

**“Final Thoughts on Litigation Reform”  
Remarks by Chairman Arthur Levitt  
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This will be my third speech on securities litigation reform before this group, and you will forgive me if I say that I hope and pray it will be my last. This wishful thinking is incorporated even into the title of my presentation—“Final Thoughts on Litigation Reform.” I’m not going anywhere, but the Private Securities Litigation Reform Act of 1995 has now become law and I am a bit tired of talking about the subject—in fact, I know few people who aren’t . . . except you, the students here at the 23rd Annual Securities Regulation Institute—or so David Ruder assures me, at any rate.

Before I go into that subject, let me say a few words about another issue that I anticipate may be on your minds, and on the minds of many people in this state today—the SEC’s actions regarding Orange County.

This morning, the Commission took three steps in its continuing investigation. First, the Commission filed and settled a civil injunctive action against the former County Treasurer, Robert Citron, and the former Assistant Treasurer, Matthew Raabe. They have been enjoined from future violations of the antifraud provisions of the federal securities laws. The Commission also instituted and settled an administrative proceeding against Orange County, the Orange County Flood Control District, and the Board of Supervisors of Orange County ordering them to cease and desist from violations of the antifraud provisions. Finally, the Commission issued a report of its investigation into the conduct of

the individual members of the Board of Supervisors of Orange County in authorizing the issuance of certain municipal securities.

The municipal bond market is of critical importance to our nation's future. It represents the schools that teach our children, the water we drink, the power that enhances our lives and drives our economy, the roads that take us where we need to go. American investors trust municipal bonds as they do few other instruments, and this has helped make them a popular investment. A decade ago, individual investors held about 45 percent of outstanding municipal securities; today, they hold more than 70 percent. Investor faith in municipal bonds has also benefitted taxpayers with low interest rates and, as a result, lower taxes.

But trust is hard to win, and easy to lose. While the origins of this particular case may be unique, the violations of the securities laws are not. The case boils down to problems with statements made to sell securities—in other words, with disclosure. Investors depend on the information provided in public offerings of securities. The law requires that the accuracy and completeness of that information be held sacrosanct.

As the Commission charged in the papers filed today, Orange County made material misstatements and omissions of fact regarding some \$2 billion of municipal securities it sold to investors in 1993 and 1994. Many of these offerings were made for the purpose of reinvesting into pools run by the Treasurer. Citron and Raabe leveraged the deposits in the pools. But when the time came to persuade investors to buy its bonds, the County either misrepresented or did not disclose information that brought into question the County's ability to repay its securities, information concerning the pools' investment strategy and results, and other material matters.

Today's action involves no new laws, but principles that were established long ago. It has been the longstanding view of the Commission that, "Although municipalities have certain unique attributes by virtue of their political nature, insofar as they are issuers of securities, they are subject to the proscription against false and misleading disclosures." For almost 20 years now, since the New York City fiscal crisis of the 1970s, we've been cautioning officials who authorize the issuance of municipal securities that they have a critical role in ensuring that official statements representing those securities are accurate and not misleading.

Borrowing the public's money is a huge responsibility. But the essentials are simplicity itself: You tell the truth, the whole truth, and nothing but the truth. And if you fail to do so, you can expect the SEC to act, as we have in this case and will in others. I should note, before

I leave this subject, that our investigation of the Orange county matter is ongoing.

Disclosure is the keystone of our securities regulation system. The main issue I'll discuss today, litigation reform, also has to do with the disclosure of information in public offerings of securities. Indeed, one of the main arguments used by proponents of reform was that liability concerns were preventing companies from disclosing information—especially forward-looking information.

As you may know, I'm not a lawyer, and therefore I won't try to give this gathering a detailed legal analysis of the newly adopted legislation. You can get your fair share of that, and more, in the various sessions of this important Institute. Rather, I'm here today to reflect a bit on a legislative system that, while not flawless, works reasonably well.

I know you've heard various pundits complaining that the legislation just passed goes too far, or doesn't go far enough, or will allow people to defraud investors without remedy, or doesn't provide adequate protection against frivolous suits. Believe me, I've heard all of those complaints dozens, perhaps hundreds of times. The SEC has been in the middle of the controversy—I have felt all along that it had to be—and when I leave this world an autopsy will no doubt reveal arrow wounds from both directions.

For me, a relative newcomer to Washington, the legislative process that brought us litigation reform was like a sprint through the no-man's-land between warring camps—a baptism by fire into the frenetic, no-holds-barred way that laws are made, and unmade, in our nation's capital. Along the way, I was castigated as a tool of business interests, genuflecting before the new Republican majority in Congress. I also was denounced for letting the interests of investors blind me to the long-term need of business to be free from meritless lawsuits. Some said that I held the fate of reform in my hands; others asserted with equal fervor that I was nowhere near being "in the loop."

Perhaps I'm wrong, but anyone who has been attacked this way by both sides must be in about the right place.

As some of you will remember, early in my tenure I appeared at this Institute and set out the reasons why a degree of reform was desirable. My experience in business taught me something about the dangers and expenses involved in meritless litigation. It doesn't help investors or the markets if we're too accommodating of those who think they should be able at the drop of a hat—or the drop of a stock—to file a lawsuit

immediately, hoping to wring out a profitable settlement, whether or not the company or its officers did anything wrong.

It was understandable that my speech would set off some alarms. Traditionally, as you know, the SEC has aligned itself with plaintiffs' interests, not defendants', and with good reason. The threat of litigation serves a valuable purpose in our system, encouraging corporations to observe their disclosure obligations carefully. That's good for investors and good for our markets. It's a vital part of the framework that has given us the best, deepest, most liquid securities markets in the world.

So it was unusual for an SEC Chairman to acknowledge that the litigation system required reform. But the pendulum had swung too far toward plaintiffs, and it needed to be brought into better balance.

At the time, we had a long-tenured Democratic Senate and House. The only legislation addressing the question, introduced by Senators Dodd and Domenici in the Senate and by Congressman Tauzin in the House, wasn't given much of a chance of going anywhere. But it seemed an important issue on which to take a stand, in order to set out a middle ground where the sharply polarized interests might eventually be persuaded to meet.

A year later, you invited me back. There had been Washington's equivalent of an earthquake in the interim—for the first time in 40 years, the Republicans had a majority in both houses of Congress. All of a sudden, securities litigation reform was very real: it was part of the Contract with America. Responsibility for introducing legislation was in the hands of Congressman Chris Cox of Orange County.

In that second speech, I told you that while change was important, we needed measured reform, not wanton revolution. I said that Congressman Cox's bill had the virtue of jump-starting the debate, but that it went too far in several important ways. I repeated my message of 1994: Meritless litigation costs capital and discourages disclosure, but in fighting it, we must be careful not to eviscerate important investor protections. That would be a cure far worse than the disease. I also discussed the SEC's redoubled efforts to address the problem, including our examination of ways to expand the safe harbor for forward-looking statements.

After that speech, the legislative process moved forward in earnest. The Commission ignored all requests to publicly support or denounce the legislation that was making its way through Congress. Instead, we went furiously to work, debating the issues among ourselves, and then focusing our efforts, along with elected officials on both sides of the aisle, toward making sure the legislation struck a proper balance.

The bill that eventually became law is not perfect—but that may be said about almost every other statute that runs the legislative gauntlet.

Even our most honored legal document, the Constitution, has required amendment 26 times since its adoption. I believe that if you can cut through the rhetoric and emotionalism that has surrounded this issue, and read the message issued by the President when he vetoed the bill, you will agree that his veto was a reasoned, moderate attempt to improve the bill. He did not reject reform. He tried to strengthen the bill in a way most of us can agree with. The President asked for three specific revisions: that the legislation specifically reflect the Second Circuit's standards for pleading scienter—which was the avowed intention of the bill's drafters; that the Statement of Managers accompanying the bill be modified to avoid eroding further the "bespeaks caution" standard embodied in the bill itself; and that the Rule 11 sanctions provisions be clarified. With those changes, he said (and I quote) "I will sign such a bill as soon as it reaches my desk."

As you know, the SEC is an independent agency, and we guard our independence zealously. I mention the President's veto message simply to demonstrate that the concepts contained in the legislation had widespread acceptance. The points raised by the President were an attempt to make the bill a bit better. The Congress decided to go ahead with the legislation as it was. So be it.

I have to say that I found the legislative process fascinating—I only wish that I had had an anthropologist there with me. A key turning point in that process comes when lobbying groups bring the fight to the media. Advertisements are created that overstate the problem, overstate the consequences, and overstate the solution. As this rhetorical whirlwind starts to spin, a huge centrifugal force is created, pushing people outward toward the extremes. Supporters and opponents of the measure become polarized.

By its nature, a middle position will have some views in common with each side. But in a polarized debate, the middle disappears, and every statement that arises there is allocated to one side or another. In this context, my view that the system needed fine-tuning was misconstrued by both sides. Much to my surprise, I briefly became one of the most quoted people in Washington—but only because I was being quoted by both sides.

To avoid being misquoted or misunderstood, the Commission put its views in writing. We expressed concern about some sections of the bill, and supported other sections. Still, some on each side took quotes out of context to bolster their own views.

But in the end, even as the rhetorical breach widened, the policy differences narrowed. And the result was a bill that many people regard not as radical change but as fine-tuning.

As I consider what we accomplished in the process of working with the Congress on this legislation, I think of the old saying that success has a hundred fathers but defeat is an orphan. Judged by that standard, the litigation reform bill must be a success, for there are certainly many people claiming paternity. But I'm also reminded of Bismarck's aphorism that "Laws are like sausages—it is better not to see them being made."

Most of the interaction between the SEC and Capitol Hill centered on the bill's safe harbor provisions. Our goal was to encourage companies to provide more meaningful forward-looking information to the market by affording them greater protection. At the same time, if a call was close, we tried to err in favor of plaintiff investors, in view of the important role they have traditionally played in policing fraud our markets.

As finally adopted, the general safe harbor applies only to companies that are subject to SEC reporting, and to people who are making statements on behalf of such a company or on the basis of information provided by such a company. It doesn't apply to initial public offerings or partnerships offerings. It doesn't apply to tender offers or going-private transactions. It doesn't apply to often-problematic penny stock or blank check companies, or to companies that have been found to have violated the securities laws within the past three years. It doesn't apply to financial statement information. These exclusions, as well as some others I didn't mention, ended up in the legislation because the SEC asked for them.

As sought by the Commission, the legislation authorizes the SEC to provide additional safe harbors, consistent with the public interest and the protection of investors. This will allow the Commission to provide protection for statements outside the legislative safe harbor on a basis tailored to address specific needs. The Commission has already announced that it plans to use this authority to propose safe harbor rules for the required valuation of employee stock options and derivative securities. In these areas, we thought that it was better to work through the rule-making process, where the SEC is better able to consider various alternatives, take comments from a variety of people, and adopt well-targeted rules. The Congress evidently agreed.

The safe harbor provision underwent several critical changes. In earlier drafts, a company that offered any reasons their projections might not materialize would have gained the protection of the law. We felt this was a formula for fraud. The final version, as you know, generally

requires that companies identify important reasons why their projections might fail to come true. The additional requirement that the disclosure be "meaningful" should work to discourage the omission of important information. I also note that the safe harbor doesn't provide any protection from SEC enforcement action. And nothing in the safe harbor permits misrepresentations or omissions about existing facts.

Where do we go from here? The Private Securities Litigation Reform Act of 1995 is now the law of the land. If it succeeds, investors can expect two distinct benefits: more and better forward-looking information coming into the marketplace from public companies, and less shareholder assets siphoned away by meritless litigation. This would be a very positive achievement in behalf of American investors. Of course, only time will tell whether the bill will achieve the aims set out by its authors. But you can be sure that the SEC will enforce the law vigorously—I've asked the Division of Corporation Finance to pay close attention to forward-looking statements issued under the law's safe harbor, and the Division of Enforcement to pursue abuses aggressively when they are found.

The question of litigation reform has now moved to the courts—and to states such as California, where ballot initiatives will debate the issue further. For the SEC, the closing of this episode provides an opportunity to redouble our efforts in our core mission of investor protection. That is especially important in the wake of litigation reform, because to the degree private rights of action are curtailed, further demands will be placed on the Commission's already stretched resources.

And we'll do our best to meet those demands . . . assuming we're still open for business. The SEC is one of the agencies caught in the Battle of the Budget. As things stand right now, we're funded only through next week.

Perhaps I haven't been in Washington long enough, but I'm hopeful that our funding situation will get resolved. If that's the case, it may be helpful to you if I close by singling out four of the key initiatives you can expect to see the Commission work on in the year ahead:

First, we will continue our efforts to achieve a higher standard of clarity and understanding for investors, through a combination of simplified prospectuses, investor education, emphasis on the use of plain English in disclosure documents, and greater electronic access to disclosure. This decade has seen a huge influx of new investors into the marketplace, especially through mutual funds. Too many of them don't

understand risk; too few of them have seen a bear market. We're working to better prepare these newcomers for the risks of being in the market. As you may know, we have proposed for public comment rules that are intended to assure that investors receive a higher quality of order execution, no matter in which market their order is entered. We put a high priority on addressing the issues raised by these rules. The core mandate of the Commission is vigorous investor protection—protection from fraudulent practices and protection in terms of market structure that ensures the primacy of investor interests.

Second, we will work to raise standards in the retail brokerage industry. The SEC's aggressive efforts to keep the industry free of bad brokers will continue, especially in view of the newcomers in the market. But a comprehensive approach to fraud includes prevention as well as prosecution. I'm proud that, within the past year, many firms within the industry have restructured their compensation methods to bring the interests of brokers more in line with the interests of their clients. Continuing education for brokers has also become a reality, and we're now exploring the possibility of advanced education leading to some sort of certification.

Third, we will continue to keep a close eye on the municipal debt market. The SEC's intense interests in the municipal market follows its transformation from a market dominated by institutional investors to one in which individual investors predominate. We will work to ensure that it maintains the standards of integrity and disclosure expected by investors and required by law.

Finally, the Commission is taking a serious look at our self-regulatory system. As you know, the industry itself is the front line of regulation. It is especially important that its regulatory arms be effective, as well as fair, to investors and market professionals alike. It is the SEC's responsibility to oversee self-regulation; and if the system is working less than ideally, it is our job to hold the self-regulatory organizations accountable. In the year ahead, you'll see the SEC work to address some of the questions that have been raised about the self-regulatory system, in order to strengthen it.

I've raised many issues with you today—from Orange County to litigation reform and our agenda for 1996. But as different as these issues may seem, one thread unites them all, and that is the SEC's overriding concern for investors, whose trust has made American markets the greatest in the world. It is not exchanges, not computers, not stocks, and not bonds that make a market, but people willing to entrust others with their hard-earned money—their future. We must never take their trust for granted. Whatever our various roles—you and

I and everyone involved in our markets—we must always be worthy of that trust, and we must work constantly to increase it.