected Member Charlotte O'Connell
Massachusetts Public Interest Research Group, Executive Director Janet Domenitz and Consumer Program Director Deidre Cummings
Massachusetts Senior Action Council, Legislative Director Manny Weiner
Massachusetts State Attorney General Scott Harshbarger
Massachusetts State Council of Carpenters AFL-CIO, President Andris J. Silins
Massachusetts Teachers Association, Vice President Melanie Kasperian
Massachusetts Turnpike Authority Employees' Retirement Board, Elected Member Francis M. Hoey
Middlesex County, Treasurer James E. Fahey, Jr.
Middlesex County Retirement System, Chairman James E. Fahey, Jr.
Norfolk County Board of Commissioners, Chairman William O'Donnell, Commissioners Peter H. Collins and John M. Gillis (resolution)
Norfolk County Retirement Board, Executive Director A. Joan Ventura
Plymouth County Board of Commissioners, Chairman John R. Buckley, Jr. and County Treasurer John F. McLellan
Plymouth County Retirement Board, Ex-officio Member and Board Chairman John F. McLellan and Elected Member Joseph F. McDonough
Sons of Mary Missionaries, Framingham
Tax Equity Alliance for Massachusetts (TEAM), Director Jim Braude
Town of Abington Board of Selectmen, Executive Secretary Richard J. LaFond
Town of Andover, Finance Director Anthony J. Torrisi
Town of Arlington, Treasurer John J. Bilafer
Town of Arlington Retirement Board, Retirement Administrator Claire A. Smith
Town of Athol Retirement Board, Chairman/Secretary Charles E. Baker
Town of Bedford, Finance Director Peter P. Naum
Town of Belmont, Accountant Steve Szabo
Town of Belmont Contributory Retirement Board, Chairman Rosario A. Sacco and Administrator Marion E. Cote
Town of Canton, Treasurer James R. Magee
Town of Clinton Retirement Board, Chairman Robert D. White and Member George T. Kittredge
Town of Concord, Finance Director Anthony T. Logalbo
Town of Danvers, Assistant Town Manager Diane Norris, Accountant Leonard A. Marshall, Assistant Accountant William G. Perreault

Town of Dedham Retirement Board, Administrator June F. Rosado and Ex-Officio Member/Comptroller Mary J. Shea

Town of East Bridgewater Board of Selectmen, Chairman Paul R. Nisby, Member Irena Swartz, Treasurer Frank M. Savino, Accountant George G. Samia, Executive Assistant John J. Clifford and Clerk Eric W. Greene

Town of East Bridgewater Public Schools, Superintendent Gordon W. Mitchell

Town of Easthampton Contributory Retirement Board, Chair Mary T. Brewer, Elected Member James P. Dunham, Ex-Officio Member Joanne E. Lukowski and Administrative Assistant Leo G. Riel

Town of Falmouth Retirement Board, Member Jeanne L. Clifford

Town of Framingham Retirement Board, Executive Secretary Nancy A. Grifone

Town of Greenfield, Treasurer/Collector Paul J. Mokrzecki

Town of Greenfield Retirement Board, Chairman William P. Devino

Town of Groveland, Treasurer Thomas C. Abisalih

Town of Hull Board of Retirement, Chairman Maurice E. Murphy, Ex-Officio Emily A. O'Brien, and Elected Member James A. Yacobucci

Town of Lexington, Finance Director/Comptroller John J. Ryan

Town of Lexington Retirement Board, Chairman Robert W. Cunha and Administrator Barbara E. Glynn

Town of Ludlow, Treasurer Helen Garrow

Town of Marblehead, Finance Director George B. Snow

Town of Medfield, Accountant Georgia K. Colivas

Town of Methuen Contributory Retirement System, Chairman Thomas J. Kelly

Town of Milford Retirement Board, Administrator Barbara A. Alberta and Administrative Assistant Eveline M. Berry

Town of Milton Retirement Board, Ex Officio Member Edward Spellman, Jr., and Retirement Analyst Mary MacKenzie

Town of Montague Retirement Board, Executive Secretary Marianne L. Fiske

Town of Natick, Comptroller E. Ruthann Cashman

Town of Natick Contributory Retirement System, President Robert Drew, Comptroller and Ex-Officio Member Ruthann Cashman and Administrative Assistant Kathleen S. Bacon

Town of Needham, Town Administrator Carl F. Valente

Town of Newton Retirement Board, Ex offiicio Comptroller David Wilkinson

Town of Norfolk, Finance Director Susan L. Gagner

Town of Norwood, Treasurer William T. Crozier

Town of Norwood Retirement Board, Chairman Thomas J. P. Collins (resolution)

Town of Pembroke, Treasurer/Collector Linda Robbins Porazzo

Town of Plymouth, Finance Director Michael Daley

Town of Plymouth Contributory Retirement Board, Ex-officio Board Member and Secretary Michael Daley

Town of Randolph, Accountant Therese Steele

Town of Reading, Finance Director Elizabeth W. Klepeis and Accountant Richard Foley

Town of Revere Retirement Board, Elected Board Member Steven Parsons

Town of Shrewsbury Retirement Board, Elected Board Member Kevin M. McNeil
Town of Southbridge, Town Manager Florence C. Chandler and Finance Director John A. Lafleche
Town of Stoughton, Treasurer Thomas A. Rorrie and Accountant Wendy V. Nightingale
Town of Sudbury, Treasurer/Collector Mary Ellen Normen Dunn
Town of Uxbridge, Treasurer/Collector Cortney A. Keegan
Town of Wakefield, Contributory Retirement Board Chairman and Town Accountant Richard P. Conboy, Jr.
Town of Watertown Retirement Board, Chairman Robert E. Ford, Appointed Board Member R. Wayne MacDonald and Ex-officio Board Member and Secretary Thomas J. Tracy
Town of Wellesley, Treasurer/Collector Marc V. Waldman
Town of West Springfield Contributory Retirement System, Chairman Thomas J. Cummings and Appointed Member Raymond N. Spear
Town of Winchester Retirement Board, Administrator/Executive Secretary Lorraine F. McDonough
Town of Winthrop Retirement Board, Chairman Andrew W. Maylor
Town of Yarmouth Board of Selectmen, Town Administrator Robert C. Lawton, Jr.
Worcester County Commissioners, Chairman Joann M. Sharp, John R. Sharry, and John C. Burke
Xaverian Brothers, American Northeastern Province, Milton

Cape Cod Times editorial opposing H.R. 1058/S. 240 (September 28, 1995)
Middlesex News editorial opposing H.R. 1058/S. 240 (October 15, 1995)
The Boston Globe commentary opposing H.R. 1058/S. 240 (November 13, 1995)
The Boston Globe commentary opposing H.R. 1058/S. 240 (June 22, 1995)

A Republican attempt to swindle investors

ROBERT KUTTNER

Since the 1930s, the regulation of stocks, bonds and stock exchanges has been a model of unobtrusive government. The system of securities regulation has been built largely on the principle that sunlight is the best disinfectant. Nobody tells the investor what to buy, when to sell; no one directs the company where to raise its capital. The rules mainly insist on accurate information – the better to protect both parties.

Despite the business community's general aversion to being regulated, investors and honest businesses share a common interest in clean capital markets and reliable financial information. Even conservatives who want a minimal role for government generally concede the need for substantial disclosure requirements and penalties for outright fraud in the sale of securities. And most observers consider the Securities and Exchange Commission among the most competent and professional of our public agencies.

Enter Newt Gingrich and the Republican revolution.

Almost lost amid the myriad of other assaults on government is a bill now pending before a House-Senate conference that could wreak havoc with financial markets by undermining an investor's confidence in what he is buying. The bill would make it almost impossible to sue for securities fraud, no matter how badly a company had misled investors. It would also shield accountants from responsibility for failing to detect or disclose fraud in certifying financial audits.

Another section of the bill, promoted as the "safe harbor" provision, would protect companies and their agents from suits based on false projections of their earnings, even if they were deliberate lies. SEC chairman Arthur Levitt Jr. has derided this provision as a "safe ocean."

Initially, the bill was advertised as part of a broad reform to discourage "frivolous" lawsuits. In reality, it would be a license for a broad array of securities swindles. Despite alarms about a "litigation explosion," the number of investor lawsuits has held roughly constant since 1989; only about 1 percent of publicly traded companies are sued by investors at all.

The bill would make it almost impossible to sue for securities fraud.

The premise was that discouraging lawsuits would be good for business. Sure, it would be great for business – if you like businessmen on the model of savings and loan swindler Charles Keating.

Why would a political party that believes in the virtues of efficient capitalism want to wreck the system's ability to police itself? The answer, as with much of the rest of the GOP program, is special-interest politics masquerading as high principle.

For one thing, the accounting industry wants to shield itself from liability. Public accountants make very nice incomes for certifying that the books they audit are accurate.

But in the S&L scandal, accountants must have been dozing off under their eyeshades. Accountants paid out some $1.6 billion in damage awards in the aftermath of the scandal for failing to detect or report funny-money accounting in the books of failed financial institutions.

Evidently it is far cheaper for the accounting profession to invest in lobbying to waive the rules than to raise its own standards. And these are the people we rely on to keep other businesses honest.

Another set of inside players are securities firms. They would love to be able to hype new stock issues and other baroque forms of securities without being held accountable afterward if the hype turned out to be bogus. Like the accountants, Wall Street firms have pumped serious campaign contributions into the coffers of key legislators.

A third major force behind this bill is a segment of the high-tech industry, which often overpromises results when selling stock to finance start-ups. Hot new companies would like to be able to sweet-talk potential investors without being held liable for the veracity of their claims.

To add insult to injury, the Republican Congress also wants to cut the SEC's enforcement budget by 20 percent. If you can't gut consumer protection by the front door, try the back.

This bill has been a sleeper. But belatedly, opposition is mounting.

A coalition of state and municipal officials, including state attorneys general, municipal treasurers, the National League of Cities and the National Association of Counties, all oppose it. In the Orange County, Calif., bankruptcy, reputable securities firms peddled highly speculative investments. The last thing localities need is freer rein for securities hustlers.

Money magazine, ordinarily a supporter of swashbuckling free-market capitalism, is so incensed by this assault on investors that it is urging its readers to write key lawmakers opposing the bill.

Now, perhaps emboldened by Clinton's increasing toughness on other issues, White House aides are saying the president may refuse to sign the bill. The sponsors are frantically trying to broker a compromise. Let's hope they fail.

"There's a sucker born every minute," said P.T. Barnum. If this bill passes, the sucker is the American voter.

Robert Kuttner's column appears regularly in the Globe.

MIDDLESEX NEWS, Framingham, MA, October 15, 1995

Middlesex News

Hold line against fraud

We've long argued that there are too many frivolous civil suits filed in this country by too many people trying to blame other parties for their own misjudgments.

When you place a paper cup of hot coffee between your legs when you're driving, or ignore the sign warning you not to feed the bear, we believe you have no one to blame but yourself.

Not always so in the complex world of investments. Sure, if you decide on your own to take a flier on an upstart company, it's an assumed risk for which you are responsible. And even if you rely on an investment adviser or stockbroker, there's an understanding that you are being offered a recommended course of action, not guaranteed results.

However, when stockbrokers and corporate executives knowingly falsify financial and sales reports to inflate their stock prices, defrauded investors should be allowed legal redress.

Right now they are, but under legislation passed by Congress as part of the Republicans' "Contract with America," victims of such securities fraud would have a much harder time recovering their losses through the courts.

Enactment of the bill into law would allow stockbrokers and corporations to legally make knowingly false predictions about investment performance and company profits in advertising and telephone sales pitches. The proposed law also would prevent victims of investment fraud from suing the "aiders and abettors" of such companies — accountants, brokers, bankers and lawyers — to recover their losses.

The use of bogus financial information to defraud investors is a growing problem in the high technology industry. Kendall Square Research Corp. of Waltham, a maker of supercomputers, has acknowledged inflating earnings figures by counting as sales many computers that customers hadn't and couldn't pay for. Cambridge Biotech Corp. of Worcester has made similar admissions, as have companies in California and South Carolina.

Many of the more than 43,000 Massachusetts residents who have recovered $81.5 million of their losses from securities swindles would have been prevented from doing so under this proposed law, which is opposed by a wide cross-section of state and local officials.

If Congress doesn't reject this misguided legislation, President Clinton should veto it.

The Commonwealth of Massachusetts
Office of the Attorney General
One Ashburton Place,
Boston, MA 02108-1698

SCOTT HARSHBARGER
ATTORNEY GENERAL

(617) 727-2200

June 21, 1995

The Honorable John F. Kerry
United States Senate
Washington, DC 20510

Dear Senator Kerry:

As you know from my earlier letter, I am deeply concerned about S.240 (Dodd-Domenici), the Private Securities Litigation Reform Act bill now before the Senate. I appreciate your attempts to improve the bill during the deliberations of the Senate Banking Committee and I urge you to vote against this legislation which penalizes victims of securities fraud and protects those who impose this fraud on an unsuspecting public.

As noted in my letter of May 22, I oppose S. 240, as do many other state government officials and law enforcement agencies as well as AARP, because it unfairly and adversely affects the legitimate interests of small investors, workers, consumers, veterans, and seniors.

S.240 imposes new and blatantly unfair requirements on victims of securities fraud that would effectively prevent them from seeking redress through the courts. Under the "loser pays" provision, investors risk paying defense costs if they decline to participate in an alternative dispute resolution (ADR) --even if that process is biased against defrauded investors.

Provisions in S. 240 eliminating joint and several liability are, in essence, legal loopholes for corporate wrong-doers. Limiting recovery when the primary wrongdoer is bankrupt or has fled will penalize consumers. Coupled with provisions in S. 240 immunizing from liability "aiders and abettors" (including accountants, lawyers, and brokers) who help carry out the fraud, this represents a step backwards in accountability and responsibility.

S. 240 would require fraud victims to "specifically allege facts giving rise to a strong inference that the defendant acted with the required state of mind." This would establish a new, almost impenetrable threshold for bringing suit in securities fraud cases.

The legislation limits the rights of small investors by restricting the "most adequate plaintiff" (who could select lead counsel and control the case) to the investor with the largest financial interest in the case. Denying control of a case to an injured plaintiff because of his/her wealth (or lack of same) is a new and alarming concept for American law.

Finally, S. 240 fails to lengthen the statute of limitations which is presently inadequate. Given the numerous and severe problems with S.240, I urge you to oppose it. Thank you for your kind attention.

Sincerely,

Scott Harshbarger

6858D

Given the numerous and severe problems with S. 240, I urge you to oppose it. Thank you for your kind attention.

Sincerely,

Scott Harshbarger

6858D

Tech Concerns Fudge Figures To Buoy Stocks

By Lee Berton

Staff Reporter of The Wall Street Journal

More small technology companies are pumping up their sales and earnings through aggressive and sometimes questionable accounting to help inflate their stock prices, accountants say.

But they say investors can protect themselves by watching for telltale signs of manipulation.

Amid a sell-off in technology stocks, many companies are finding it hard to raise funds through public offerings. And banks are wary about lending to them because such companies often lose money in their early years, accountants say.

"As a result, high-tech and biotech concerns are being pressured to improve or maintain profits by pushing the envelope in revenue- and inventory-accounting rules," says Paul R. Brown, an associate professor of accounting at New York University's Stern School of Business.

Many such companies recently have been accused of booking sales too early—for example, when buyers still have the right to return items for a full refund or before the product is delivered or paid for. Also, some companies wait too long to take charges against earnings for asset revaluation and inventory obsolescence, accountants say.

For example, Kendall Square Research Corp., a Waltham, Mass., maker of supercomputers, has acknowledged that it counted as sales numerous computers that customers apparently couldn't pay for.

"There is tremendous pressure on

Please Turn to Page B8, Column 3

Tech Firms Fudge Figures to Buoy Stocks

Continued From Page B1

companies such as ours to continue their revenue-growth trend," says Zachary Shipley, who was recently brought to Kendall Square as chief financial officer to help clean up an accounting scandal that led to the dismissal of several top executives late last year. Kendall Square had predicted 1993 revenue of about $60 million; it reported only $18.1 million.

Other examples:

- Cambridge Biotech Corp. of Worcester, Mass., which develops vaccines and diagnostics for humans and animals, has said it reported revenue from transactions that "don't appear to be bona fide."
- Media Vision Technology Inc., Fremont, Calif., which makes equipment that brings sound and animation to personal computers, was accused by the San Francisco Chronicle of operating a phantom warehouse to hide inventory for returned products already booked as sales. Media Vision declined to comment. Tuesday, its top three executives resigned amid a federal investigation into alleged irregularities at the company. Paul Jain, company chairman and founder, said he resigned because of "untruthful and unfair allegations" by the Chronicle "and the possible impact of the negative publicity on the integrity of Media Vision."
- Policy Management Systems Corp., a Blythewood, S.C., insurance-software concern, has said that it reported some sales before contracts were signed or before products were delivered.

Cambridge Biotech, Media Vision and Policy Management declined to comment on reasons for their accounting problems.

Kendall Square conceded in a recent Securities and Exchange Commission filing that it booked revenues too early in the past two years. The company said it was misinformed about contingencies involved with the sales, and that customers had the right to trade in equipment for big credits and to receive more equipment without additional payments.

Paul Regan, a partner in the San Francisco accounting firm of Hemming Morse and a forensic accountant, says investors should look for sharp increases in monthly sales at the end of each quarter or for a big jump in fourth-quarter sales, which may signal more sales than warranted. Forensic accountants comb financial results for signs of fraud or aggressive accounting.

Some technology companies say sales rose late in the quarter because customers delay placing orders in hopes of getting a better price. But accounting specialists say repeated late-quarter surges should raise a red flag.

Consider MiniScribe Corp., a software company that collapsed several years ago after it allegedly inflated sales improperly, according to testimony in shareholders suits in Texas state court and federal court in Colorado. In all four quarters of 1986, sales rose spectacularly in each period's final month; more than half the fourth-quarter increase was booked on Dec. 29.

Mr. Shipley of Kendall Square says customer orders tended to bunch at the end of certain quarters but says monthly sales figures aren't available. Cambridge Biotech, Policy Management and Media Vision declined to disclose or discuss monthly sales.

Mr. Regan cites other signs that companies may be improperly inflating sales. "If cash flows are going down and revenues are going up, it could be a sign that the company is being too aggressive," he says. He also advises looking at whether warehouse inventories and accounts receivable are growing too quickly — information that sometimes appears in annual or quarterly reports to the SEC.

Douglas Carmichael, a professor of accounting at City University of New York's Baruch College, says "investors should scrutinize the side agreements these companies make with customers to see if the sales are legitimate or consummated."

For example, Prof. Carmichael says high-tech or biotech companies that sell to universities or hospitals could easily record sales that haven't been completed. "These nonprofit customers have many levels of approval, including overseeing government units, and sales that appear to be made sometimes fall by the wayside," he says.

For example, Kendall Square recently said it is negotiating with various universities for payment for computers valued at $20 million, but that it had no assurance of receiving any.

Howard Schilit, an associate professor of accounting at American University, Washington, D.C., and author of a recent book on financial shenanigans, cites three warning signals for investors. "Beware of product shipments before the sale is finalized, recording revenues when important uncertainties exist" — for example, if the purchasing company hasn't fully paid for the product and may go out of business — "and recording sales when future services are due," such as repairs guaranteed over a long period, he says.

The key to a real sale under accounting rules is that "the risks and benefits of ownership should be completely transferred to the buyer," Prof. Schilit says.

CITY OF BOSTON • MASSACHUSETTS

OFFICE OF THE MAYOR
THOMAS M. MENINO

June 13, 1995

Senator John F. Kerry
421 Russell Senate Office Building
Washington, DC 20510

Dear Senator Kerry:

I am writing to you to express my strong opposition to S.240 (Dodd-Domenici). As you know, S.240 would deprive individuals, institutions, and state and local governments of their right to use federal courts to recover their money when they are defrauded in the securities markets.

S.240 fails to seek justice for victims of investment fraud. In fact, several of the major points in S.240 are slanted towards the exoneration of corporate defendants while leaving the consumer with the legal bill. Some of the points of S.240 include:

* Three year statute of limitations;
* Difficult for victims to recover losses;
* Victims face paying legal fees of corporations if the victim loses.

If S.240 were to pass the Senate, we would be allowing corporate criminals to swindle millions of unsuspecting senior citizens, small investors, and consumers, as well as state and local governments. I urge you to vote against S.240 so that residents from the City of Boston, the Commonwealth of Massachusetts, and the nation are protected from corporate fraud.

Sincerely,

Thomas M. Menino

Thomas M. Menino
Mayor of Boston

MASSACHUSETTS
ASSOCIATION OF
COUNTY COMMISSIONERS

May 24, 1995

The Honorable John F. Kerry
United States Senate
421 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Kerry:

I am writing on behalf of the Massachusetts Association of County Commissioners to express our opposition to Senate Bill 240 (the Dodd-Domenici bill) and to urge your opposition to this bill. I am advised that you will vote in favor of this bill, but I believe you would condition your support of the legislation on its effects on local governments.

County Commissioners want to see legal and tort reform, but Senate Bill 240 is not a prudent step in that direction. Several local governments lost taxpayers money in investments last year because of fraudulent sales practices by some investment companies and a few investment brokers. Not only did some counties lose money on these investments, but some are still holding investments for substantially less than what they paid for them. Some counties have chosen to seek legal remedies and others might yet do so. Senate Bill 240 will make it extremely difficult, if not impossible, for them to pursue legal redress.

This legislature protects the interests of large investment companies, stockbrokers, accountants and attorneys at the expense of the taxpaying public and small investors. I believe this legislation places special interests above the interests of the public and small investors. It is not wise nor is it needed. I urge you to reconsider your support for it.

Please feel free to contact me if you have any questions regarding this matter. My phone number is 617-447-7720. My fax number 617-447-6515. Thank you for your consideration of this matter.

Sincerely,

Robert J. Stone

Robert J. Stone, President
Massachusetts Association of County Commissioners

May 24, 1995

Honorable John Kerry
United States Senate
Washington, DC 20510

Dear Senator Kerry:

We are writing to urge you not to cosponsor or support S. 240, the Dodd-Domenici bill now before the Senate. This measure penalizes victims of securities fraud and protects the swindlers who impose this fraud on an unsuspecting public.

This legislation is anti-small investor, anti-worker, anti-consumer and anti-senior. First — and most outrageous — the legislation limits the rights of small investors by restricting initiation of a class action lawsuit to those investors who own either one percent of the total shares of a security or whose investment is worth at least $10,000. Basing one's rights on the extent of one's wealth is a new and alarming concept for American law, and one we cannot accept.

S. 240 also imposes new and blatantly unfair requirements on victims of securities fraud that would make it effectively impossible for those victims to seek redress through the federal courts. Under the "loser pays" provision, investors risk paying defense costs if they decline to participate in an alternative dispute resolution — *even if that process is biased against defrauded investors*. And, of course, the prospect of paying one's opponents legal fees is always more intimidating to victims (faced with the multi-million dollar defense teams large corporations deploy in such cases) than it is for defendants.

The bill establishes a new, almost impenetrable threshold for bringing suit in securities fraud cases. The measure would require fraud victims to cite in their complaints "specific facts demonstrating the state of mind of each defendant at the time the violation occurred." In virtually all cases, the true extent of the fraud and evidence pertaining to the state of mind of the defendant(s) are uncovered only as part of the discovery process. Requiring such allegations *as a condition* for filing suit will effectively eliminate the ability to sue in even the most egregious circumstances.

Provisions in S. 240 that eliminate joint and several liability in many cases are, in essence, legal loopholes for corporate criminals. Limiting recovery when the primary wrongdoer is bankrupt or has fled will penalize consumers. Had this language been the law during the S&L crisis, the 20,000 Lincoln bondholders would not have been able to recover their $240 million losses from the accountants and lawyers who helped Charles Keating carry out his fraud.

Finally, the measure would result in a dramatic increase in the incidence of securities fraud as the likelihood and level of punishment declined. This would hurt our entire economy as small investors lost confidence in the integrity of our markets.

Given the numerous and severe problems with S. 240, we urge you to stand up for the constituents you are elected to represent and oppose this ill-conceived measure.

Sincerely,

Janet Domenitz, Executive Director
Massachusetts Public Interest Research Group (MASSPIRG)

Joseph M. Vonavita, Executive Director
AFSCME Council 93

Edward Kelly, Director
Citizen Action of Massachusetts

Michael Giannetti, President
Fraternal Order of Police, Greater Boston Lodge

Melanie Kasperian, Vice President
Massachusetts Teachers Association

James Megson, Director
ICA Group (Industrial Cooperative Association)

Rand Wilson, Director
Massachusetts Jobs with Justice

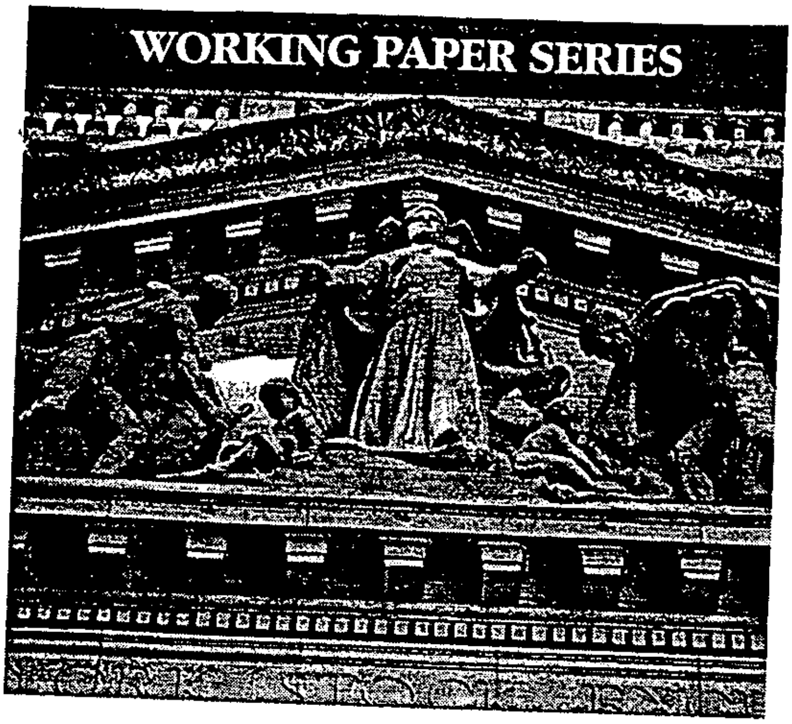
Jim Braude, Director
Tax Equity Alliance for Massachusetts (TEAM)

John Murphy, Sec./Treas.
Teamsters Local 122

Dave Robbins, Sec./Treas.
Teamsters Local 504

Richard Reardon, Recording Secretary/Field Representative
Teamsters Local 25

Securities Litigation Reform



Securities Litigation Reform
The First Year's Experience

A Statistical and Legal Analysis of
Class Action Securities Fraud Litigation Under the
Private Securities Litigation Reform Act of 1995

Release 97.1

Joseph A. Grundfest
Michael A. Perino

Stanford Law School
February 27, 1997

CORNERSTONE RESEARCH

The authors would like to acknowledge the outstanding work of our team of research assistants, all members of the Stanford Law School Class of 1997: Elizabeth Harmer-Dionne, Philip A. Giordano, Robert L. Monkmeyer, and Andor D. Terner. We would also like to thank Cornerstone Research for valuable computational assistance.

Cornerstone Research provided funding to support the preparation of this report, but exercised no control or influence over its substance or over any of the conclusions or analyses reported herein. The views expressed are solely those of Professors Grundfest and Perino who accept total responsibility for the contents of this report.

This report also appears as Working Paper No. 140 in the John M. Olin Program in Law and Economics Working Paper Series at Stanford Law School.

**SECURITIES LITIGATION REFORM:
THE FIRST YEAR'S EXPERIENCE**

Release 97.1

**A Statistical and Legal Analysis of
Class Action Securities Fraud Litigation Under the
Private Securities Litigation Reform Act of 1995**

Joseph A. Grundfest*
and
Michael A. Perino**

Stanford Law School
February 27, 1997

* Professor of Law and Crocker Faculty Scholar; Director, Roberts Program in Law and Business at Stanford Law School; Commissioner, United States Securities and Exchange Commission (1985-1990).

** Lecturer, Stanford Law School; Deputy Director, Roberts Program in Law and Business at Stanford Law School.

This research report is based on a preliminary analysis of class action securities fraud litigation filed during calendar year 1996. We expect that some of our findings will change as we expand our database and continue to refine our analyses. We also believe that certain trends observed during the first year of litigation will not continue in the future. We therefore caution all readers to recognize the preliminary nature of these results and to check at *http://securities.stanford.edu/report* for more recent analyses, if available.

We also caution readers of this report that the information on which it is based may be materially incomplete in several respects. There is no centralized depository of information regarding federal or state class action securities fraud litigation, and we recognize that we have likely missed some litigation, particularly at the state level outside of California. We are most grateful for any information and copies of filings, briefs, orders, or other litigation material that appear not to be reflected in this report, and for any suggestions as to how this report can be improved. Please direct all such communications by post to Associate Director, Securities Litigation Project, Stanford Law Library, Stanford, CA 94305-8612, or by e-mail to: *director@securities.stanford.edu.*

SUMMARY OF MAJOR FINDINGS

The Private Securities Litigation Reform Act of 1995 became effective on December 22, 1995, after Congress for the first time overrode a veto by President Clinton. Opponents of the legislation characterized it as providing a "license to lie." Its supporters claimed that it provided necessary protection against meritless litigation.

This report compares patterns of class action securities fraud litigation in federal and state courts since the Act's effective date with litigation patterns observed prior to the Act's adoption. Although our analysis is based on partial data and is subject to further amendment and modification, we can report ten significant preliminary findings. As discussed in greater detail in the body of our Report, many of the policy implications of these findings are subject to dispute and interpretation. It is prudent to await further information regarding the operation of the Act before reaching any conclusions regarding the Act's "success" or "failure."

Our significant preliminary findings are as follows:

Overall litigation rates are little changed.

Our best estimate is that class action securities fraud litigation in federal and state court is being filed at an annual rate of 148 to 163 defendant issuers per year. Prior to the Reform Act, litigation was being filed at a rate of approximately 176 defendant issuers per year. The total volume of litigation activity in 1996 is thus down by about 7% to 16%, but is not very different from the level of activity observed in 1991, 1993, and 1995. In addition, increasing stock market prices in 1996 may have depressed litigation activity. It is therefore too soon to draw any firm conclusions as to whether litigation reform has had any material effect on the aggregate securities class action litigation rate.

About 26% of litigation activity has moved from federal to state court.

The relative stability of the aggregate litigation rate masks a significant shift of activity from federal to state court. Approximately 26% of class action claims are state court proceedings without parallel federal claims filed in 1996. This increase in state court litigation is likely the result of a "substitution effect" whereby plaintiffs' counsel file state court complaints when the underlying facts appear not to be sufficient to satisfy new, more stringent federal pleading requirements, or otherwise seek to avoid the substantive or procedural provisions of the Act. Plaintiffs may also be resorting to increased parallel state and federal litigation in an effort to avoid federal discovery stays or to establish alternative state court venues for the settlement of federal claims.

Allegations of accounting irregularities or trading by insiders now explain the lion's share of federal class action litigation.

Approximately 67% of post-Reform Act Section 10(b) complaints involving publicly-traded companies allege accounting fraud as a basis for liability. In sharp contrast, similar allegations are found in only 34% of pre-Reform Act cases. Allegations of trading by insiders now appear in about 57% of post-Reform Act cases, whereas these allegations are found in only 21% of pre-Reform Act cases. Alleged trading by insiders is particularly important in cases against high technology companies, appearing in 73% of those cases, but that statistic must be interpreted with caution because of the prevalence of option-based compensation in the high technology sector.

Pure "false forecast" cases explain a relatively small percentage of pending Reform Act claims.

Complaints alleging false forward-looking statements as the sole basis for liability account for only about 14% of all post-Reform Act complaints analyzed, and only about 6.5% of post-Reform Act federal complaints involving publicly-traded companies.

Litigation typically follows larger price declines than observed prior to the Reform Act.

Prior to the Reform Act, the average stock price decline preceding the filing of a claim was about 19%. During 1996, the average decline jumped to 31%. This increase is consistent with the observation that heightened pleading requirements induce plaintiffs' counsel to pursue cases that are correlated with larger price declines, and therefore seem to be more apparent instances of fraud.

Federal claims are now rarely filed against the largest issuers.

The average company sued in a federal securities fraud class action in 1996 had a market capitalization of $529.3 million. Prior to the Reform Act, the average market capitalization was $2,080 million. This decline appears to be attributable almost exclusively to a reduction in litigation naming issuers with market capitalization in excess of $5.0 billion. Prior to the Reform Act, these large corporations represented about 8.4% of federal court activity, but very few of these companies appear to have been sued in 1996.

High technology issuers continue to be the most frequent targets of class action litigation.

High technology companies represent 34% of all issuers sued in federal court since the effective date of the Reform Act. That statistic is not materially different from the pre-Reform Act experience.

The dominant plaintiffs' class action law firm, Milberg Weiss Bershad Hynes & Lerach, appears to have increased its significance nationally and in California in particular.

Milberg Weiss' appearance ratio nationwide stood at approximately 31% prior to the Reform Act. Aggregating parallel federal and state activity, Milberg Weiss' appearance ratio today stands at about 59% nationwide and 83% in California. Milberg Weiss' increased significance can be explained by the fact that it is likely the best capitalized plaintiffs' firm and therefore best able to finance the delays associated with slower procedures under the Reform Act. It also has the most diversified portfolio of plaintiffs' claims and is therefore better able to absorb the risk associated with litigation under the new regime. In addition, it is best situated to internalize the externalities associated with the need to invest to create new precedent interpreting the Reform Act's novel provisions.

In the courthouse, judges appear to be resolving legal questions regarding the interpretation of the "strong inference" requirement in favor of plaintiffs.

The most frequently litigated issue to date—the interpretation of the "strong inference" pleading requirement—has with but a single exception been uniformly interpreted to apply the Second Circuit standard, not some higher pleading requirement. This is the position espoused by plaintiffs. Moreover, no complaint subject to the "strong inference" pleading standard has been dismissed without permitting plaintiffs the opportunity to replead a material portion of the claims asserted in the original complaint.

The growth of parallel state and federal litigation, with concomitant disputes over discovery stays and other matters, suggests that attention to federal preemption issues is warranted.

In addition to the growth in "pure" state class action fraud claims, at least 28% of federal class action securities fraud cases also have pending parallel state securities fraud class action claims. Parallel state court securities fraud class actions were quite rare prior to the Reform Act. This parallel litigation appears to be brought to avoid the Reform Act stay on discovery, and perhaps for other strategic and settlement-related reasons as well. This boom in state class action securities fraud litigation raises issues regarding the optimal coordination of federal and state litigation regimes and suggests that a systematic review of the issue by Congress is in order.

TABLE OF CONTENTS

I. INTRODUCTION AND OVERVIEW

The Private Securities Litigation Reform Act of 1995 (the "Reform Act" or the "Act") took effect on December 22, 1995,[1] after Congress for the first time overrode a veto by President Clinton. The Act put in place a variety of procedural and substantive hurdles aimed at curtailing what its proponents considered abusive practices in class action securities fraud litigation. For example, the Act creates a heightened pleading standard that generally makes it more difficult for plaintiffs to file allegations of securities fraud without having solid information beforehand on which to base such a claim. Hand-in-hand with this provision, the Act also provides for a stay of discovery while a motion to dismiss is pending. With the stay, Congress sought to prevent plaintiffs from building their case solely on information provided by defendants during discovery and to address the concern that in the past, innocent defendants may have been induced to settle meritless claims simply to avoid the high cost of discovery.

To address concerns about the influence of "professional plaintiffs" and class action attorneys, the Act contains a "lead plaintiff" provision and class notification process aimed at giving the plaintiffs with the largest financial interest at stake (presumably, institutional investors) the right to control the course of the litigation and to select lead counsel for the class, subject to court approval. The Act also creates a limited "safe harbor" for the release of forward-looking information about a firm's prospects. Congress provided the safe harbor to prevent companies from being subjected to class action securities litigation simply because their forecasts proved inaccurate, regardless of any proof of intent to mislead or the presence of appropriate cautionary language.

These and many other provisions of the Reform Act were hotly contested by plaintiffs' counsel, issuers of publicly traded securities, accounting firms, the Securities and Exchange Commission, state securities regulators, and many other constituencies.[2] Opponents of the legislation bemoaned its passage and questioned the extent of the perceived problems. They predicted that the United States' securities markets would become a magnet for fraud and that meritorious litigation would no longer be heard in federal courts.

[1] Pub. L. No. 104-67, 109 Stat. 737 (1995) (to be codified at 15 U.S.C. §§ 77a et seq.).

[2] For an overview of the legislative process leading up to the enactment of the Reform Act, *see* John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335 (1996).

This article is a first attempt at an empirical analysis of the litigation patterns observed since the adoption of the Act, and a comparison with experience that preceded the Act's adoption. In particular, this article focuses on the changes in the number and nature of actions commenced in the year following passage of the Act (December 22, 1995 through December 31, 1996), as well as judicial interpretation of the Act through January 31, 1997.[3]

This twelve month period is short given the historic life cycle of securities fraud litigation.[4] Indeed, procedural delays associated with some of the Reform Act's more novel provisions—such as the class notification process, lead plaintiff selection procedures, and stays on discovery—are likely to slow the litigation process further. In addition, disputes over the proper interpretation and application of many of the Reform Act's innovative provisions—such as new pleading standards, discovery stays, and the scope of the safe harbor—are already generating uncertainty and will further slow the litigation process, at least until generally accepted precedent evolves.

The data that underlie this report are therefore, by their very nature, preliminary and suggestive, and can describe only the earliest phases of the litigation process. The data do not, to any significant degree, describe the outcome of motions for summary judgment, settlements, or verdicts because relevant data are either unavailable or too sparse to support a reliable inference.[5] This research will, however, be updated on a regular basis to reflect ongoing experience with the Act, including the progress of litigation, settlements, and verdicts. We will also introduce more detailed statistical analyses of the characteristics of the companies being sued. Updates on this research can be found at the following Internet address: *http://securities.stanford.edu/report.*

This report seeks primarily to measure and to explain observed patterns in litigation behavior. It does not offer policy judgments regarding the desirability of observed trends or of the merits of litigation filed under the new Act. The debate over class action securities fraud litigation often has been heated, and Senator Dodd has observed that conflicting constituencies often are unable to agree even on "the basic facts."[6] We hope that this report and its successors can serve as an objective point of reference that provides common factual ground for all parties in this continuing debate.

The remainder of this report is organized as follows: Sections II through IX compare the pre- and post-Reform Act experience in terms of litigation rates, characteristics of companies that have been sued, nature of frauds alleged, incidence of claims alleging trading by insiders, incidence of claims alleging fraud in initial or follow-on public offerings, the role of plaintiff law firms, the geographic incidence of litigation, and settlements. Section X discusses judicial interpretation of the Act. Section XI provides concluding comments and a brief discussion of the policy issues raised by this review.

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[3] This includes what we believe to be a complete census of all decisions rendered in federal court, as well as the state court decisions of which we are aware that are relevant to the interpretation or operation of the Reform Act's provisions.

[4] In a recent Federal Judicial Center study, the median time from filing to ultimate disposition for a sample of 103 federal class action securities fraud cases was 21.7 months. THOMAS E. WILLGING, FEDERAL JUDICIAL CENTER, EMPIRICAL STUDY OF CLASS ACTIONS IN FOUR FEDERAL DISTRICT COURTS 117 (1996).

[5] We are aware of five settlements and seven decisions on motions to dismiss in actions filed during the study period. *See infra* Sections IX and X.

[6] *Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 103d Cong., 1st Sess. 280 (1993) [hereinafter *Private Litigation Under the Federal Securities Laws*] (Statement of Senator Dodd).

II. LITIGATION RATES

Perhaps the most basic question regarding the impact of the Reform Act is whether it has caused a decline in class action securities fraud litigation. To measure changes in litigation activity, we focus on the number of issuers sued rather than the number of class action complaints filed.[7] In a typical class action securities litigation, a single issuer will be sued in multiple complaints filed by different named plaintiffs represented by different plaintiffs' law firms. These complaints are generally consolidated and litigated as a single proceeding. The number of issuers sued is therefore a superior predictor of the volume of post-consolidation litigation, of the costs imposed by litigation, of recoveries by plaintiffs, and of the number of dispositions either by dismissal, settlement, or verdict.

Because the Reform Act is a federal legislative initiative that may or may not preempt state law, plaintiffs may attempt to avoid the heightened pleading requirement and other provisions of the Reform Act by seeking alternative remedies through state court proceedings. If these alternative remedies are equally effective, we should observe a substitution effect that simply shifts litigation from the federal forum to state court without reducing the aggregate incidence of filings. To the extent that state court causes of action are less attractive than federal claims, the substitution effect may be correlated with a decline in the aggregate volume of litigation. The Reform Act's effect on overall litigation rates can therefore be measured only by aggregating post-Reform Act litigation activity at the federal and state level and comparing that litigation rate with aggregate federal and state activity prior to the Act.

The aggregate litigation rate must also distinguish between issuers sued in state court only—cases which provide strong indicia of substitute litigation—and issuers sued in parallel federal and state court proceedings, a pattern which may be characteristic of litigation strategies unrelated to a pure substitution effect. In addition, issuers can be sued in state court on derivative claims which are not subject to the provisions of the Reform Act. The state court data must therefore be carefully filtered to identify only those claims and causes of action which are either substitutes for or parallel to claims that could otherwise be asserted as federal class action securities fraud claims.

[7] Information on issuers sued in securities class actions was obtained from a number of sources. The Reform Act simplified our data collection efforts in this regard because it requires that plaintiffs filing class action complaints in federal court publish a notice in either a widely-circulated, national, business-oriented publication or a wire service advising putative class members of the pendency of the action, the claims asserted, and the purported class period. 15 U.S.C. §§ 77z-1(a)(3)(A), 78u-4(a)(3)(A). We have searched for these notices, which to date have tended to appear in Business Wire or as legal notices in *Investors Business Daily*. We have supplemented review of these sources with computer searches of the Westlaw news database, Nexis, the LEXIS SEC filings database, and *Securities Class Action Alert*.

The data described below suggest that the Reform Act has at most only modestly reduced the aggregate rate of securities class action fraud litigation, but has induced a material substitution effect that may have shifted weaker claims to state court. The data are also consistent with the hypothesis that the Reform Act and the Supreme Court's recent decision in *Matsushita v. Epstein*[8] may have created strategic incentives to file parallel state and federal actions against a company in order to gain advantage in discovery and settlement.

Federal Litigation Rates

Between December 22, 1995, and December 31, 1996, at least 109 companies were named as defendants in securities fraud class actions filed in federal court. Appendix A lists the companies sued in federal complaints and notes the dates of the first identified filings and the courts in which the litigation was brought. Cases were included in the database if we were able to obtain information concerning the filing date, the parties, the court in which the action was filed, and the nature of the allegations.[9] Table 1 presents the total number of companies sued per calendar quarter in 1996 and shows that the filing rate of sixteen in the first quarter of 1996 was approximately half the average quarterly rate of thirty-one recorded in the remaining three quarters of the year.

Table 1
Federal Court Litigation
December 22, 1995–December 31, 1996

	Companies Sued
December 22, 1995–March	16
April–June	28
July–September	34
October–December	31
Total	109
Annualized Federal Litigation Rate Based on April–December Filing Rate	124

The low filing rate in the first quarter of 1996 appears to be the consequence of both an inventory effect and a "learning curve" effect. Anecdotal evidence suggests that there was a significant increase in the filing rate for securities class action litigation in the period just prior to passage of the Reform Act, as plaintiffs' attorneys sought to avoid application of the Act to cases they were preparing to file.[10] This phenomenon would have decreased the number of securities class action cases filed during the first quarter of 1996 if cases that would have otherwise been filed during that period were instead filed in December 1995 to beat the Reform Act's effective date. The relatively low filing rate in the first quarter may also be the result of a learning curve effect, whereby plaintiffs'

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[8] 116 S. Ct. 873 (1996).

[9] There are several cases for which at least one piece of this information was unavailable. These cases were omitted from the study. Our estimates of litigation activity are therefore conservative.

[10] Richard B. Schmitt, *Laws Intended to Limit Suits Clog Up Courts*, WALL ST. J., Jan. 24, 1996, at B1.

attorneys delayed filings until they had analyzed how to best plead cases under the Reform Act's new provisions and resumed activity once they had developed pleading strategies that they believed were more suitable to the new statutory environment.[11]

The filing rate that prevailed during the last three quarters of 1996 is therefore likely a better predictor of the overall post-Reform Act litigation rate. Extrapolating from the last nine months of 1996 suggests an annual rate of 124 companies named in federal securities fraud class actions.

Obtaining a measure of the pre-Reform Act filing rate, however, is not so straightforward.[12] The traditional source of statistical information concerning overall civil and criminal filing rates in federal court are the yearly statistical abstracts of litigation activity published by the Administrative Office of the United States Courts. The legislative history to the Reform Act contains Administrative Office data suggesting that for fiscal years 1990 and 1991, 315 and 299 securities class actions were filed, respectively.[13] These statistics are not reliable, however. The Administrative Office data are generated from tabulations of Civil Action Cover Sheets that are completed by the counsel filing the complaint. It is common practice for more than one complaint to be filed against a company alleged to have committed a fraud and for those complaints to be later consolidated into a single action. In some situations as many as fifteen complaints may be filed against a single company, and all may later be consolidated.[14] To the extent that each counsel filing a complaint that is later consolidated into a single action also files a Civil Action Cover Sheet identifying a securities fraud class action, the Administrative Office data may overstate the volume of litigation activity by including duplicative lawsuits in the count.

At the same time, however, Administrative Office data can also understate litigation activity because plaintiffs' counsel can fail to identify their claims accurately on the Civil Action Cover Sheet as securities fraud class actions. A recent Federal Judicial Center study of all terminated class action litigation in four district courts from July 1, 1992, to June 30, 1994, concluded that the Administrative Office data tended to undercount substantially the amount of class action litigation.[15] There appear to be no reliable techniques that can be applied to the Administrative Office data to generate accurate estimates of the number of issuers that historically have been sued in federal courts alleging class action securities frauds. We therefore do not rely on these data.

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[11] The 1997 data compiled to date support these hypotheses. In January 1997, at least fourteen companies were sued in federal securities fraud class actions. By comparison, only five companies were sued in January 1996, and the number of companies sued in January 1997 is only two less than were sued in the entire first quarter of 1996.

[12] During the Congressional debates over securities litigation reform, Senator Dodd, at the time the Chair of the Senate Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, commented that the

> academic and other experts who had done studies on top of studies on securities litigation ... disagreed as to the facts.
>
> Consequently, after a long hearing...we found no agreement on whether there is in fact a problem, the extent of the problem, or the solution to the problem. In my experience with this subcommittee, I've never encountered an issue where there is such disagreement over the basic facts. We often argue about policy, we argue about ideology, we often argue about politics, but it is rare that we spend so much time arguing about basic facts.

Private Litigation Under the Federal Securities Laws, *supra* note 6, at 280; *see also* WILLGING, *supra* note 4, at 199 (concluding that "in the recent past there were no reliable national data on the number of class action filings and terminations in the federal courts.").

[13] *Private Litigation Under the Federal Securities Laws*, *supra* note 6, at 121 (Prepared Statement of William R. McLucas, Director, Division of Enforcement, United States Securities and Exchange Commission).

[14] This is the case in the post-Reform Act securities fraud litigation involving the shares of Vista 2000.

[15] WILLGING, *supra* note 4, at 198-99. The Federal Judicial Center study documented that the Administrative Office data identified only between one-fifth to one-half of the class action activity in the four districts.

Instead, for estimates of baseline data describing the volume of litigation activity prior to passage of the Reform Act, we turn to two surveys that tabulate different measures of federal class action securities fraud litigation activity but generate highly consistent measures of average litigation rates over the five year period spanning 1991 through 1995. First, as described in Table 2, a survey of federal court filings of security class action suits found a range of 153 to 220 filings per year, with an average annual litigation filing rate of 177 filings per year. Second (also in Table 2), a survey of total dispositions of federal class action securities fraud litigation shows a range of 138 to 220 dispositions per year, with an average of 176 dispositions per year over the 1991–1995 period. While annual disposition rates can differ dramatically from annual filing rates because of unstable lags in the litigation process, in a steady state the number of filings per year will, on average and over time, equal the number of dispositions of securities fraud class actions per year, whether by settlement, motion to dismiss, summary judgment, jury verdict, or other means. Taken together, the two surveys support an estimate of 176.5 filings per year in the five years prior to the effective date of the Reform Act.

Table 2
Average Annual Litigation Rates
Pre-Reform Act

	Federal Court Filings[16]	*Total Dispositions*[17]
1991	153	138
1992	192	156
1993	158	173
1994	220	191
1995	162	220
Total	**885**	**878**
Annual Average	**177**	**176**

At this stage, the natural inclination is to compare the volume of 1996 litigation reported in Table 1 with the baseline data reported in Table 2 and conclude that the volume of litigation has decreased from approximately 176 companies per year to either: (a) 109 companies per year (a 38% decline) based on observed annual filings; or (b) 124 companies per year (a 30% decline) based on an annualized litigation rate that ignores the low-level first quarter activity due to potential inventory and learning curve effects. Either interpretation of the data is fundamentally flawed because much of this decline appears to be the result of a substitution effect from federal to state court proceedings.

[16] Denise N. Martin, et al., *Recent Trends IV: What Explains Filings and Settlements in Shareholder Class Actions?* (National Economic Research Associates, Nov. 1996) at Table 1.

[17] *Id.* at Table 5.

State Litigation Rates

It has historically been more profitable for plaintiffs to initiate class action securities fraud litigation in federal court rather than in state court. Counsel with substantial experience in litigating securities fraud matters suggest that the volume of class action securities fraud litigation in state court has, until passage of the Reform Act, been *de minimis*.[18] Four recent developments, however, suggest an increased incentive to initiate class action securities fraud litigation in state court either instead of or in addition to federal litigation.

First, the new pleading requirements, rules governing joint and several liability, discovery stays, and other provisions of the Reform Act impose costs on plaintiffs that can potentially be avoided in state court. To the extent that the Act shifts the relative profitability of class action litigation in favor of state court, there should be a substitution into state court from federal court. For the defendant, however, the burdens and costs of defending against a state law claim are likely just as large as those in a federal action, and the size of a settlement or judgment can also be just as great.

Second, the automatic stay of discovery contained in the Reform Act provides an incentive to file a parallel state law action as a means to avoid the federal stay. Recent litigation suggests that this incentive is in fact at work. State actions filed for this reason are not, however, a measure of increased litigation activity, rather they are evidence of a new litigation strategy. Any attempt to measure the effect of the Reform Act on class action securities fraud litigation activity must therefore be careful to distinguish between state cases that represent new claims against companies not otherwise sued in federal court and parallel claims that are brought primarily for strategic advantage. Nonetheless, parallel state actions represent an increase in the costs of litigation to the extent that the Act provides an incentive to file duplicative actions.

Third, the Supreme Court's recent decision in *Matsushita v. Epstein*[19] may strengthen the incentives to file substitute or parallel claims by establishing that state court settlements may discharge federal securities law claims that could otherwise only be brought in federal court. A plaintiff who seeks to avoid the new settlement procedures adopted in the Reform Act, who prefers not to deal with the lead plaintiff designated in the federal action, or who otherwise concludes that a more favorable settlement may be available in the state forum, may attempt to resolve all federal and state claims through state procedures that may not respect the Reform Act's innovations.

[18] It is important to distinguish state securities class actions from state derivative actions that "piggyback" on the filing of a federal court class action. Derivative actions filed in the wake of a class action suit are not uncommon and typically allege that the company's officers and directors violated their fiduciary duties by exposing the company to litigation expenses and potential liability in the securities class actions. *See* Joseph A. Grundfest and Michael A. Perino, *The Pentium Papers: A Case Study of Collective Institutional Investor Activism in Litigation*, 38 ARIZ. L. REV. 559, 590-91 n.171 (1996). By contrast, state securities class actions assert either: (i) a claim involving an IPO or follow-on offering under the Securities Act of 1933; or (ii) a state common law or Blue Sky claim alleging fraudulent activity in connection with the purchase or sale of a security.

[19] 116 S. Ct. 873 (1996).

Fourth, the prospect of passage of California's Proposition 211, a ballot initiative that sought to establish California state securities laws that were substantially more plaintiff-favorable than current federal law, may have also increased the incentives to commence litigation in California state court.[20] With the defeat of Proposition 211 in November of 1996, this incentive to file in California state court is not currently present. The pendency of Proposition 211 may therefore be the cause of a transitory and non-recurring increase in the volume of California state litigation activity.

Because plaintiffs are not required to disseminate notice of the filing of state court securities class actions, it is difficult to obtain accurate information on the number and nature of these state court cases.[21] As a result, the data upon which this report is based may significantly undercount the actual number of state court filings, particularly for state court cases outside of California. For this reason, we do not attempt to draw any conclusions from these data concerning seasonal filing rates or trends in state court filings. Nonetheless, the available evidence suggests a significant increase in state litigation activity over the *de minimis* levels of prior years.[22] Table 3 shows that from December 22, 1995, to December 31, 1996, sixty-nine companies were sued in securities fraud class action lawsuits filed in state court.[23] Of these, thirty-nine were sued solely in state court with no parallel federal complaint in 1996. Although some of this increase in activity may be due to factors like Proposition 211, it appears that a significant portion of this increase is in some way attributable to the Act.

Table 3

State Court Litigation
December 22, 1995–December 31, 1996

	Companies Sued
Number of Companies Sued in State Court (adjusted for multiple state court filings)	69
Number of Companies Sued in Both Federal and State Court	30
Number of Companies Sued Solely in State Court	39

[20] Proposition 211 was defeated in elections held on November 5, 1996. Elizabeth Corcoran, *California Voters Reject Proposition 211; Silicon Valley Fought Measure Making Shareholder Fraud Suits Easier*, WASH. POST, Nov. 7, 1996, at D3; Greg Lucas, *Prop 211 Loses By Wide Margin*, S.F. CHRON., Nov. 6, 1996, at A9.

[21] See Appendix B for a list of the companies we have identified in state complaints, along with the filing dates, the courts in which the litigation was brought, and whether there is a parallel federal complaint arising out of the same factual allegations.

[22] *Nation Briefly: Federal Tort Law Seems to Increase State Cases*, ORANGE COUNTY REG., Jul. 23, 1996, at C3; Patrice Duggan Samuels, *Investing It: Litigation Law Creates Work for Disclaimer Writers*, N.Y. TIMES, Apr. 14, 1996, at § 3, at 3.

[23] This figure is adjusted to account for companies that were sued in more than one state.

Table 4 describes actual and estimated class action securities fraud litigation rates in federal and state courts. We have observed a total of 148 companies actually sued in state or federal court in the study period, after eliminating double-counting due to the presence of parallel state and federal proceedings. Annualizing the April through December federal litigation rates yields an expected total of 163 companies sued in federal and state court. These figures represent a decline of 7% to 16% when compared to the average number of filings and dispositions in the period from 1991 through 1995. However, the 1991 though 1995 data demonstrate a significant range, and the 1996 data are not materially different from the data for 1991, 1993, and 1995, when filings were 153, 158, and 162, respectively.

Table 4
Actual and Estimated Litigation Rates in Federal and State Court Based on 1996 Data

	Actual Litigation	*Extrapolated Rate Based on April–December Federal Filings*
Federal	109	124
State	39	39
Total	**148**	**163**

It is too soon to draw any firm conclusions from these data with respect to the effect the Reform Act has had on the aggregate number of securities class action lawsuits filed per year. The difficulty in drawing such conclusions is compounded by the difficulties associated with obtaining a complete census of state court class action activity. Nonetheless, these data suggest that the Reform Act appears to have had a modest effect at best on aggregate securities litigation activity. The more significant effects associated with the Reform Act appear to be the substitution effect that has shifted the venue for much of this litigation from federal to state court and the newly created incentives to file parallel litigation in state court.

III. CHARACTERISTICS OF THE COMPANIES SUED

In addition to questions concerning the Act's effect on the level of securities litigation activity, another important question is whether the Act has caused any material decline in the number of "meritless" lawsuits. Direct evidence on this issue may be difficult to obtain, particularly in light of disputes between plaintiff and defendant constituencies as to whether any individual claim has merit. Nonetheless, an investigation of the market characteristics[24] of the firms sued before and after the Act reveals interesting patterns that may, over time, shed light on the extent to which plaintiff class action securities fraud litigation is, or is not, "merit-driven."

Market Capitalization

Data on the capitalization of companies named as defendants in federal class action securities fraud litigation suggest that issuers sued since the Reform Act became effective are, on average, smaller than issuers that were sued prior to the Reform Act. The reduction in the size of the average defendant issuer appears to be attributable entirely to a dramatic decline in litigation against the largest issuers, *i.e.*, those with a market capitalization in excess of $5 billion.

Table 5 presents data comparing the size of issuers sued before and after the effective date of the Reform Act. The mean market capitalization of issuers sued in cases raising Section 10(b) claims but no Section 11 claims prior to the Reform Act was approximately $2,080 million, with a median of $180.0 million. Since the effective date of the Reform Act, the mean capitalization of issuers sued in comparable Section 10(b) cases has dropped to $529.3 million while the median has increased to $193.0 million.

[24] Basic firm characteristics, including measures of market capitalization, stock price declines, and beta were calculated using information obtained from Bloomberg for a number of different sub-samples of the sixty-five companies named in post-Reform Act complaints we were able to obtain. These complaints are listed in Appendix C. Appendix D describes these sub-samples. A number of companies were eliminated from the samples when calculating market capitalization, stock price declines, and beta because of insufficient information. Appendix D also contains a description of the companies eliminated and the reasons for their elimination. Market capitalization was calculated for the day before the stock price decline around the end of the class period (day t-1) using Bloomberg's historical price and Edgar filing functions. Daily stock price return on the day of this stock price decline (day t) was also calculated using the historical price function. For those cases that did not have a stock price decline around the end of the class period, t-1 is defined to be the last day of the class period. Finally, Bloomberg's beta function was used to obtain stock beta over the 125 day period ending on t-1. Beta was calculated by regressing daily stock price returns on S&P 500 index returns.

Table 5

Market Capitalization
Pre- and Post-Reform Act

	Sample Size	*Mean (Millions)*	*Median (Millions)*	*Standard Deviation (Millions)*
Section 10(b)/No Section 11				
Pre-Reform Act Simmons Sample[25]	166	$2,080.0	$180.0	$716.0
Post-Reform Act Sample	45	$529.3	$193.0	$787.5
Section 10(b) and/or Section 11				
Pre-Reform Act Jones and Weingram Sample of Litigation Following Stock Price Declines ≥ 10%[26]	200	$1,264.0	$247.0	$3,691.0
Post-Reform Act Sample	58	$467.0	$173.0	$725.0
Post-Reform Act Sample of Litigation Following Stock Price Declines ≥10%	53	$496.0	$175.0	$751.0

As is apparent from Table 6, this sharp decline in mean capitalization accompanied by relative stability in median capitalization is almost entirely attributable to the absence in the sample studied of any litigation against issuers with a capitalization in excess of $5 billion.[27] Preliminary analysis thus suggests that the Reform Act has cut off the tail of the size distribution of defendant firms by sharply reducing claims against the largest firms.

[25] Laura E. Simmons, database compiled for doctoral dissertation, *Rule 10b-5 Litigation: An Examination of Merit and Nonmerit-Based Factors Associated with Litigation Outcomes* (Aug. 1996) (on file with authors) [hereinafter *Simmons Database*].

[26] CHRISTOPHER L. JONES & SETH E. WEINGRAM, THE DETERMINANTS OF 10b-5 LITIGATION RISK (John M. Olin Program in Law and Economics, Stanford Law School, Working Paper No. 118, June 1996) at Table 3 [hereinafter *Determinants of 10b-5 Litigation Risk*].

[27] At least one company sued in federal court in 1996, United Healthcare, has a market capitalization in excess of $5 billion. That action has already been voluntarily dismissed. *See infra* Section IX. The market capitalization figures discussed herein will be updated to encompass all companies sued in federal court in 1996.

Table 6
Breakdown of Market Capitalization Samples

	Pre-Reform Act Simmons Sample[28]		*Post-Reform Act Sample*	
Capitalization (Millions)	*Observations*	*Percent*	*Observations*	*Percent*
Under $100	54	32.53%	12	26.67%
$100–$199	31	18.67%	11	24.44%
$200–$499	30	18.07%	7	15.56%
$500–$999	20	12.05%	9	20.00%
$1,000–$4,999	17	10.24%	6	13.33%
Over $5,000	14	8.43%	0	0.00%
Total	**166**	**100.00%**	**45**	**100.00%**
Mean	$2,080.0		$529.3	
Median	$180.0		$193.0	
Standard Deviation	$716.0		$787.5	

Because the average IPO has a smaller capitalization than the average firm already traded on the market, we expect that the pre- and post-Reform Act differentials in size of defendant firms would diminish if capitalizations are calculated for pooled Section 10(b) and Section 11 claims. Table 5 indicates just such an effect, but demonstrates that post-Reform Act defendant firms are, on average, still significantly smaller than defendants sued prior to the Reform Act's effective date.

As explained in detail below, this new pattern in defendant selection is consistent with our observation that the preponderance of post-Reform Act litigation involves allegations of accounting irregularities and trading by insiders.[29] Larger, more established firms are less likely sources for material accounting irregularities or statistically significant trading by insiders. Larger firms are therefore less likely to be named as defendants. In addition, the stock market has experienced a substantial increase in value since the effective date of the Reform Act, with much of the market's strength centered on the most well-capitalized issuers. Between December 29, 1995, and December 31, 1996, the total returns for the S&P 500 were 22.92%. In contrast, the returns for the Russell 2000 Index were 16.52% over the same period.[30] That price pattern is also consistent with a shift toward litigation targeting smaller issuers.

Recent speculation that plaintiffs' class action law firms are avoiding litigation against the largest issuers because of concerns regarding the vigor with which they will defend such litigation is therefore not necessarily correct. Other factors may be sufficient to explain this pattern in the data.

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[28] *Simmons Database*, *supra* note 25.

[29] *See infra* Sections IV and V.

[30] Both figures include dividends reinvested monthly.

Stock Price Declines Associated With Litigation

Among the more controversial claims made in the debate leading up to adoption of the Reform Act was that a significant stock price decline was frequently sufficient to trigger a class action securities fraud claim.[31] Recent research suggests that this assertion is overstated.[32] A more accurate characterization is that a significant stock price decline over a short period of time can be a necessary but not sufficient condition leading to class action securities fraud litigation.

Analysis of data describing litigation instituted since the Reform Act became effective suggests that, whatever the causal mechanism linking stock price declines and the institution of class action securities fraud litigation, the decline triggering post-Reform Act litigation is greater than the decline triggering pre-Reform Act litigation. As illustrated in Table 7, the average one-day stock price decline around the end of the class period in a sample of 161 pre-Act cases alleging violations of Section 10(b) but not of Section 11, was approximately 19%. A sample of forty-six equivalent post-Reform Act lawsuits indicates an average one-day decline around the end of the class period of about 31%.

Table 7
Stock Price Declines
Pre- and Post-Reform Act

	Observations	*Mean*	*Median*	*Standard Deviation*
Section 10(b)/No Section 11				
Pre-Reform Act Simmons Sample[33]	161	-19.32%	-17.54%	14.32%
Post-Reform Act Sample	46	-30.68%	-28.18%	19.07%
Section 10(b) and/or Section 11				
Pre-Reform Act Jones and Weingram Sample of Litigation Following Stock Price Declines ≥ 10%[34]	200	-24.80%	-21.40%	13.40%
Post-Reform Act Sample of Litigation Following Stock Price Declines ≥ 10%	54	-33.50%	-31.50%	15.40%
Post-Reform Act Sample Without Regard to Level of Price Declines	59	-30.70%	-29.00%	17.60%

A similar increase in stock price declines is found if Section 11 and Section 10(b) cases are pooled in a single sample. A study of 200 class action lawsuits instituted after 10% price declines finds that the average decline surrounding the end of the class period was 24.8%.[35] The equivalent statistic for a sample of fifty-four post-Reform Act cases shows a decline of 33.5%. A sample of fifty-nine post-Reform Act cases, which includes five cases brought after one-day declines of less than 10%, shows a one-day average decline of 30.7%.

[31] *See* H.R. CONF. REP. NO. 369, 104th Cong., 1st Sess. 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730.

[32] *Determinants of 10b-5 Litigation Risk*, *supra* note 26.

[33] *Simmons Database*, *supra* note 25.

[34] *Determinants of 10b-5 Litigation Risk*, *supra* note 26, at Table 3.

[35] *Id.*

This increase in one-day stock price declines observed around the end of the class period is consistent with the theory that plaintiffs must, on average, demonstrate more dramatic wrongdoing in the post-Reform Act environment in order to satisfy the new federal pleading standard. Further statistical analysis is necessary, however, to support this conjecture. In particular, it would be valuable to know whether the average stock price decline associated with state court filings that have no parallel federal claims are systematically smaller than those associated with federal claims.

Beta of Defendant Issuers

Beta is a measure of the riskiness of a given firm's stock based on correlation between the movement of its stock price and the movement of a broad-based stock market index. A beta in excess of one indicates greater than average risk in that the stock price tends to move more dramatically than the index as a whole, while a beta of less than one indicates below-average risk in that the stock price tends to move less dramatically than the index as a whole.

Preliminary analysis of a sample of forty-six companies suggests that companies sued after the Reform Act are riskier than the market, with an average beta of 1.39, but perhaps no riskier than the targets of pre-Reform Act litigation, with average betas variously reported as 1.190,[36] 1.25,[37] 1.408.[38] Thus, while targets of class action securities fraud litigation continue to be riskier, on average, than the market index as a whole, the data do not yet indicate a systematic change in the average beta of target companies.

The Incidence of Litigation by Industry

High-technology companies were among the most vocal proponents of securities litigation reform,[39] in large part because experience prior to the Reform Act indicated that high-technology companies were involved in a disproportionately large number of securities fraud class action cases. One study of securities fraud class action litigation from 1989 through 1992 concluded that high-technology companies were sued twice as often as firms in other industries.[40] A study of 348 settlements of open-market fraud securities class actions found that 30.5% were high-technology companies, 22.4% were in financial services, and 47.1% were in some other industry.[41] Thus, an important question is whether the overall rate of litigation against high-technology or other industries has changed in the post-Reform Act period.

[36] Vincent E. O'Brien, *A Study of Class Action Securities Fraud Cases 1988-1996* at 8 (available at http://www.lecg.com/study2.htm#att).

[37] LAURA E. SIMMONS, CORNERSTONE RESEARCH, THE IMPORTANCE OF MERIT-BASED FACTORS IN 10b-5 LITIGATION Table 2 (Nov. 14, 1996) (on file with authors) [hereinafter *Merit-Based Factors*].

[38] *Determinants of 10b-5 Litigation Risk*, *supra* note 26, at Table 3.

[39] *See generally*, *Private Litigation Under the Federal Securities Laws*, *supra* note 6.

[40] CHRISTOPHER L. JONES AND SETH E. WEINGRAM, WHY 10b-5 LITIGATION RISK IS HIGHER FOR TECHNOLOGY AND FINANCIAL SERVICES FIRMS 4 (John M. Olin Program in Law and Economics, Stanford Law School Working Paper No. 112, July 1996) [hereinafter *Litigation Risk*].

[41] Willard T. Carleton, et al., *Securities Class Action Lawsuits: A Descriptive Study*, 38 ARIZ. L. REV. 491, 497-98 (1996). Other studies have found similar or higher percentages of high-technology companies. Jones and Weingram studied a sample of 411 cases and found 27.3% involved high-technology companies and 26% involved financial services companies. *Determinants of 10b-5 Litigation Risk*, *supra* note 26, at Table 2. Another study of 319 securities class action settlements found that 31.7% involved high-technology companies while 20.4% involved commercial banking, finance, and insurance. In 81 cases that were dismissed, 43.21% involved high-technology. Overall, 34% of the cases studied involved high-technology companies. Frederick C. Dunbar, et al., *Recent Trends III: What Explains Settlements in Shareholder Class Actions?* (National Economic Research Associates, June 1995) at Tables 6a & 6b [hereinafter *Recent Trends III*].

To determine the post-Reform Act incidence of litigation activity by industry, we use the Standard Industrial Classification ("SIC") codes that were employed in the Jones and Weingram (1996) study. We rely on the primary SIC codes listed on the issuer/defendant's Form 10-K as it appears in the LEXIS database or on company profiles contained in the LEXIS Company library. Where no SIC information was available on-line for a particular defendant, we rely on SIC information compiled by the Center for Research in Security Prices ("CRSP") at the University of Chicago.

Table 8 indicates that of the 109 issuers sued in federal court from December 22, 1995, through December 31, 1996, approximately 34% are high-technology companies, an estimate within the range found in pre-Reform Act samples. The Reform Act thus seems to have had little effect on the percentage of "high-tech" firms named in securities fraud class action lawsuits.

Table 8
Litigation by Industry
Pre- and Post-Reform Act

	Jones and Weingram Study[42]		*Post-Reform Act Complaints*	
Industry	*Number*	*Percent*	*Number*	*Percent*
High-Technology	112	27.3%	37	33.9%
Finance	107	26.0%	11	10.1%
Other	192	46.7%	61	56.0%
Total	**411**	**100.0%**	**109**	**100.0%**

Actions involving finance companies constitute 10.1% of the complaints. In contrast to the rate of litigation against high-technology companies, the rate of litigation against finance companies appears to have dropped significantly. It does not appear, however, that this decrease is attributable to passage of the Reform Act. This result is, instead, consistent with the results of earlier studies which observed a decreasing rate of litigation against commercial banks[43] attributable primarily to the end of the savings and loan crisis and the associated reduction in loan loss reserve litigation.[44]

[42] *Determinants of 10b-5 Litigation Risk*, *supra* note 26.

[43] *See, e.g.*, *Recent Trends III*, *supra* note 41, at 7.

[44] For suits alleging misrepresentations regarding loan portfolios and loan loss reserves, see generally *Shields v. CityTrust Bancorp, Inc.*, 25 F.3d 1124 (2d Cir. 1994); *Ratner v. Bennett*, 1996 U.S. Dist. LEXIS 6259, Fed. Sec. L. Rep. (CCH) ¶ 99,225 (E.D. Penn., May 8, 1996); *Grossman v. Texas Commerce Bancshares, Inc.*, 1995 U.S. Dist. LEXIS 13501, Fed. Sec. L. Rep. (CCH) ¶ 98,964 (S.D.N.Y., Sept. 15, 1995); *Lerner v. FNB Rochester Corp.*, 841 F. Supp. 97 (W.D.N.Y 1993); *Goldberg v. Hankin*, 835 F. Supp. 815 (E.D. Penn. 1993).

IV. THE NATURE OF FRAUDS ALLEGED

Another measure of the impact of the Act on securities litigation is whether there have been material changes in the frequency of particular allegations of fraudulent conduct. Our analysis of the nature of the frauds alleged is based on our review of sixty-five, post-Reform Act, federal court complaints that we were able to obtain.[45] A comparison of these post-Reform Act complaints and available baseline data from pre-Reform Act cases suggests that there has been a significant change in the frequency of particular allegations, apparently in response to the Reform Act's new heightened pleading standard.[46]

As illustrated in Table 9, one of the most common forms of fraud alleged in the sixty-five complaints analyzed are misrepresentations or omissions in financial statements which appear in 58.5% of the complaints. Thirty complaints (or 79% of those alleging false and misleading financial statements) allege a violation of Generally Accepted Accounting Principals ("GAAP"). Of the thirty-eight complaints alleging misrepresentations or omissions in financial statements, thirty-six (or 95%) allege improperly recorded sales, revenues, or earnings. Allegations of misstated financials account for 67.4% of the forty-six complaints that are based solely on alleged Section 10(b) violations.

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[45] We were unable to obtain every complaint filed against every issuer. While complaints filed against a single issuer often contain substantially similar allegations, there may be variations in the allegations made or defendants sued among the separate complaints, and our data may therefore undercount the incidence of certain types of claims. To prevent an over-counting problem, our database consists of only one complaint for each issuer sued. If we were able to obtain more than one complaint, we chose for our sample either: (i) the first complaint we received, or (ii) if multiple complaints were received at one time, the complaint that appeared to contain the most detailed allegations. Appendix C contains a list of the complaints reviewed in our analysis.

[46] Because a single complaint can contain multiple allegations of fraud, the total number of "violative acts" constituting fraud exceeds the number of lawsuits filed.

Table 9

Comparison of Allegations Contained in Pre- and Post-Reform Act Cases

Type of Allegation	*Pre-Reform Act 10b-5 Cases* (174 Observations)		*Post-Reform Act 10b-5 Cases* (46 Observations)		*All Post-Reform Act Cases* (65 Observations)	
	Number	*Percent*	*Number*	*Percent*	*Number*	*Percent*
Misrepresentations in Financial Statements	59	33.9%	31	67.4%	38	58.5%
Trading by Insiders During Class Period	36	20.7%	26	56.5%	34	52.3%
False or Misleading Forward-Looking Statement	N/A	N/A	28	60.9%	42	64.6%
False or Misleading Forward-Looking Statement as Sole Allegation	N/A	N/A	3	6.5%	9	13.8%

The frequency of these accounting-driven allegations appears to have increased markedly in the post-Reform Act period. A study of 174 pre-Reform Act Section 10(b) cases found that only 33.9% of the sample contained allegations of misstated financials.[47] This change in allegations does not mean that there is more accounting fraud in the post-Reform Act period. The significant increase in the number of cases involving misrepresentations and omissions in financial statements, particularly those that allege improperly recorded sales, earnings, or revenues or a GAAP violation, is consistent with the Reform Act's higher pleading standard which requires plaintiffs to plead facts giving rise to a strong inference of scienter. Plaintiffs may believe that courts will be more likely to find that they have satisfied their pleading obligations in cases involving such misrepresentations or omissions.

One unexpected result found in the complaints analyzed, however, is the significant number that also contain allegations involving false or misleading forward-looking statements. The Reform Act created a safe harbor for the release of forward-looking information in certain circumstances. Indeed, one of the chief concerns expressed in the Act's legislative history is that companies that released forward-looking information in the pre-Reform Act period were susceptible to securities fraud class actions if those forecasts proved to be inaccurate, regardless of any proof of the company making an intentionally misleading forecast.[48] Nonetheless, as detailed in Table 9, forty-two of the sixty-five post-Reform Act complaints analyzed (or 64.6%) contain allegations of false forward-looking statements. Among the forty-two complaints alleging false forward-looking statements, thirty-two (or 76%) allege that the misleading forward-looking statement concerned earnings, sales, or revenue forecasts.

[47] *Merit-Based Factors, supra* note 37, at Table 2.

[48] H.R. CONF. REP. NO. 369, 104th Cong., 1st Sess. 42-43 (1995), *reprinted in* 1995 U.S.C.C.A.N. 741-42.

One possible reason that allegations of false forecasts remain a significant part of the litigation landscape is that many of the forecasts alleged to be false occurred prior to the passage of the Reform Act, making it unlikely that any of the companies complied with the safe harbor requirements. It is also important to recognize that allegations of false forecasts were rarely the sole allegation contained in the complaint. Indeed, only nine complaints (or 13.8%) had false forward-looking information as the sole basis for their allegations of securities fraud. In the sample of forty-six Section 10(b) cases that figure drops to three (or 6.5%). In the remaining cases, allegations of false forward-looking statements, were combined with some other allegation of fraud. Thus, where other allegations may be sufficient to satisfy the new pleading standards, plaintiffs may consider that there is little downside in alleging false forecasts as well.

It may also be significant that the nine complaints alleging false forward-looking statements as the sole basis for liability all arose after June 1, 1996. These complaints were thus all filed after the Central District of California's May 21 decision in *Marksman Partners, L.P. v. Chantal Pharmaceutical Co.*[49] As discussed more fully below,[50] that decision is significant because the court's interpretation of the new pleading standard was consistent with pre-Reform Act precedent from the Second Circuit. The court rejected language in the Act's legislative history suggesting that the pleading standard was even more stringent than the Second Circuit's interpretation. Some plaintiffs' attorneys may have taken this ruling to suggest that some forward-looking statement cases might be able to survive even under the new pleading standard.

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[49] 927 F. Supp. 1297 (C.D. Cal. 1996).

[50] *See infra* Section X.

V. THE INCIDENCE OF ALLEGED TRADING BY INSIDERS

In addition to an observed increase in the frequency of allegations concerning misrepresentations and omissions in financial statements, passage of the Act also appears to be correlated with an increase in allegations of insider trading. As illustrated in Table 9, 52.3% of the complaints studied in this report contain allegations of trading by insiders during the period the alleged fraud was alive in the market. For the forty-six complaints brought solely under Section 10(b), the percentage rises to 56.5%. The only pre-Reform Act study of which we are aware that analyzes insider trading patterns suggests that insider trading allegations appeared in only 20.7% of a sample of 174 Section 10(b) pre-Reform Act cases.[51] This significant increase in alleged insider trading is consistent with the theory that plaintiffs are increasingly relying on trading by insiders to support the "strong inference" pleading requirement of the Reform Act.

There also appears to be a significant correlation between the frequency of alleged trading during the class period and the industry of the issuer.[52] Table 10 shows that 73.1% of the complaints involving high-technology companies contain allegations of insider sales, compared to approximately 38.5% for all other issuers. Given that stock option compensation in the high-technology sector is more common than in other sectors of the economy, this finding is not surprising. At the same time, however, this compensation practice also means that the baseline level of "normal" insider sales in the high-technology sector is greater than in other sectors. It would therefore be incorrect to draw any inference from these data that opportunistic behavior by insiders is more common in the high-technology sector than in other sectors.

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[51] *Simmons Database*, *supra* note 25. This study differed from our study because it did not analyze complaints but instead relied on case descriptions from *Securities Class Action Alert*, *Class Action Reports*, press articles, and any available court opinions.

Other studies have commented on the connection between insider trading and class action litigation. One commentator observed that there appeared to be some correlation between securities suits and active trading by management prior to a decline in the stock price. O'Brien, *supra* note 36, at 8. The author, however, did not quantify the connection, and only reported that "for most of the companies sued, management had been actively trading the company's stock prior to the decline in stock price." *Id.* The author also noted that "no scientific study was done" to confirm whether there was indeed a correlation. At least one other study, however, has found no evidence that trading by insiders increases a firm's litigation risk. CHRISTOPHER L. JONES AND SETH E. WEINGRAM, THE EFFECTS OF INSIDER TRADING, SEASONED EQUITY OFFERINGS, CORPORATE ANNOUNCEMENTS, ACCOUNTING RESTATEMENTS, AND SEC ENFORCEMENT ACTIONS ON 10b-5 LITIGATION RISK (John M. Olin Program in Law and Economics, Stanford Law School, Working Paper No. 139, Dec. 1996).

[52] Indeed, our estimates concerning the frequency of insider trading allegations may be somewhat skewed because our sample of cases contains a slightly higher percentage of high-technology companies (40% for the sample of sixty-five and 48% for the sample of forty-six) than the entire population of 109 companies sued in 1996 (34%). Future versions of this report will examine complaints in all filed class actions.

Table 10
Allegations Contained in Post-Reform Act Cases by Industry

	All Companies (65 Observations)		*High-Technology (26 Observations)*		*Finance (7 Observations)*		*Other (32 Observations)*	
Type of Allegation	*Number*	*Percent*	*Number*	*Percent*	*Number*	*Percent*	*Number*	*Percent*
Misrepresentations in Financial Statements	38	58.5%	13	50.0%	2	28.6%	23	71.9%
Trading by Insiders During Class Period	34	52.3%	19	73.1%	1	14.3%	14	43.8%
False or Misleading Forward-Looking Statement as Sole Allegation	9	13.8%	2	7.7%	2	28.6%	5	15.6%

The observation that trading by insiders occurs even when there is no allegation of fraud raises an important and as yet unresolved question with regard to the interpretation of the "strong inference" pleading standard. If trading by insiders during a period when a fraud is allegedly alive in the market is consistent with patterns observed in situations not involving fraud, how is a court to decide whether such conduct will support a *strong* inference of a state of mind connoting scienter? The resolution of this complex but exceedingly important issue—especially for the high-technology sector—will likely require further statistical research and the evolution of additional legal doctrine refining the notion of strong inference of fraud in the context of "plain vanilla" sales by corporate insiders.

VI. THE INCIDENCE OF CLAIMS ALLEGING FRAUD IN INITIAL OR FOLLOW-ON PUBLIC OFFERINGS

One possible consequence of the Reform Act would be to shift litigation toward claims that do not come under the new heightened pleading standard.[53] In particular, claims brought under Section 10(b) must adequately allege scienter, while Section 11 or Section 12(2) claims alleging fraud in initial or follow-on offerings are not subject to this requirement. The heightened pleading requirement thus imposes a differentially greater burden for pleading Section 10(b) claims than for the pleading of Section 11 or Section 12(2) claims. One predictable consequence of the differential pleading standard would be a shift toward Section 11 and Section 12(2) cases.

Prior to the Reform Act, approximately 21% to 24% of class action securities fraud cases involved claims arising from the sale of securities in initial public offerings or follow-on offerings.[54] Of these underwritten offerings, IPOs accounted for approximately 14%[55] and follow-on offerings 8% to 10%.

To date, we have not observed any increase in the percentage of litigation raising claims of fraud in the sale of securities governed by Section 11 or Section 12(2). In a sample of sixty-five post-Reform Act complaints, fifteen (or 23%) alleged violations of Section 11 or Section 12(2). Allegations involving IPOs are significantly more frequent, accounting for eleven of these claims. Subsequent versions of this report will analyze all 109 companies sued in federal court in 1996 and state court complaints that may assert Securities Act claims.

[53] *See* John C. Coffee, Jr., *The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung*, 51 BUS. LAW. 975, 1002-03 (1996) (noting this possibility).

[54] O'Brien, *supra* note 36, at 7 (estimate of 21-22%); *Recent Trends III*, *supra* note 41, at Table 13 (estimate of 24%).

[55] O'Brien, *supra* note 36, at 7.

VII. APPEARANCE RATIOS OF PLAINTIFF LAW FIRMS

It was generally understood that prior to passage of the Reform Act, a single law firm, Milberg Weiss Bershad Hynes & Lerach ("Milberg Weiss"), played a dominant role as plaintiffs' class action counsel. Available data suggest that during the period from April 1988 through September 1996, Milberg Weiss represented clients in approximately 31.4% of 842 class action securities fraud cases pending nationwide.[56]

Since passage of the Reform Act, Milberg Weiss appears to have become even more dominant in the class action securities fraud litigation process. As illustrated in Table 11, of the total of 109 companies sued in federal court, Milberg Weiss has entered an appearance in at least 51 of these federal cases, for a national federal appearance ratio of 46.8%. If the national sample is expanded to include state claims with parallel federal proceedings, we are able to identify Milberg Weiss appearances in 64 of 109 cases, for a 58.7% appearance ratio.

Table 11

Milberg Weiss Appearance Ratios
December 22, 1995–December 31, 1996

	Companies Sued	*Milberg Weiss Appearances*	*Appearance Ratio*
Federal Court Proceedings	109	51	46.8%
Parallel Federal and State Court Proceedings	109	64	58.7%
California Federal Court Proceedings	24	17	70.1%
Parallel California Federal and State Court Proceedings	24	20	83.3%

These national appearance ratios understate Milberg Weiss' particularly active role in litigation pending in California federal and state courts. In the 24 cases identified as filed in a California federal court, at least 17, or 70.1%, involve appearances by Milberg Weiss. If the California sample is expanded to include California state court claims with parallel federal proceedings, we are able to identify Milberg Weiss appearances in 20 of 24 cases, for a 83.3% percent appearance ratio.

[56] *Id.* 16.

These data must be interpreted with caution, however. In addition to the previous comments regarding the preliminary nature of this research, it is important to emphasize that an appearance ratio should not be confused with a market share for several reasons. First, it is common practice for many law firms to enter appearances on behalf of different plaintiffs in the same case. If the average consolidated class action brings together claims filed by different law firms, then the aggregate appearance ratio for the market as a whole will be greater than 100%. Any individual law firm's appearance ratio, calculated as a percentage of the market's aggregate appearance ratio, will therefore be lower than its appearance ratio calculated on a stand-alone basis. At present, we lack a sufficiently large sample of complete dockets to develop a reliable estimate of any firm's appearance ratio as a fraction of average aggregate appearance ratios.

Second, not all appearances are equal. Prior to the Reform Act, a lead counsel was often designated in class action securities fraud litigation, and that lead counsel typically asserted disproportionate control over the litigation and collected a disproportionate share of the fees awarded, if any, to plaintiffs' counsel in the litigation. It is generally believed that Milberg Weiss, which is the largest of the nation's law firms specializing in class action securities fraud litigation, is often designated lead counsel and often plays a dominant role in the prosecution of these claims. Accordingly, an appearance by Milberg Weiss in any given lawsuit may, on average, indicate a greater influence by that firm than any other making an appearance in the litigation. Again, however, we lack data necessary to adjust for this observation.

Third, the Reform Act established a procedure whereby a lead plaintiff has the obligation to select class counsel subject to approval by the court.[57] To the extent that the addition of this statutorily mandated approval process either increases or decreases the probability of Milberg Weiss being named lead counsel, or changes the dynamics of inter-firm management of plaintiff litigation, appearance ratios observed prior to the Reform Act may have a significance that is different from the appearance ratios observed since the Reform Act's effective date. In particular, to the extent that economies of scale for larger firms, such as Milberg Weiss, make it easier for them to attract coalitions of plaintiffs willing to act as lead plaintiff and to designate Milberg Weiss as counsel, this provision of the Act may increase the firm's significance in the litigation process. On the other hand, to the extent that large institutional investors step forward to influence the counsel selection process away from Milberg Weiss, this provision may diminish Milberg Weiss' future influence. Again, we must await further experience before drawing firm conclusions regarding these effects of the Reform Act.

No doubt, data describing the percentage of total plaintiff class action attorney fee awards captured by each class action counsel would play a useful role in estimating a true "market share" as opposed to an appearance ratio statistic. The data necessary for such calculations are not, however, publicly available. While courts are required to approve the aggregate fee award paid to counsel in class action litigation, the court is typically not called upon to approve the division of that fee among the many law firms potentially representing plaintiffs, and the public record typically contains no information regarding these allocations.

[57] 15 U.S.C. § 78u-4(a)(3)(B)(v).

Notwithstanding these important cautionary statements, Milberg Weiss' increased dominance as measured by the appearance ratios observed to date is consistent with economic theory regarding firm behavior in a market subject to externalities. Specifically, if Milberg Weiss is the largest and best capitalized of the plaintiffs' class action firms, which it appears to be, then it will be best situated to bear the additional cost of delay and uncertainty associated with litigation in the post-Reform Act era. Further, to the extent that in the earliest years following adoption of the Reform Act any one decision reached by any court interpreting a provision of the Reform Act may have a disproportionately large effect on the resolution of other cases, the Milberg Weiss firm has an incentive to internalize this externality by assuring that early cases do not establish precedents adverse to the interests of the firm. No other firm will have an equally strong incentive to invest for this reason. Put another way, in the early years following adoption of the Reform Act, there will be relatively less well established doctrine on which smaller firms, less capable of financing or undertaking riskier litigation, will be able to "free-ride." Thus, just as the Reform Act may create economic incentives for Milberg Weiss to expand its appearance ratio, it may also establish an incentive for smaller firms to shrink their appearance ratios.

If the preceding analysis is correct, and if historical patterns are not disturbed by lead plaintiffs' decision to exercise a new degree of control over the counsel designation process, then we would not be surprised to find a material period of increased dominance by Milberg Weiss in the market for class action securities fraud litigation.

VIII. THE GEOGRAPHIC INCIDENCE OF LITIGATION

Table 12 presents data describing the incidence of litigation by judicial circuit from December 22, 1995 through December 31, 1996. As that table demonstrates, the geographic distribution of post-Reform Act litigation by circuit is similar to the distribution of litigation prior to the Reform Act.[58] This result is not surprising given the relative stability of high-technology firms among the companies sued. As in the pre-Reform Act period, the Ninth Circuit (which includes California) is the most active forum for securities class actions; however the percentage of cases in that circuit has dropped from 36% to 27.6%. The Second Circuit (which includes New York) remains the next most active circuit, although there has been a modest increase in cases from 15% to 18.1%. Among circuits with significant numbers of filings, modest increases have also been observed in the Fifth (which includes Texas) and Eleventh (which includes Florida) Circuits.

Table 12

Comparison of Settlements by Circuit Pre-Reform Act[59] with Filings by Circuit Post-Reform Act December 22, 1995–December 31, 1996

Circuit	*Pre-Reform Act Settlements*	*Percent of Total*	*Post-Reform Act Filings*	*Percent of Total*
D.C.	2	1%	0	0.0%
1st	17	8%	11	9.5%
2nd	31	15%	21	18.1%
3rd	25	12%	14	12.1%
4th	5	2%	2	1.7%
5th	6	3%	8	6.9%
6th	4	2%	4	3.4%
7th	8	4%	2	1.7%
8th	8	4%	3	2.6%
9th	74	36%	32	27.6%
10th	9	4%	4	3.4%
11th	18	9%	15	12.9%
Total	**207**		**116**	

[58] The number of filings exceeds the number of issuers because several issuers were sued in more than one circuit or district. Percentage calculations for incidence of litigation by circuit use a denominator of 116 to account for these multiple filings. District court filings use a denominator of 117.

[59] *Recent Trends III*, *supra* note 41, at Table 7b

Table 13 lists the top five districts for securities class action filings and describes the number of securities class action filings per thousand civil case filings in those districts. The districts in which the most companies have been sued are the Northern District of California (Silicon Valley's home district) and the Southern District of New York (which includes Manhattan). Each district had fifteen filings or about 13% of the total. In total, California district courts account for about 21% of securities class action litigation in the post-Reform Act period. New York district courts have the second highest incidence of securities class action litigation during the study period with 17.9% of the post-Reform Act litigation activity.

Table 13

Federal Filings by District
December 22, 1995-December 31, 1996

District	*Number of Filings*	*Filings Per Thousand*[60]
Northern California	15	2.872
Southern New York	15	1.460
Massachusetts	8	2.296
Central California	7	0.679
Middle Florida	6	1.082
Northern Texas	6	1.215

Securities class actions are, however, a significantly larger portion of the docket in Northern California, which has nearly twice as many securities class action filings per thousand civil cases (2.872) as the Southern District of New York (1.460).[61] While these figures suggest that securities class actions account for only a small percentage of total civil filings, they do not capture the magnitude of the burdens these cases place on the judiciary. The average class action demands considerably more judicial time than either the average civil case or the average non-class action securities fraud case.[62]

[60] Source: ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS, 1995 FEDERAL COURT MANAGEMENT STATISTICS (1996). The figures for total civil filings are for the time period October 1, 1994–September 30, 1995, the latest Administrative Office data available, and so do not correspond to the same time period as the securities class action filing data. We have no reason to believe that overall civil filings have changed substantially in these districts.

[61] The observed differences in securities class action filing rates among districts do not seem to be closely correlated with overall civil action filing rates. For example, for the 12 month period from October 1, 1994 through September 30, 1995, overall civil filings in the Northern and Central Districts of California were 5,223 and 10,303, respectively. ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS, 1995 FEDERAL COURT MANAGEMENT STATISTICS (1996) 127, 129. Nonetheless, during the study period, the Northern District had more than twice as many securities class action filings as the Central District.

[62] WILLGING, *supra* note 4, at 22-23 (noting that class actions, if separately categorized, would have a higher "case weight" than all civil cases other than death penalty habeas corpus cases and that securities class actions require 3.2 times the judicial time spent on all securities cases).

IX. SETTLEMENTS

It has frequently been observed that the large majority of federal class action securities litigation filed prior to the Reform Act was resolved by settlement. One study has reported that 87.6% of the securities class actions filed from April 1988 through September 1996 ended in a settlement,[63] with the large majority of the remainder being resolved by dispositive motions or voluntary dismissal. Very few class action securities fraud cases go to trial. Another study has found that the median time between filing and settlement was 21.7 months.[64] Any trends in the number of cases settling, the length of time between filing and settlement, and the average settlement amounts will provide important data as to the effects of the Reform Act.

The first year of practice under the Reform Act, however, is too short a period within which to expect substantial settlement activity, particularly given the novelty of many of the Reform Act's provisions. We are aware of only five settlements in 1996[65] of cases brought under the Reform Act, and we expect that it may take several years of experience before we are able to draw broad conclusions as to the effect of the Reform Act on settlement behavior. Nonetheless, early experience supports the tentative inference that plaintiffs are quickly dismissing certain claims with little or no recovery. Such conduct is consistent with a plaintiff filing a lawsuit only to discover quickly that the claim lacks merit or is otherwise not profitable to pursue. It therefore remains an open question as to whether the Reform Act has successfully deterred the filing of claims that can quickly be determined to be weak.

The settling cases are as follows:

1. *Caramonta v. Dingus*.[66] On May 30, 1996, Touchstone Software, a developer and publisher of utility software, announced a settlement of three shareholder class action and derivative suits brought against it and several of its officers and directors. The agreement calls for the establishment of a settlement fund consisting of $500,000 to be paid by Touchstone and issuance of 200,000 new shares of the company's common stock. The agreement also calls for plaintiff review of certain policies.[67]

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[63] O'Brien, *supra* note 36, at 3.

[64] WILLGING, *supra* note 4, at 117.

[65] We are aware of two additional settlements in early 1997 involving cases against Network Computing Devices and Nutrition for Life International, Inc.

[66] No. SACV-96-81-GLT (Eex) (C.D. Cal., filed Jan. 26, 1996).

[67] *Touchstone Reaches Agreement in Principle to Settle All Pending Class Action Suits*, Business Wire, May 30, 1996, *available in* LEXIS, News Library, Wires File.

2. *Levy v. United HealthCare Corporation.*[68] On December 18, 1996, United HealthCare announced that all claims against it in the *Levy* action had been voluntarily dismissed with prejudice. Pursuant to a Stipulation and Order, the parties agreed to dismiss all claims prior to class certification. No payment was made to the named plaintiff or his counsel.

3. *Alexander v. Health Management.*[69] Health Management, Inc., announced a settlement of all pending shareholder class actions filed against it. The settlement, subject to final court approval, calls for a $2 million cash payment and the issuance of 2.2 million shares of common stock and 2.2 million warrants to purchase common stock.[70]

4. *Trieff v. Cirrus Logic Inc.*[71] Cirrus Logic agreed to pay $31.3 million to settle shareholder lawsuits filed against the company in 1993, 1995, and 1996. The post-Reform Act complaint was filed in California state court and alleged claims arising out of Cirrus Logic's announcement that it would restate quarterly results. On August 22, 1996, the Alameda Superior Court dismissed four of plaintiffs' claims for relief. Plaintiffs then filed a second class action complaint against the company in September 1996 alleging the company misstated demand for certain of its products. The company will pay $2.3 million of the settlement.

5. *Fradin v. HighwayMaster Communications, Inc.*[72] Plaintiffs agreed to dismiss voluntarily their class action lawsuit without costs to either side. The complaint alleged that HighwayMaster omitted to disclose in its IPO prospectus certain product defects in mobile communications equipment the company manufactured.

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[68] No. 96 Civ. 750 (D. Minn., filed Aug. 7, 1996).

[69] No. CV-96-0889 (E.D.N.Y., Feb. 28, 1996).

[70] *Health Management, Inc. Reaches Agreement to Settle Shareholder Litigation*, PR Newswire, Sept. 17, 1996, *available in* LEXIS, News Library, Wires File.

[71] No. 188961 9 (Supr. Ct. Alameda County, CA, filed Feb. 21, 1996).

[72] (S.D.N.Y., filed Feb. 23, 1996).

X. DECISIONS INTERPRETING THE REFORM ACT AND RELATED MATTERS

As of the date of this paper, we are aware of twenty-six decisions interpreting provisions of the Reform Act. Because these decisions arise in cases that have all been filed within the last year, they involve exclusively the earliest judicial determinations in class action securities litigation under the Reform Act. These twenty-six decisions involve the: (a) interpretation of the "strong inference of fraud" pleading standard; (b) scope of a discovery stay on a pending motion to dismiss; (c) conflicts between federal and state court; (d) adequacy of notice and the appointment of a lead plaintiff; (e) survival of the recklessness standard for scienter; (f) safe harbor for forward-looking information; and (g) retroactive application of the Reform Act. Two additional decisions, although not decided under the Reform Act, may provide important precedents for its interpretation. This section discusses the decisions chronologically within each of these categories.

To the extent that it is possible to generalize from this early experience, three developments appear to be worth mention. First, of the seven courts interpreting the strong inference pleading requirement, six have concluded that the statute incorporates the Second Circuit's pleading requirement and not some higher standard implied in the legislative history. This is the conclusion preferred by plaintiffs. Second, only one motion to dismiss has been granted without leave to replead the major portion of the case. The sole exception involved a Section 11 claim that was not subject to the new strong inference standard. The new heightened pleading standard therefore does not yet appear to be functioning as a useful device for quickly dismissing claims drafted with an eye toward satisfying the statute's new requirements.

Third, complex issues regarding the interplay of federal and state jurisdiction are rapidly emerging. The application of the discovery stay to state litigation while a federal claim is pending and the interpretation of the federal safe harbor in a state proceeding when there is no state law safe harbor are but two examples of the many issues now arising in class action securities fraud litigation. This tension between the federal and state courts will likely grow over time and may well draw attention from Capital Hill.

Interpretation of the "Strong Inference of Fraud" Pleading Standard

One of the primary reforms Congress put in place to curtail the filing of "meritless" lawsuits was a new heightened pleading standard. Section 21D(b)(2) of the Reform Act requires, among other things, that plaintiffs in securities fraud actions "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." The "strong inference" language was taken from Second Circuit case law interpreting the requirements of Federal Rules of Civil Procedure 8 and 9(b) in the context of securities fraud cases.[73] President Clinton cited this provision in his veto of the Reform Act because, in his view, language in the legislative history indicated that Congress was adopting a standard that was more stringent than that of the Second Circuit. Since the veto and subsequent override, commentators and courts have disagreed over what facts will satisfy Section 21D(b)(2) and whether the Second Circuit tests for finding a strong inference of fraud survived passage of the Act. Through January 1997, at least seven courts addressed the new pleading standard, with six finding that the Second Circuit tests survived passage of the Reform Act. In addition, it is significant to note that no motion to dismiss in a case subject to the new pleading standard has been granted without permitting plaintiffs the opportunity to replead at least some of their claims.

1. *Marksman Partners, L.P. v. Chantal Pharmaceutical Corp.*[74] *Chantal* is the first decision to interpret the Reform Act's more stringent pleading requirements. The Central District of California denied a motion to dismiss and found that plaintiffs had satisfied their pleading obligations. In so holding, the district court determined that Congress did not adopt a more stringent pleading standard than had existed in the Second Circuit. The court also found that two tests the Second Circuit employed to determine whether the plaintiff satisfied its pleading obligations—the "motive and opportunity" test and the "strong circumstantial evidence" test—survived passage of the Reform Act.[75] The court held that allegations that the Chairman and CEO sold 20% of her stock during the class period for proceeds of $6.3 million were sufficient to allege a strong inference of fraud, particularly where she had not sold any stock during the previous three years.

2. *Zeid v. Kimberley.*[76] The court dismissed with leave to replead[77] a securities class action brought against Firefox Communications, Inc. and certain of its officers and directors. The complaint alleged that defendants had misrepresented the demand for the company's products and the success of its sales and marketing program in the United States. The complaint also alleged that Firefox improperly recognized certain revenues and failed to keep adequate reserves in violation of GAAP and SEC rules.

The court found that plaintiffs failed to plead with sufficient specificity: (i) when or how allegedly misleading statements were communicated to the market; (ii) that the company adopted certain analysts' statements; and (iii) the reasons why certain statements were misleading. Allegations that Firefox violated GAAP by "parking" inventory with distributors were insufficient because the complaint did not "name a single customer or sale where Firefox 'parked' its inventory or prematurely recognized revenue."[78] The court did find that the complaint alleged with particularity facts surrounding the company's failure to maintain adequate reserves. However, these claims were dismissed as well for failure to plead a strong inference that defendants' actions were intentional or reckless. As in *Chantal*, the court in *Zeid* found that the Second Circuit's tests for pleading scienter survived passage of the Reform Act.

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[73] *See, e.g., Shields v. CityTrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994); *In re Time Warner, Inc. Sec. Litig.*, 9 F.3d 259, 269 (2d Cir. 1993), *cert. denied*, 114 S. Ct. 1397 (1994).

[74] 927 F. Supp. 1297 (C.D. Cal., May 21, 1996).

[75] For an in depth analysis of the *Chantal* decision, see Michael A. Perino, *A Strong Inference of Fraud? An Early Interpretation of the 1995 Private Securities Litigation Reform Act*, 1 SEC. REFORM ACT LITIG. REPT. 397 (1996).

[76] 930 F. Supp. 431 (N.D. Cal., June 6, 1996).

[77] The court rejected defendants' argument that the Reform Act required dismissal with prejudice. *Id.* at 438.

[78] *Id.* at 437.

Finally, the court dismissed with prejudice plaintiffs' claims that certain warnings and disclaimers contained in the company's Form 10-Qs were false and misleading. Plaintiffs argued that these statements were merely boilerplate and that the company's reports should have contained specific disclosures of the adverse factors which were then negatively affecting the company's business. The court rejected this argument as "absurd," and held that the warnings were not actionable as a matter of law because plaintiffs did not allege that the warnings were wrong. Instead, they alleged that the warnings "should have been more specific." This was not a proper claim under Section 10(b) and Rule 10b-5, which do not protect against "statements that are too abstract."[79]

An amended complaint has been filed and is now pending before the court.

3. *Sloane Overseas Fund, Ltd. v. Sapiens International Corp.*[80] The Reform Act's provisions did not apply to this case because the action was filed prior to the effective date of the Act. In deciding a motion to dismiss, however, the court noted in *dicta* that the Reform Act "codif[ied the] Second Circuit standard for pleading scienter."[81]

4. *In re Silicon Graphics, Inc. Securities Litigation.*[82] The court in *Silicon Graphics* reached a substantially different conclusion with respect to plaintiff's pleading obligations than the courts in *Chantal* and *Zeid*. Unlike those cases, the *Silicon Graphics* court held that the Reform Act did not simply codify the prior Second Circuit standard.[83] Instead, the court found that Congress meant to erect a higher pleading barrier that requires "that plaintiff must allege specific facts that constitute circumstantial evidence of conscious behavior by defendants."[84]

The court found that plaintiff's attempt "to couple allegations of defendants' awareness of negative internal reports with their false and misleading statements and stock sales ... [was] not specific enough to raise a strong inference of fraud."[85] The court held that because every sophisticated corporation uses some form of internal reporting, allowing a case to proceed on the basis of unsupported general claims of the existence of negative internal reports would "expose all those companies to securities litigation whenever their stock prices dropped."[86] Allegations that certain of Silicon Graphics' insiders sold shares during the class period did not create a strong inference of fraud either because the defendants' SEC filings demonstrated that their sales were not "unusual or suspicious."[87]

The court granted plaintiff leave to replead, and an amended complaint was filed on October 17, 1996. A second motion to dismiss the amended complaint is now pending.

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[79] *Id.*

[80] 941 F. Supp. 1369 (S.D.N.Y., Aug. 19, 1996).

[81] *Id.* at 1377.

[82] 1996 U.S. Dist. LEXIS 16989, Fed. Sec. L. Rep. (CCH) ¶ 99,325 (N.D. Cal., Sept. 25, 1996).

[83] 1996 U.S. Dist. LEXIS 16989 at *15-16.

[84] *Id.* at *16.

[85] *Id.* at *34-35.

[86] *Id.* at *35.

[87] *Id.* at *36-37.

5. *STI Classic Funds v. Bollinger Industries, Inc.*[88] In *Bollinger*, a magistrate judge ruling on a motion to dismiss held that the motive and opportunity test survived passage of the Reform Act. The magistrate judge then found that the facts pleaded in the amended complaint at issue satisfied this standard with respect to claims against the company and certain of its officers, but not with respect to a subsidiary company.

Defendants Glenn and Bobby Bollinger founded and were the two senior officers of Bollinger. The complaint alleged that the company invoiced fraudulent sales transactions with one or more customers in order to inflate reported sales and earnings. These misstatements of financial performance allegedly stemmed from inadequate financial and accounting controls and violations of GAAP of which the company and its senior management were aware. Bollinger was also allegedly aware prior to an announcement in March 1995 that supervisors at its NBF subsidiary were falsifying production reports. In June 1995, two of the company's outside directors and its auditor resigned, allegedly because of these problems.

With respect to motive, the court noted that allegations of materially inflated financial health "benefited the value of Bollinger's shares and likewise increased the value of the Brothers Bollinger's interest in the company."[89] The court rejected defendants' argument that a similar finding of motive would apply to any small, family-dominated business. A strong inference could be drawn from the individual defendants' positions within the company "that they were knowledgeable about the methods and billing practices utilized by Bollinger which led to the over-stated sales and revenues reported in the SEC filings signed by them."[90] The court found the allegations against the individual defendants with respect to NBF inadequate to satisfy the Reform Act's pleading standard because they failed to plead sufficiently that the defendants knew that the statements were false when made.

The district court adopted the magistrate judge's findings on November 12, 1996.

6. *Fischler v AmSouth Bancorporation*.[91] Plaintiff brought a class action on behalf of all purchasers of non-deposit investment products from AmSouth, claiming that AmSouth failed to disclose certain surrender charges applicable to these instruments. In a brief opinion, the court determined that the complaint satisfied the requirements of Federal Rule of Civil Procedure 9(b) and the Reform Act. The court noted that Rule 9(b) had three purposes: (i) ensuring that the allegations of fraud are specific enough so that defendants will be able to respond effectively; (ii) eliminating those complaints filed as a pretext for discovery of unknown wrongs; and (iii) protecting defendants from unfounded charges of wrongdoing. The court then applied the Second Circuit tests for pleading a strong inference of fraud without discussing whether those tests survived passage of the Act. The also court noted that the "motive and opportunity" test was a "common method for establishing a strong inference of scienter".[92]

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88 No. 3-96-CV-823-R (N.D. Tex., Nov. 12, 1996).

89 *Id.* at 2-3.

90 *Id.* at 4.

91 1996 U.S. Dist. LEXIS 17670 (M.D. Fla., Nov. 14, 1996).

92 *Id.* at *8.

7. *Rehm v. Eagle Finance Corp.*[93] The court in *Eagle Finance* found that the Reform Act "does not impose a more rigorous pleading requirement than that enunciated by the Second Circuit."[94] The Reform Act, however, also "declines to bind courts to the Second Circuit's interpretation of its standard."[95] Nonetheless, the court employed the motive and opportunity and strong circumstantial evidence of fraud tests in refusing to dismiss the action, which alleged that Eagle materially understated its credit losses and overstated its earnings.

Following Second Circuit precedent, the court found that certain generic motives that were likely held by executives generally were not enough to create a strong inference of fraud. Similarly, alleged insider sales did not satisfy the motive and opportunity test. The court first noted that two of three individual defendants did not sell any stock during the class period. The third defendant sold only 6% of his personal holdings. While this was the defendant's first sale, the court did not find this unusual because the stock was originally issued only sixteen months earlier.

The court found that plaintiff's combination of allegations constituted strong circumstantial evidence of conscious misbehavior or recklessness. First, Eagle allegedly overstated its 1995 earnings by 91%. This allegedly serious GAAP violation, when combined with allegations that defendants were responsible for calculating and releasing the financial information, supported the conclusion that defendants acted with scienter. Second, the company reported "massive" year-end increases to credit loss reserves and decreases to earnings. The magnitude of these reporting errors lent weight to the allegations of recklessness, especially where defendants were in a position to detect the errors. Third, the court pointed to the nature of Eagle's loan servicing business and defendants' statements downplaying the significance of the accounting errors to support a finding of scienter. "[T]he crucial significance of accurate credit loss accounting in determining the financial viability of Eagle, combined with defendants' careful statements mitigating the seriousness of the credit loss problem, raises a strong inference that defendants acted with knowledge of their public misstatements or were willfully blind to the truth."[96]

Other Motions to Dismiss

1. *Steckman v. Hart Brewing, Inc.*[97] Hart Brewing is the only post-Reform Act case to date where a complaint was dismissed without leave to replead. Ironically, the Act's new heightened pleading standard did not apply to the case because it alleged only violations of Sections 11 and 12(2) of the 1933 Act in connection with Hart's initial public offering. Nonetheless, the court noted that the Reform Act "encouraged the use of motions to dismiss in certain securities cases."[98] The court also echoed one of the Reform Act's rationales when it noted that courts should dismiss 1933 Act claims to "minimize the chance that a plaintiff with a largely groundless claim will bring a suit and conduct extensive discovery in the hopes of obtaining an increased settlement."[99]

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[93] 1997 U.S. Dist. LEXIS 767 (N.D. Ill., Jan. 27, 1997).

[94] *Id.* at 16.

[95] *Id.*

[96] *Id.* at *31.

[97] No. 96-1077-K (RBB) (S.D. Cal., Dec. 24, 1996).

[98] *Id.* at 9.

[99] *Id.*

The *Hart* complaint alleged that defendants failed to disclose material facts indicating an adverse trend of declining sales. Plaintiff alleged that disclosure of partial fourth quarter 1995 results would have shown that Hart could not sustain its past high growth and that this disclosure would have reduced the IPO stock price.

The court's decision hinged on the interpretation of Item 303 of Regulation S-K, which requires companies going public to disclose trends that are presently known to management and reasonably likely to have a material effect on financial condition or operating results. The court found that Item 303 only required a company to disclose intra-quarter results where those results represent an extreme departure from earnings of prior quarters. The complaint was found to allege no facts indicating either that defendants actually knew that the quarterly results would be an extreme departure or that the results were in fact an extreme departure. The court also noted the company had no duty to disclose trends about future performance or to supply other forward-looking information.

The Scope of the Discovery Stay on a Motion to Dismiss

In passing the Reform Act, Congress was concerned that "[t]he cost of discovery often forces innocent parties to settle frivolous securities class actions."[100] To combat this problem, the Reform Act provides in new Section 27(b) of the 1933 Act and new Section 21D(b)(3) of the 1934 Act that "all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party."

At least three federal courts addressed the scope of this discovery stay in 1996. These decisions suggest that courts will interpret broadly the Reform Act's mandatory stay provision.

1. *Medical Imaging Centers of America, Inc. v. Lichtenstein.*[101] Plaintiff, the subject of a corporate control contest, filed an action alleging violations of Section 13(d) of the Exchange Act. Defendants called a special shareholders meeting and filed a proxy indicating their intent to unseat plaintiff's current board of directors. Defendants also moved to dismiss the complaint and requested expedited discovery to be completed before the shareholders' meeting. Plaintiff moved to stay discovery based on Section 21D(b)(3)(B).

The court held that discovery was properly stayed while the motion to dismiss was resolved. The "undue prejudice" standard was held to require the party seeking discovery to show an improper or unfair detriment. The court characterized this showing as something less than irreparable harm. The court noted that if the party seeking discovery "had shown that the discovery stay would prejudice it because [the opposing party] would be shielded from eventual liability for any material violations of the securities laws, the Court would find that an 'undue prejudice' exception to the statutory stay had been shown."[102] The court also rejected an argument that Congress did not mean for the statutory stay to apply to proxy contests. Although no absolute "carve out" exists for such actions, the court noted that it would be proper for the court to consider the nature of the action in determining whether an exception to the stay should be recognized.[103]

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[100] H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. 37 (1995), *reprinted in* 1995 U.S.C.C.A.N. 736.

[101] 917 F. Supp. 717 (S.D. Cal., Feb. 14, 1996).

[102] *Id.* at 721 n.3.

[103] *Id.* at 721.

2. *Novak v. Kasaks*.[104] The court stayed discovery in a class action involving AnnTaylor Stores because it found that plaintiffs had not satisfied their burden of showing "exceptional circumstances." In response to plaintiffs' concern that non-parties might not retain relevant documents during a stay, the court ordered the 30 non-parties that had previously been served with subpoenas to preserve all responsive documents.

3. *Medhekar v. United States District Court*.[105] In *Medhekar*, the district court held that the statutorily required stay did not apply to mandatory disclosure obligations under local civil court rules and the Federal Rules of Civil Procedure.[106] The court found that disclosure is distinct from discovery and that if Congress had meant to stay both it would have listed both in the statute.[107] The court also found that the statutory phrase "other proceedings" did not clearly encompass disclosure. Instead, it interpreted "other proceedings" to refer to formal procedures involving a hearing or other court activity.[108]

Defendants sought and obtained a writ of mandamus directing the lower court to stay the initial disclosure requirements pending disposition of defendants' motion to dismiss.[109] The Ninth Circuit held that mandatory disclosures constitute "discovery" for purposes of the Act's stay provisions. The Ninth Circuit rejected the lower court's conclusion that disclosure and discovery were distinct; instead, it found that disclosure was merely a subset of discovery. The time and expense associated with disclosure were exactly the type of burden the Act sought to eliminate. The court thus found that: "Congress clearly intended that complaints in these securities actions should stand or fall based on the actual knowledge of the plaintiffs rather than information produced by the defendants after the action has been filed."[110]

The Ninth Circuit also rejected the lower court's interpretation of the phrase "other proceedings". The legislative history and context of the phrase suggested that the term was intended to include litigation activity relating to discovery. Thus, the term includes disclosures. The court was careful to emphasize, however, that the term does not include "all litigation activity in general."[111]

Conflicts Between State and Federal Court

One strategic response to the Reform Act is to avoid it altogether. Some plaintiffs have sought to escape from the Act's discovery stay and other procedural restrictions by filing parallel or stand-alone state court actions alleging either claims under the 1933 Act or state common law or Blue Sky claims. This strategy raises interesting and difficult federalism problems. In 1996, at least six state courts appear to have addressed whether the Reform Act's discovery stay should apply in state court proceedings. So far, state courts have split on whether the Reform Act's discovery stay is a substantive policy decision that should be respected in state courts or merely a procedural mechanism with no applicability in state fora. The significant substitution effect into state court and the emerging strategy of filing parallel federal and state court actions suggest that resolution of this issue may significantly affect the practical effectiveness of the stay provision.

[104] 1996 U.S. Dist. LEXIS 11778, Fed. Sec. L. Rep. (CCH) ¶ 99,307 (S.D.N.Y., Aug. 16, 1996).

[105] 99 F.3d 325 (9th Cir., Oct. 31, 1996).

[106] *Hockey v. Medhekar*, 932 F. Supp. 249, 252-53 (N.D. Cal., Jul. 11, 1996)

[107] *Id.* at 252.

[108] *Id.* at 253.

[109] The authors of this study submitted an *amicus curiae* brief on behalf of Bank of America and the American Electronics Association urging that the Ninth Circuit accept review of the writ of mandamus and reverse the lower court decision.

[110] 99 F.3d at 328.

[111] *Id.*

1. *Milano v. Auhll.*[112] Plaintiff brought a class action against Circon Corporation and certain of its officers and directors alleging violations of the Securities Act of 1933 and the California Corporations Code in California state court. No parallel federal action was pending. Defendants moved to stay discovery pursuant to the Reform Act and the plaintiffs argued that the Act was inapplicable in state court proceedings. The court found that the Reform Act's stay provisions were applicable in state court actions and determined that discovery on both the federal and state claims should be stayed. This result was necessary in order not to undermine the congressional intent "to provide a broad and effective method of weeding out frivolous and unsupported lawsuits."[113]

2. *Sperber v. Bixby.*[114] In this class action involving Brooktree Corporation, plaintiffs alleged solely state Blue Sky and common law claims. No parallel federal action was filed. Defendants filed both a motion to dismiss and a motion to stay discovery pending resolution of the dismissal motion. Defendants argued that plaintiffs filed in state court to evade the Reform Act's procedures, including the stay of discovery and the heightened pleading standard. In this situation, defendants argued that the Reform Act, although not controlling, provided persuasive authority that should be considered in ruling on stays in state securities class actions. The court stayed discovery pending resolution of the motion to dismiss.

3. *Marinaro v. The Superior Court of Santa Clara County.*[115] In this case involving Network Computing Devices four federal complaints arising out of the same facts and circumstances were filed after the state court complaint. Defendants sought to stay the state case, arguing that the state claims were brought in a separate action in order to avoid the procedural provisions contained in the Reform Act. The lower court denied the stay without opinion and the intermediate appellate court denied a petition for a writ of mandamus. The California Supreme Court, however, directed the appellate court to reconsider defendants' request for a stay.[116] As of the date of this paper, we are unaware of any decision from the appellate court.[117]

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[112] No. SB 213 476 (Cal. Super. Court, Santa Barbara County, Oct. 2, 1996).

[113] *Id.* at 7.

[114] No. 699812 (Cal. Super. Court, San Diego County, Oct. 25, 1996).

[115] 1996 Cal. LEXIS 6105 (Oct. 30, 1996).

[116] *Id.*

[117] We have been informed that this matter was settled in January 1997 and that, as a result, there will be no decision from the intermediate appellate court. To date, we have no information on this purported settlement.

We have also been informed of three other cases in which these issues have arisen, although we have been unable to obtain opinions in any of these cases. First, in a class action involving Diamond Multimedia, *Pass v. Hyung Hwe Huh*, No CV758927 (Cal. Super. Court, Santa Clara County), the trial court denied a motion to stay the state action in favor of a parallel federal action. However, a discovery master in the case recommended that the trial court stay discovery pending resolution of class certification issues. Second, in a class action involving Fritz Companies, *Levenson v. Fritz*, No 979971 (Cal. Super. Court, San Francisco County), a trial judge denied a motion to stay discovery in the state action. Defendants sought a writ of mandate from the Court of Appeal. In the interim, however, a second trial court judge sustained a demurrer to the state complaint without leave to replead. Third, in an action involving Cinergi Pictures, *Shores v. Cinergi Pictures Entertainment, Inc.*, No. BC149861 (Cal. Super. Court, Los Angeles County), the court held that plaintiff could not circumvent the Reform Act's discovery stay by filing 1933 Act claims in state court. The court, however, permitted substantially similar discovery to proceed on a common law negligent misrepresentation claim.

Adequacy of Notice and Appointment of Lead Plaintiff

Under the Reform Act, Congress sought to increase litigant oversight of plaintiffs' class action attorneys by reducing the number of "professional plaintiffs" and by encouraging institutional investors to become more active in securities fraud litigation. To achieve this result, the Reform Act requires that plaintiffs filing securities class actions file sworn certifications describing, among other things, their transactions in the security and their prior appearances as named plaintiffs in securities class actions.[118] The Act also requires the named plaintiff to publish a notice "in a widely circulated national business-oriented publication or wire service" that informs potential class members of the right to move to be appointed "lead plaintiff."[119] The law establishes a rebuttable presumption that the lead plaintiff will be the party who volunteers and who "has the largest financial interest in the relief sought by the class."[120] Lead plaintiffs can control the course of the class action, including selection of lead counsel, subject to court approval.[121]

Through January 1997, at least four opinions addressed these provisions.[122] The activity to date suggests three significant trends are emerging. First, most of the activity has not involved the institutions Congress sought to get involved in securities litigation. Instead competing groups of individual plaintiffs have tended to vie for the lead plaintiff position. Indeed, one of the unintended consequences of the Reform Act has been to encourage traditional plaintiffs' law firms to cobble together large numbers of smaller claimants who, in aggregate, have the largest financial interest of any individual or group seeking the lead plaintiff position.

Second, firms' initial reaction to the notification procedures was to publish inconspicuous notices in *Investors Business Daily*. One court found these notices to be inadequate. But that decision may have little practical impact because before it was issued firms had already begun to employ the Act's notification procedures as a means of advertising their actions in order to attract additional plaintiffs or others with relevant information about the asserted claims. The notices therefore now tend to be widely-disseminated on wire services and contain lengthy descriptions of the factual bases for the complaint.

Finally, the decisions to date suggest that if institutions are interested in becoming lead plaintiffs, they should be able to do so in most cases. Significant questions remain concerning the kind of discovery institutions will be subject to if they assume that position, and it is unclear that many major institutional investors will conclude that the benefits of participation as lead counsel will outweigh the costs.[123]

1. *In re Cephalon Securities Litigation*.[124] Under the Reform Act's provisions for the appointment of lead plaintiff, "discovery relating to whether a member or members of the purported plaintiff class is the most adequate plaintiff may be conducted by a plaintiff only if the plaintiff first demonstrates a reasonable basis for a finding that the presumptively most adequate plaintiff is incapable of adequately representing the class."[125] In *Cephalon*, the Court permitted discovery to resolve a dispute over whether a plaintiff that was seeking to be named lead plaintiff was in fact an institutional investor.[126]

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[118] 15 U.S.C. §§ 77z-1(a)(2)(A), 78u-4(a)(2)(A).

[119] 15 U.S.C. §§ 77z-1(a)(3)(A)(i), 78u-4(a)(3)(A)(i).

[120] 15 U.S.C. §§ 77z-1(a)(3)(B)(iii)(I)(bb), 78u-4(a)(3)(B)(iii)(I)(bb).

[121] 15 U.S.C. §§ 77z-1(a)(3)(B)(v), 78u-4(a)(3)(B)(v).

[122] We are also informed that institutions or entities purporting to be institutional investors were active in at least six additional cases. These activities included filing the initial or a subsequent complaint or moving to be named co-lead plaintiff with individual investors. These cases involved the following companies: Bollinger Industries, Fleming Companies, Ivax Corporation, Micro Warehouse, Inc., Pepsi Cola Puerto Rico Bottling Co., and Summit Technology.

[123] Grundfest and Perino, *supra* note 18, at 599-604.

[124] 1996 U.S. Dist. LEXIS 10546 (E.D. Pa., July 18, 1996).

[125] 15 U.S.C. §§ 77z-1(a)(3)(B)(iv), 78u-4(a)(3)(B)(iv).

[126] It is unclear whether significant discovery was undertaken. An subsequent order indicates that the competing factions agreed to be named co-lead plaintiffs with their respective counsel named as co-lead counsel. *In re Cephalon Secur. Litig.*, 1996 U.S. Dist. LEXIS 13492, Fed. Sec. L. Rep. (CCH) ¶ 99,313 (E.D. Pa., Aug. 27, 1996).

2. *Greebel v. FTP Software.*[127] *Greebel* is the first substantive decision addressing a number of important issues that arise from the Reform Act's lead plaintiff provisions. First, the court addressed the defendant's role in the lead plaintiff determination. The court held that defendants have standing to contest plaintiff's failure to file a certification with the complaint or the failure to provide adequate notice to the class. Defendants lack standing to challenge whether a particular plaintiff satisfies the requirements set forth in Section 21D(a)(3)(B)(iii), in particular, whether the proposed lead plaintiff "otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure." Because defendants have traditionally been permitted to challenge a plaintiff's satisfaction of the Rule 23 requirements at the class certification stage, the court held "that its determination to appoint a person or persons as lead plaintiff must be without prejudice to the possibility of revisiting that issue in considering a motion for class certification."[128]

Second, the court held that only representative plaintiffs that file complaints are required to file the certifications required in Section 21D(a)(2). Finally, the court held that publication of a notice on *Business Wire*, a computer database service that distributes press releases to news media, on-line services, and subscribers in the investment community, satisfies the Reform Act's notice requirement.

3. *Gluck v. Cellstar Corporation.*[129] The State of Wisconsin Investment Board ("SWIB") sought in this case to be named sole lead plaintiff. Class members who had filed a complaint and were represented by Milberg Weiss opposed that motion. Milberg Weiss argued that SWIB was not an appropriate lead plaintiff because SWIB is a sophisticated institutional investor that had used derivatives and is not typical of the entire class of plaintiffs. Milberg Weiss argued that the court should therefore not appoint SWIB as sole lead plaintiff and should instead appoint a plaintiffs' committee that would serve as lead plaintiffs, with Milberg Weiss and SWIB's counsel appointed as co-lead counsel. The court appointed SWIB as sole lead plaintiff and required SWIB, subject to court approval, to appoint counsel for the class within 30 days of the order.

4. *Chan v. Orthologic Corp.*[130] In *Orthologic*, the City of Philadelphia pension fund and a group of non-institutional plaintiffs (the "Chan Plaintiffs") competed to be appointed lead plaintiff. It was undisputed that the City of Philadelphia had the largest financial stake in the outcome of the case and was therefore the presumptive lead plaintiff under the terms of the Reform Act.[131] The Chan Plaintiffs sought to overcome the presumption by arguing that they represented a narrower class of purchasers that purportedly conflicted with the Philadelphia class. As in *Cellstar*, the Chan Plaintiffs argued that Philadelphia, as a sophisticated, institutional investor, was not typical of the class as a whole and that it was subject to unique defenses. In particular, Philadelphia's investment strategy was said to be atypical of the class as a whole because Philadelphia was a "speculator" that allegedly purchased Orthologic securities after certain bad news had already been disseminated to the market. As a result, the Chan Plaintiffs sought either to be appointed co-lead plaintiffs with Philadelphia or to be named to their own subclass.

The court held that these factors were insufficient to rebut the Act's presumption that Philadelphia was the most adequate plaintiff. First, the court held that the differing class periods did not create a conflict because the parties had similar injuries arising out of the same course of conduct. The court did, however, reserve the right to create appropriate subclasses if a conflict was subsequently revealed. Second, the court held that Philadelphia's sophistication was irrelevant in this case because all

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[127] CA No. 96-10544-JLT (D. Mass., Aug. 15, 1996).

[128] *Id.* at 6-8.

[129] No. 396CV14356 (N.D. Tex., Oct. 1, 1996).

[130] No Civ 96-1514 PHX RCB (D. Ariz., Dec. 19, 1996).

[131] 15 U.S.C. §§ 77z-1(a)(3)(B)(iii)(I)(bb), 78u-4(a)(3)(B)(iii)(I)(bb).

plaintiffs had consistent interests. Finally, the court rejected pre-Reform Act precedent that found institutional investors to be atypical of the class. Instead, it relied on Ninth Circuit precedent finding that differences in sophistication among purchasers have no bearing in fraud-on-the-market cases.[132]

After appointing Philadelphia as lead plaintiff, the court also approved its choice of Milberg Weiss; Barrack Rodos & Bacine; and Bonnett Fairbourn Friedman & Balint as co-lead counsel. The court noted the firms' "extensive experience in the area of class action securities fraud" in finding that they would provide capable representation to the class as a whole.

5. *Ravens v. Iftikar.*[133] In this class action involving Syquest Technology, Inc., Judge Vaughn Walker examined the Reform Act's requirements for the content of the required notice. The notice at issue in *Ravens* simply stated the date the action had been filed, where it was filed, the alleged class period, the security at issue, and that the complaint asserted violations of Sections 10(b) and 20(a) of the Exchange Act. The notice did not contain a description of the facts underlying the claims. Judge Walker held that the notice did not satisfy the Reform Act's requirements because it was "inadequate to apprise investors of the claims asserted so that those who may wish to do so have a fair opportunity to intervene and assume control of the litigation."[134]

Congress employed the lead plaintiff and notice provisions to curb "the disproportionate influence lawyers have exerted over securities class actions."[135] The Court found that these provisions were meant to "transfer primary control of private securities litigation from lawyers to investors" and were similar to other constitutionally mandated notices required under Federal Rule of Civil Procedure 23(b)(3). He held that the Reform Act notice must at a minimum contain three elements: (1) a notice of the pendency of the action; (2) a description of the claims asserted therein; and (3) a specification of the purported class period.

The bulk of the court's opinion focused on the second element. The court found that the notice provisions will only permit investors to make an informed decision about whether to seek control of the case if investors "are notified of the nature and character, not just the existence, of the claims asserted."[136] The notice must contain information describing the legal and factual basis for the claims and not just a recitation of the statute or statutes under which the claims are brought. The court also held that a notice that omits these elements is not cured by an invitation to call the lead lawyer for more information because such a lawyer has incentives to discourage investor competition. Finally, the court noted that a diligent investor might review the complaint itself to obtain notice of the plaintiff's claims. The court held that the complaints provided inadequate notice because they were "verbose, amorphous and confusing" and therefore did not provide the best practicable notice under the circumstances.

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[132] *Chan*, slip op. at 11 (*citing Blackie v. Barrack*, 524 F.2d 891, 905 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976); *Hanon v. Dataproducts Corp.*, 976 F.2d 497, 506 (9th Cir. 1992).

[133] No. C-96-1224-VRW (N.D. Cal., Jan. 7, 1997).

[134] *Id.* at 3.

[135] *Id.* at 2.

[136] *Id.* at 5.

Survival of the Recklessness Standard for Scienter

Whether reckless conduct satisfies the scienter requirement of Section 10(b) and Rule 10b-5 has been an open question at the Supreme Court level since the Court's 1976 decision in *Ernst & Ernst v. Hochfelder*,[137] although every Court of Appeals that has addressed the issue has concluded that recklessness constitutes scienter. The Reform Act makes limited reference to recklessness and seemingly avoids any implication that it was codifying or eliminating that standard of liability. Nonetheless, two courts have reached opposite conclusions as to the Act's effect on the sufficiency of allegations of recklessness as establishing scienter under Section 10(b).

1. *Marksman Partners, L.P. v. Chantal Pharmaceutical Corp.*[138] The *Chantal* court held that recklessness continues to satisfy the scienter requirement of Section 10(b). The court gave three reasons for its conclusion. First, it argued that strengthening the pleading standard for scienter does not necessarily result in a change to the nature of the scienter required. Second, although the Reform Act created an actual knowledge requirement for forward-looking statements and joint and several liability, that requirement does not extend to other kinds of Section 10(b) violations.

Third, the court found the Act's legislative history did not support a finding that recklessness had been eliminated as a basis for scienter. The court noted that an earlier House bill had contained a definition of recklessness but that definition had been dropped in the final version of the bill. The court recognized "some ambivalence on the part of Congress regarding recklessness liability in securities fraud cases."[139] Nonetheless, in the absence of any express provision eliminating liability for recklessness in the Act itself, the court was unwilling to conclude that it was no longer adequate to establish scienter.

2. *In re Silicon Graphics Securities Litigation*.[140] The court rejected plaintiff's argument that liability for recklessness still exists under the Reform Act. It held that "in order to state a private securities claim, plaintiff must now allege false or misleading statements, describe how the statements are false or misleading, and create a strong inference of knowing misrepresentation on the part of the defendants. This standard applies whether the statements in question are forward-looking or not."[141]

The court dismissed plaintiffs' initial complaint for failure to satisfy this standard and an amended complaint has been filed. On the currently pending motion to dismiss the amended complaint, the SEC has filed an *amicus* brief urging the district court to reverse its ruling on the recklessness standard.

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[137] 425 U.S. 185, 194 n.12.

[138] 927 F. Supp. 1297 (C.D. Cal. 1996).

[139] *Id.* at 1309 n.9.

[140] 1996 U.S. Dist. LEXIS 16989, Fed. Sec. L. Rep. (CCH) ¶ 99,325 (N. D. Cal., Sept. 25, 1996).

[141] *Id.* at *21.

The Safe Harbor for Forward-Looking Information

The Reform Act sought to encourage the disclosure of forward-looking information by creating a limited safe harbor for these statements if they are identified as such and accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."[142] The safe harbor is subject to significant limitations and does not apply to IPOs and other specified transactions. To date, the only decision interpreting the safe harbor suggests limitations on its usefulness at the motion to dismiss stage. Another decision, however, suggests the continuing importance of the bespeaks caution doctrine in situations where the safe harbor does not apply.

1. *In re Silicon Graphics, Inc. Securities Litigation.*[143] The Silicon Graphics decision contains the first judicial interpretation of the Reform Act's safe harbor provision. The court rejected as a basis for a motion to dismiss defendants' argument that they had in fact provided warnings in analyst conference calls. This argument was based solely on the declaration of the company's Chief Financial Officer. Such evidence was not properly considered on a motion to dismiss because it was neither part of the public record nor referenced in the complaint.

2. *Steckman v. Hart Brewing, Inc.*[144] As noted previously, *Hart* is the only post-Reform Act case dismissed without leave to replead. The Reform Act's safe harbor did not apply because the case involved alleged misrepresentations and omissions in connection with an IPO. Nonetheless, the decision is significant because it emphasizes the continuing viability of the bespeaks caution doctrine in cases where the safe harbor may be inapplicable.

The complaint in *Hart* alleged that the IPO prospectus omitted "trends and uncertainties" regarding the company's ability to continue its prior record of increased sales and earnings. The court, however, dismissed the complaint in part because "these alleged omissions were actually addressed in the Prospectus' 'Risk Factors' discussion."[145] The court went on to list seven warnings "directly addressing Plaintiff's allegations of omissions."[146] The court emphasized that the complaint must be read as a whole and in the context of the type of investment being offered for sale. "Because Plaintiff's allegations that he was not fully informed of the risk and nature of his investment is unsubstantiated by the plain language of the Prospectus, he fails to allege sufficient facts to support any claim under the Securities Act of 1933."[147]

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[142] 15 U.S. C. § 77z-2(c)(1)(A)(i).

[143] 1996 U.S. Dist. LEXIS 16989, Fed. Sec. L. Rep. (CCH) ¶ 99,325 (N.D. Cal., Sept. 25, 1996).

[144] No. 96-1077-K (RBB) (S.D. Cal., Dec. 24, 1996).

[145] *Id.* at 7.

[146] *Id.* at 7-8.

[147] *Id.* at 8-9.

Retroactive Application of the Reform Act

Section 108 of the Reform Act states that the provisions of the Act "shall not affect or apply to any private action arising under title I of the [1934 Act] or title I of the [1933 Act], commenced and pending on the date of enactment of this Act." This statutory language has given rise to two questions as to the retroactive effect of the Act. First, does the Act's elimination of securities fraud as a predicate act under the Racketeer Influenced and Corrupt Organizations Act ("RICO") apply retroactively? Second, the Reform Act clarified an issue left open in the Supreme Court's decision in *Central Bank of Denver v. First Interstate Bank of Denver* by providing that the SEC could still bring actions for aiding and abetting violations of Section 10(b). Did that provision apply retroactively? Four decisions analyzed these questions and held that the RICO may not be retroactively applied but that the aiding and abetting provision could be retroactively applied in certain limited circumstances.

1. *District 65 v. Prudential Securities.*[148] The Reform Act provides that "no person may rely upon any conduct that would have been actionable as fraud in the purchase or sale of securities to establish a violation of [RICO]."[149] The court ruled that this provision of the Reform Act did not apply retroactively so as to bar plaintiffs' RICO claim, which had been filed prior to the effective date of the Reform Act.[150]

2. *In re Prudential Sec. Inc. Ltd. Partner. Litig.*[151] The court held that the Reform Act did not apply retroactively so as to deprive the court of jurisdiction over a RICO claim that had been filed prior to the effective date of the Reform Act.[152]

3. *Baker v. Pfeifer.*[153] Consistent with *District 65* and *Prudential*, the court held that the Reform Act did not apply retroactively so as to bar plaintiffs' RICO claim, which had been filed prior to the effective date of the Reform Act.[154]

4. *Securities and Exchange Commission v. Fehn.*[155] In 1994, the Supreme Court held in *Central Bank of Denver v. First Interstate Bank of Denver* that a private party may not maintain an action for aiding and abetting a violation of Section 10(b).[156] The Court refused to address whether the SEC could still maintain an aiding and abetting action. The Reform Act, however, permits the SEC to file actions for injunctive relief and to seek monetary penalties against a "person that knowingly provides substantial assistance to another person in violation of [the Securities Exchange Act of 1934 and regulations promulgated thereunder.]"[157] The court held that the Reform Act barred extension of the *Central Bank* decision to SEC injunctive actions given the peculiar timing of events in the case. The activities at issue occurred before the *Central Bank* decision but the Reform Act was passed while Fehn's appeal was pending. In these circumstances, retroactive application of the Reform Act did not impair rights that existed when the defendant acted, increase liability for past conduct, or attach new legal consequences to the events underlying the SEC's injunction.

[148] 925 F. Supp. 1551 (N.D. Ga., Apr. 29, 1996).
[149] 18 U.S.C. § 1964(c).
[150] 925 F. Supp. At 1566-70.
[151] 930 F. Supp. 68 (S.D.N.Y., June 10, 1996).
[152] *Id.* at 77-81.
[153] 940 F. Supp. 1168 (S.D. Ohio, Sept. 20, 1996).
[154] *Id.* at 1175-79.
[155] 97 F.3d 1276 (9th Cir., Oct. 9, 1996).
[156] 511 U.S. 164 (1994).
[157] 15 U.S.C. § 78t(f).

Cognate Decisions

At least two decisions rendered in 1996 could provide significant persuasive authority for interpreting provisions of the Reform Act, although they do not themselves interpret the Act. One decision concerns whether and under what circumstances allegations of insider trading during the class period are sufficient to satisfy plaintiff's obligation to plead scienter. This issue is important because of the significant number of cases alleging insider trading since the effective date of the Reform Act. The other decision concerns the appropriate role for institutions in shareholder litigation, which may be relevant to interpretation of the lead plaintiff provision.

1. *Provenz v. Miller.*[158] The district court granted summary judgment in favor of defendants in this pre-Reform Act class action brought on behalf of purchasers of stock of MIPS Computer Systems, Inc. The Ninth Circuit reversed the district court's determination that there was insufficient evidence to support a finding of scienter. Expert testimony that MIPS violated GAAP and its own internal policies for revenue recognition tended to support a finding of scienter and made summary judgment inappropriate.

Some of the individual defendants' stock sales during the class period were also found to support a finding of scienter. The Chairman and CEO sold 20% of his stock for $1.3 million and the President sold 90,000 shares, six times more than in the 12 months preceding the class period. These sales were also found to have been at "sensitive times," *i.e.*, shortly after an analysts conference call when allegedly false and misleading statements were made. Two other defendants who provided unrebutted evidence of innocent explanations for their stock sales were entitled to summary judgment on the issue of scienter.

This decision may be important for courts interpreting the Reform Act's requirement that a plaintiff plead facts giving rise to a strong inference of fraud. As noted previously, a significant percentage of post-Reform Act cases allege insider sales as support for a finding of scienter. The *Provenz* decision suggests that such allegations may be sufficient to meet the new higher pleading standard. At the same time, *Provenz* emphasizes that the mere fact of trading during the class period is not enough. A careful analysis of timing, amounts, and circumstances of the alleged trading is necessary to determine whether trading supports a finding of scienter.

2. *Weiser v. Grace.*[159] This shareholder derivative action involves claims that W.R. Grace & Co. paid excessive "perks" to its former Chairman and paid $20 million in improper severance payments to its former President who resigned after charges of sexual harassment were lodged against him. This decision may provide an important precedent for interpretation of the Reform Act's lead plaintiff provisions.

[158] 95 F.3d 1376 (9th Cir., Sept. 11, 1996).

[159] Index No. 106285/95 (N.Y. Supreme, Sept. 3, 1996).

The court permitted the California Public Employees' Retirement System ("CalPERS") to intervene and to designate co-lead counsel after CalPERS learned that the lead counsel had failed to review key documents relevant to the derivative claims, and after it determined that a proposed settlement was inadequate. In particular, CalPERS objected to a settlement that would have merely required Grace to change its written policy for addressing claims of sexual harassment. The settlement provided no monetary payment from defendants who allegedly received improper payments. Although the court did not address the adequacy of the proposed settlement, it held that intervention was appropriate because "one very large shareholder believes that the present plaintiffs and present co-lead counsel are not adequately representing the interests of the Grace shareholders and has given persuasive reasons why that is so."[160] Moreover, the court held that "CalPERS, as a large institutional shareholder of Grace should be allowed a voice in the ongoing discovery and settlement discussions, and not simply given the opportunity to object at the end."[161]

The *W.R. Grace* decision emphasizes the important role that institutional investors can play in shareholder litigation. It demonstrates that institutional investor participation need not be limited to the role of lead plaintiff, and that courts need not focus exclusively on the lead plaintiff provision as the sole mechanism through which institutions can or should contribute to the prosecution of securities class actions.

[160] *Id.* at 6.

[161] *Id.*

XI. CONCLUSIONS AND POLICY ISSUES

The evidence presented in this report suggests that the level of class action securities fraud litigation has declined by about a third in federal courts, but that there has been an almost equal increase in the level of state court activity, largely as a result of a "substitution effect" whereby plaintiffs resort to state court to avoid the new, more stringent requirements of federal cases. There has also been an increase in parallel litigation between state and federal courts in an apparent effort to avoid the federal discovery stay or other provisions of the Act. This increase in state activity has the potential not only to undermine the intent of the Act, but to increase the overall cost of litigation to the extent that the Act encourages the filing of parallel claims.

The first year of experience with the Act also reveals that federal claims are now rarely filed against the largest firms, that larger stock price declines are associated with the decision to institute litigation now than prior to the Act's passage, and that a shift toward allegations of accounting irregularities and trading by insiders as the primary basis for litigation may be associated with both the decline in litigation against large firms and the continued high incidence of actions against high-technology firms.

The largest plaintiffs' law firm, Milberg Weiss Bershad Hynes & Lerach, has increased its significance in the litigation process most likely because of its capital base, ability to diversify increased litigation risk, and incentive to invest in the creation of favorable new precedent. The dominant emerging judicial interpretation of the Act suggests that the "strong inference" pleading requirement establishes no higher standard than that articulated by the Second Circuit, an interpretation favored by plaintiffs. Moreover, given that the courts have generally been reluctant to dismiss complaints without leave to replead, the Act does not yet appear to be a useful device for quickly eliminating complaints that do not meet the pleading requirement.

In addition to questions related to the general efficacy of the Act and the desirability of some of its outcomes, including the changing incidence of litigation by firm size and type, complex issues regarding the interplay of federal and state jurisdiction are rapidly emerging. The substitution of state for federal venues, as well as the tendency to pursue parallel litigation to avoid application of the discovery stay are examples of the way jurisdictional issues can circumvent the intent of the Act. The tension between federal and state courts will likely grow over time and may require Congressional review.

Appendix A
Companies Named in Federal Securities Fraud Class Actions December 22, 1995–December 31, 1996

Number	*Name Of Issuer*	*Court*	*Date of First Identified Filing*
1	4987 Corporation	S.D.N.Y.	10/18/96
2	ABS Industries, Inc.	N.D. Ohio	1/19/96
3	Access HealthNet, Inc.	C.D. Cal.	12/27/96
4	Alliance Semiconductor Corp.	N.D. Cal.	3/4/96
5	AmSouth Bancorporation	M.D. Fla.	8/12/96
6	AnnTaylor Stores Corp.	S.D.N.Y.	4/26/96
7	Bennett Funding Group, Inc.	S.D.N.Y.	4/11/96
8	BHP Copper Co.	D. Az.	6/13/96
9	Biocontrol Technology, Inc.	W.D. Pa.	4/30/96
10	Bollinger Industries, Inc.	N.D. Tex.	5/31/96
11	BT Office Products International, Inc.	S.D.N.Y.	4/16/96
12	Buenos Aires Embottelladora S.A.	S.D.N.Y.	9/30/96
13	CAI Wireless Systems, Inc.	N.D.N.Y.	11/22/96
14	Cedar Group, Inc.	E.D. Pa.	11/2/96
15	Cellstar Corp.	N.D. Tex.	5/14/96
16	Cephalon, Inc.	E.D. Pa.	1/29/96
17	Chantal Pharmaceutical Corp.	C.D. Cal.	2/6/96
18	Chubb Life Insurance Co. of America	D.N.H.	8/20/96
19	Communication & Entertainment Corp.	C.D. Cal.	12/24/96
20	CompuServe Corp.	S.D.Ohio & S.D.N.Y.	7/22/96 (both)
21	Computron Software, Inc.	D.N.J.	4/26/96
22	Comshare Inc.	E.D. Mich.	8/14/96
23	Cree Research, Inc.	M.D.N.C.	10/25/96
24	DAKA International, Inc.	D. Mass	10/18/96
25	Dean Witter/Discover	M.D. Fla.	3/28/96
26	Diamond Multimedia Systems, Inc.	N.D. Cal.	7/24/96
27	Digital Link Corp.	N.D. Cal.	10/18/96
28	Dignity Partners, Inc.	N.D. Cal.	12/19/96
29	Discreet Logic, Inc.	D. Mass	6/13/96
30	DonnKenny, Inc.	S.D.N.Y.	11/12/96
31	Eagle Finance Corp.	N.D. Ill. & E.D. Mo.	4/25/96 & 4/29/96
32	Ernst Home Center, Inc.	W.D. Wash.	7/16/96
33	Factory Stores of America, Inc.	E.D.N.C.	7/19/96
34	Firefox Communications, Inc.	N.D. Cal.	2/23/96
35	Fleming Cos., Inc.	W.D. Okla.	4/1/96
36	FMR Corp.	M.D. Fla.	7/17/96
37	FoxMeyer Health Corp.	N.D. Tex.	8/12/96

Appendix A continued...

Number	*Name Of Issuer*	*Court*	*Date of First Identified Filing*
38	Fritz Cos., Inc.	N.D. Cal.	7/31/96
38	FTP Software, Inc.	D. Mass.	3/14/96
40	Gaming Lottery Corp.	W.D. Wash. & S.D.N.Y.	6/13/96 & 7/24/96
41	General Nutrition Companies, Inc.	W.D. Pa.	8/2/96
42	Glenayre Technologies, Inc.	S.D.N.Y.	11/1/96
43	Grand Casinos, Inc.	D. Minn.	9/13/96
44	Great Western Financial	M.D. Fla.	12/12/96
45	Happiness Express, Inc.	E.D.N.Y.	5/23/96
46	Hart Brewing, Inc.	S.D. Cal.	6/14/96
47	Health Management, Inc.	E.D.N.Y.	2/28/96
48	Highwaymaster Communications, Inc.	S.D.N.Y.	2/23/96
49	Horizon/CMS Healthcare Corp.	D.N.M.	4/1/96
50	Housecall Medical Resources, Inc.	N.D. Ga.	9/3/96
51	Identix, Inc.	N.D. Cal.	10/8/96
52	IMP, Inc.	N.D. Cal.	10/2/96
53	Individual, Inc.	D. Mass.	11/15/96
54	Integrated Communication Network, Inc.	S.D. Fla.	7/24/96
55	International Automated Systems, Inc.	D. Utah	7/3/96
56	Italian Oven, Inc.	W.D. Pa.	7/2/96
57	Ivax Corp.	S.D. Fla.	7/16/96
58	Lincoln National Bank & Trust Co.	N.D. Ill.	10/8/96
59	Madge Networks N.V.	N.D. Cal.	8/14/96
60	Malvy Technologies, Inc. (n/k/a/ Metal Recoveries Technologies, Inc.)	D. Del.	10/31/96
61	Manhattan Bagel Co., Inc.	D.N.J.	7/8/96
	Medaphis Corp.	N.D. Ga.	8/19/96
63	Micrion Corp.	D. Mass	8/2/96
64	Micro Warehouse, Inc.	D. Conn.	10/1/96
65	Midcom Communications, Inc.	W.D. Wash.	4/19/96
66	MobileMedia Corp.	D. N.J.	10/4/96
67	Mustang Development Corp.	C.D. Cal.	2/1/96
68	Network Computing Devices, Inc.	N.D. Cal.	4/23/96
69	Network Express, Inc.	E.D. Mich.	10/8/96
70	Northstar Health Services, Inc.	W.D. Pa.	4/15/96
71	Novell, Inc.	D. Utah	4/2/96
72	Number Nine Visual Technology Corp.	D. Mass.	6/11/96
73	NuMed Home Health Care, Inc.	M.D. Fla.	2/1/96
74	Nutrition for Life International, Inc.	S.D. Tex.	8/27/96
75	Oak Technology, Inc.	N.D. Cal.	7/10/96
76	Open Environment Corp.	D. Mass.	12/5/96

Appendix A continued...

Number	*Name Of Issuer*	*Court*	*Date of First Identified Filing*
77	OrthoLogic Corp.	D. Az.	6/24/96
78	Pacific Scientific Co.	C.D. Cal.	10/18/86
79	Paracelsus Healthcare Corp.	S.D. Tex.	10/15/96
80	Pepsi Cola Puerto Rico Bottling Co.	E.D.N.Y.; D.P.R & S.D. Fla.	8/14/96; 8/16/96 & 8/15/96
81	Performance Nutrition, Inc.	N.D. Tex.	10/1/96
82	Physician Reliance Network, Inc.	N.D. Tex.	9/18/96
83	Pinnacle Micro, Inc.	C.D. Cal.	3/15/96
84	Presstek, Inc.	D.N.H. & S.D.N.Y.	6/28/96 & 7/1/96
85	PRINS Recycling Corp.	D.N.J.	5/29/96
86	ProNet, Inc.	N.D. Tex.	7/15/96
87	Proxima Corp.	S.D. Cal.	8/19/96
88	Putnam Convertible Opportunities and Income Trust	S.D.N.Y.	7/15/96
89	Quantum Corp.	N.D. Cal.	9/18/96
90	Rickel Home Centers, Inc.	S.D.N.Y.	1/26/96
91	Riscorp, Inc.	M.D. Fla.	11/21/96
92	Rockefeller Center Properties, Inc.	D. Del.	11/20/96
93	Silicon Graphics, Inc.	N.D. Cal.	1/29/96
94	Solv-Ex Corp.	S.D.N.Y.	10/4/96
95	Stratosphere Corp.	D. Nev.	8/5/96
96	Summit Technology, Inc.	D. Mass.	8/2/96
97	SyQuest Technology, Inc.	N.D. Cal.	4/2/96
98	Systems of Excellence, Inc.	S.D. Fla.	12/10/96
99	Teletek, Inc.	D. Nev.	12/2/96
100	Home Link Corp.	S.D.Fla.	10/21/96
101	TouchStone Software Corp.	C.D. Cal.	1/26/96
102	Tower Semiconductor Ltd.	E.D.N.Y. & D.N.J.	6/21/96 & 8/1/96
103	Unitech Industries, Inc.	D. Az.	1/9/96
104	United Healthcare Corp.	D. Minn.	8/9/96
105	Valujet Airlines, Inc.	N.D. Ga.	5/30/96
106	Vista 2000, Inc.	N.D. Ga.	4/17/96
107	WellCare Management Group, Inc.	N.D.N.Y. & S.D.N.Y.	4/1/96
108	Wheatley Ventures	N.D. Cal.	8/14/96
109	Wonderware, Inc.	E.D. Pa.	12/16/96

Appendix B

Companies Named in State Securities Fraud Class Actions December 22, 1995–December 31, 1996

Number	*Issuer*	*State*	*Court*	*Date of Earliest Identified Filing*	*Federal Action Filed*
1	20th Century Industries, Inc.	California	Los Angeles County	1/17/96	
2	Access HealthNet, Inc.	California	Orange County	12/19/96	Yes
3	ADAM Software Inc.	Georgia	Fulton County	4/25/96	
4	Adobe Systems, Inc.	California	Santa Clara County	2/6/96	
5	Advanced Voice Technologies, Inc.	New York	New York County	12/5/96	
6	AmSouth Bancorporation	Alabama	Alabama	4/22/96	Yes
7	Barnett Banks, Inc.	Florida	Hillsborough County	9/16/96	
8	Bennett Funding Group, Inc.	New York	New York County	4/12/96	Yes
9	Brooktree Corp.	California	San Diego County	5/6/96	
10	CellNet Data Systems, Inc.	California	San Mateo County	10/31/96	
11	Cerion Technologies, Inc.	Illinois	Cook County	8/2/96	
12	Cinergi Pictures Entertainment, Inc.	California	Los Angeles County	5/13/96	
13	Circon Corp.	California	Santa Barbara County	5/28/96	
14	Cirrus Logic, Inc.	California	Alameda County	2/21/96	
15	Citadel Holding	California	Los Angeles County	10/--/96	
16	Com/Tech Communication Technologies, Inc.	New York	New York County	12/5/96	
17	Communication & Entertainment Corp.	California	Los Angeles County	3/25/96	Yes
18	Comparator Systems Corp.	California	Orange County	5/13/96	
19	CompuServe/ H&R Block	Ohio	Franklin County	7/--/96	Yes
20	Datapax Computer Systems Corp.	New York	New York County	—	

Appendix B continued...

Number	*Issuer*	*State*	*Court*	*Date of Earliest Identified Filing*	*Federal Action Filed*
43	Mid Atlantic Medical Services, Inc.	Maryland	Montgomery County	11/12/96	
44	Nellcor Puritan Bennett Inc.	California	Alameda County	5/3/96	
45	Network Computing Devices, Inc.	California	Santa Clara County	4/10/96	Yes
46	Northeast Utilities	Connecticut	Hartford	12/5/96	
47	Nutrition for Life International, Inc.	Texas	Harris County	8/23/96	Yes
48	Oak Technology, Inc.	California	Santa Clara County	6/7/96	Yes
49	Oakley, Inc.	California	Orange County	12/26/96	
50	Orthologic Corp.	Arizona	Maricopa County	6/24/96	Yes
51	Oxford Tax Exempt Fund	Maryland	Montgomery County	1/23/96	
52	Paracelsus Healthcare Corp.	California	Los Angeles County	10/11/96	Yes
53	Paradigm Technology, Inc.	California	Santa Clara County	8/13/96	
54	Pearce International Systems, Inc.	California	San Francisco County	3/--/96	
55	Performance Development, Inc.	California	Los Angeles County	2/2/96	
56	Physician Reliance Network, Inc.	Texas	Nueces County	9/18/96	Yes
57	Pier 1 Imports, Inc.	Texas	Tarrant County	1/24/96	
58	ProNet, Inc.	Texas	Dallas County	7/3/96	Yes
59	Proxima Corp.	California	San Diego County	8/27/96	Yes
60	Pyramid Breweries, Inc.	California	San Diego County	9/3/96	Yes
61	Quantum Corp.	California	Santa Clara County	8/28/96	Yes
62	Quarterdeck Corp.	California	Los Angeles County	12/3/96	
63	Read-Rite Corp.	California	Santa Clara County	12/11/96	Yes*
64	Semitool, Inc.	Montana	Flathead County	2/21/96	

Appendix B continued...

Number	Issuer	State	Court	Date of Earliest Identified Filing	Federal Action Filed
21	Dean Witter Reynolds, Inc.	California	Los Angeles County	9/9/96	Yes
22	Dean Witter Reynolds, Inc.	New York	New York County	9/19/96	
23	Diamond Multimedia Systems, Inc.	California	Santa Clara County	6/27/96	Yes
24	Digital Link Corp.	California	Santa Clara County	4/22/96	Yes
25	Discreet Logic, Inc.	California	San Francisco County	5/29/96	Yes
26	FileNet Corp.	California	Orange County	12/20/96	
27	FoxMeyer Health Corp.	Texas			Yes
28	Fritz Cos., Inc.	California	San Francisco County	7/29/96	Yes
29	General Nutrition Companies, Inc.	Delaware	Chancery Court	8/5/96	Yes
30	Growth Hotel Investors	California	Los Angeles County	2/28/96	
31	Helmstar Group, Inc.	California	Riverside County	5/__/96	
32	Horizon/CMS Healthcare Corp.	New Mexico	Bernalillo County	3/21/96	Yes
33	I-Stat Corp.	New Jersey	Mercer County	6/19/96	
34	IMP, Inc.	California	Santa Clara County	9/17/96	Yes
35	Insignia Solutions plc	California	Santa Clara County	4/9/96	
36	John Hancock Realty Income Fund LP	New Jersey	Essex County	2/__/96	
37	Lehman Brothers	Delaware	Chancery Court	3/7/96	
38	Lehman Brothers	Maryland	Baltimore Circuit Court	2/6/96	
39	Lehman Brothers	New York	New York County	2/29/96	
40	Lehman Brothers et al.	New Jersey	Union County	8/30/96	
41	Manhattan Bagel Co., Inc.	California	Los Angeles County	8/7/96	Yes
42	Microtest, Inc.	Arizona	Maricopa County	9/29/96	

Appendix C
Complaints Contained in Database

Number	Issuer Name	Short Form Caption	Civil Action/Docket	Filing Date
1	ABS Industries, Inc.	Hawk v. ABS Industries, Incorporated	1: 96CV-0109	1/19/96
2	Alliance Semiconductor Corp.	Hockey v. Medhekar	C-96-0815 MHP	3/4/96
3	AnnTaylor Stores Corp.	Novak v. Kasaks	96 CIV. 3073	4/24/96
4	Bennett Funding Group, Inc.	Kronfeld v. Patrick R. Bennett	96 CIV 2583	4/11/96
5	BHP Copper, Inc.	Hanley v. Warburg Pincus Capital Company, L.P.	CV96-390 TVC WDB	6/13/96
6	Biocontrol Technology, Inc.	Walsingham v. Biocontrol Technology, Inc.	96-809	4/30/96
7	Bollinger Industries, Inc.	STI Classic Funds v. Bollinger Industries, Inc.	3: 96C-V-0823-R	5/31/96
8	BT Office Products International, Inc.	Wright v. BT Office Products International, Inc.	96 CIV 2685	4/16/96
9	Cellstar Corp.	Gluck v. Cellstar Corporation	396CV1353	5/14/96
10	Cephalon, Inc.	Steinberg v. Cephalon, Inc.	96CV-0633	1/29/96
11	Chantal Pharmaceutical Corp.	Marksman Partners. v. Chantal Pharmaceuticals	96-0872 WJR (JRX)	2/6/96
12	Communication & Entertainment Corp.	Pfannebecker v. Muller	96-9024 ABC	12/24/96
13	CompuServe Corp.	Romine v. CompuServe Corp.	C2-96-717	7/22/96
14	Computron Software, Inc.	Weiss v. Computron Software, Inc.	96-1921	4/26/96
15	Cree Research, Inc.	Rasheedi v. Cree Research, Inc.	1-96 CV00890	10/25/96
16	DAKA International, Inc.	Venturina v. Daka International, Inc.	96-12109	10/18/96
17	Diamond Multimedia Systems, Inc.	Frazier v. Diamond Multimedia Systems, Inc.	C 96-2644	7/24/96
18	Discreet Logic, Inc.	Friedberg v. Discreet Logic Inc.	96 - 1123 - 2 - EFH	6/13/96
19	Donnkenny, Inc.	Graver v. Rubin		11/12/96
20	Eagle Finance Corp.	Rehm v. Eagle Finance Corporation	9BC 2455	4/19/96
21	Firefox Communications, Inc.	Zeid v. Firefox Communications, Inc.	C9620136SW	2/23/96
22	Fleming Cos., Inc.	Mark v. Fleming Companies, Inc.	CIV - 96 0506M	4/4/96

Appendix B continued...

Number	*Issuer*	*State*	*Court*	*Date of Earliest Identified Filing*	*Federal Action Filed*
65	Silicon Graphics, Inc.	California	Santa Clara County	3/29/96	Yes
66	Simware, Inc.	New York	New York County	5/21/96	
67	Solv-Ex Corp.	New Mexico	Albuquerque	10/28/96	Yes
68	StorMedia, Inc.	California	Santa Clara County	9/18/96	
69	Stratosphere Corp.	Nevada	Clark County	8/16/96	Yes
70	Symantec Corp.	California	Santa Cruz County	3/18/96	Yes*
71	SyQuest Technology, Inc.	California	Alameda County	3/25/96	Yes
72	TCSI Corp.	California	Alameda County	11/4/96	
73	Valujet Airlines, Inc.	Georgia	Fulton County	6/21/96	Yes

* These companies were sued in a parallel federal action after December 31, 1996. For purposes of this analysis, these companies were included in the state court filings.

Appendix C continued...

Number	*Issuer Name*	*Short Form Caption*	*Civil Action/Docket*	*Filing Date*
23	FMR Corp.	Wildlife-In-Need, Inc. v FMR Corporation	96 1395 CIV T 25 E	7/17/96
24	Fox Meyer Health Corp.	Zuckerman v. Fox Meyer Health Corporation	3-96CV2258-T	8/12/96
25	Fritz Cos., Inc.	Polk v. Fritz	C 962712 WDB	7/31/96
26	FTP Software, Inc.	Greebel v. FTP Software, Inc.	96-10544 JLT	3/14/96
27	Gaming Lottery Corp.	Giamboi v. Gaming Lottery Corporation	C96-0924D	6/13/96
28	Glenayre Technologies, Inc.	Kwalbrun v. Glenayre Technologies Inc.	96CIV82	11/1/96
29	Happiness Express, Inc.	Jacobs v. Happiness Express, Inc.	CV 96 2552	5/22/96
30	Hart Brewing, Inc.	Steckman v. Hart Brewing, Inc.	961077 K RBB	6/14/96
31	Health Management, Inc.	Alexander v. Health Management, Inc.	CV 96 0889	2/28/96
32	Horizon/CMS Healthcare Corp.	Donnarumma v. Ortenzio	CIV 96 0442BB	4/2/96
33	Housecall Medical Resources, Inc.	Paskowitz IRA v. Housecall Medical Resources	1 96-CV-222V-JE	8/30/96
34	Identix, Inc.	Rooney v. Identix, Inc.	C 96-3637 MHP	10/8/96
35	Individual, Inc.	Cooperman v. Individual, Inc.	96-12272DPW	11/13/96
36	International Automated Systems, Inc.	Serfaty v. International Automated System, Inc.	2: 96CV 0583C	7/2/96
37	Madge Networks N.V.	Kane v. Zisapel	C-96 20652 PVT RMV	8/13/96
38	Manhattan Bagel Co., Inc.	Copland v. Grumet	96 CV 3351	7/2/96
39	Medaphis Corp.	Rosen v. Medaphis Corporation	96-CV-2217	8/30/96
40	Micrion Corp.	Geffon v. Micrion Corporation	96-CV-11596	8/2/96
41	Midcom Communications, Inc.	Myles v. Midcom Communications, Inc.	C96-0614	4/19/96
42	Mustang Development Corp.	Toplikar v. Mustang Development Corporation	96-0720 J GD	2/1/96
43	Nations Bank, Dean Witter, and affiliates	Brimacombe v. Dean Witter Discover	96-593-CIV-T-25E	3/26/96
44	Network Computing Devices, Inc.	Woodward v. Bradley	CAL C 96-1345	4/11/96
45	Northstar Health Services, Inc.	Butler v. Northstart Health Services, Inc.	96-701	4/15/96
46	Number Nine Visual Technology Corp.	RBI v. Number Nine Technology Corporation	96-11207 MLW	6/11/96

Appendix C continued...

Number	*Issuer Name*	*Short Form Caption*	*Civil Action/Docket*	*Filing Date*
47	Numed Home Health Care, Inc.	Fernhoff v. Numed Home Health Care, Inc.	96-200-CIV-T-21C	1/31/96
48	Orthologic Corp.	Boren v. Weinsten	CIV 96-1520 PHX RCB	6/24/96
49	Physician Reliance Network, Inc.	Kaufman v. Physician Reliance Network, Inc.	3-96CV2628-G	9/17/96
50	Pinnacle Micro, Inc.	Wills v. Blum	SA CV 96-261 GLT	3/15/96
51	Presstek, Inc.	Berke v. Presstek, Inc.	C-96-347-M	6/28/96
52	PRINS Recycling Corp.	Kaplan v. PRINS Recycling Corporation	96-2444 (WHW)	5/29/96
53	ProNet, Inc.	Werner v. ProNet Inc.	S-96CV1795-P	6/27/96
54	Proxima Corp.	Powers v. Eichen	961431 S AJB	8/16/96
55	Riscorp Inc.	Teitlebaum v. Riscorp Incorporated	96-2374-CW	11/19/96
56	Silicon Graphics, Inc.	Brody v. McCracken	C 96-0393	1/26/96
57	Solv-Ex Corp.	Sedita v. Solv-Ex Corporation	96 CIV 7575	10/4/96
58	Summit Technology, Inc.	Pearl v. Summit Technology, Inc.	96-11589JLT	8/2/96
59	SyQuest Technology, Inc.	Ravens v. SyQuest Technology, Inc.	C 96-1224 VRW	4/2/96
60	Italian Oven, Inc.	Schmitzer v. The Italian Oven, Inc.	961248	7/2/96
61	Wellcare Management Group, Inc.	Ward v. Wellcare Management Group, Inc.	96-CV-0521	3/29/96
62	TouchStone Software Corp.	Caramonta v. TouchStone Software Corp	CV 96-81-GLT (EEX)	1/26/96
63	Tower Semiconductor, Ltd.	Balsam v. Tower Semiconductor, Ltd.	CV 963090	6/21/96
64	Unitech Industries, Inc.	Barge v. Unitech Industries, Inc.	CIV 96-0094 PHX SMM	1/10/96
65	Vista 2000, Inc.	Sager v. Johns	1 96-CV-1053-FMH	4/30/96

Appendix D
Description of Reform Act Database Subsamples

Full Sample

Total = 65

Working Sample

Excludes:

Bennett Funding Group, Inc. (not publicly traded)
FMR Corp. (not publicly traded)
Mustang Development Corp. (not publicly traded)
Dean Witter/Discover (not typical "fraud on the market" case)
Communication & Entertainment Corp. (class period not clear in complaint)
BHP Copper Co., Inc.(class period not defined)

Total = 59

Sample Used for Comparisons with Jones and Weingram Study

Excludes:

ABS Industries, Inc.
(market capitalization calculations only)

Total =
58 (for market capitalization calculations)
59 (for all other calculations)

Sample Used for Comparisons with Simmons Study

Excludes*:

ABS Industries, Inc.
(market capitalization calculations only)
CompuServe Corp.
Computron Software, Inc.
Fleming Cos., Inc.
Hart Brewing, Inc.
Housecall Medical Resources
Individual, Inc.
Italian Oven, Inc.
Midcom Communications, Inc.
Number Nine Visual Technology Corp.
NuMed Home Health Care
ProNet, Inc.
Riscorp, Inc.
Vista 2000, Inc.

Total =
45 (for market capitalization calculations)
46 (for all other calculations)

* All cases except ABS Industries, Inc. are Section 11 claims.

Cornerstone Research
1000 El Camino Real, Menlo Park CA 94025
(415) 853-1660