

Securities Litigation Attorney Accountability and Transparency Act
Testimony of William Francis Galvin
Secretary of the Commonwealth of Massachusetts

As Secretary of the Commonwealth of Massachusetts, I am the chief securities regulator in Massachusetts. Among other provisions, my Office administers and enforces the Massachusetts Uniform Securities Act.

The work of my Securities Division includes the review of securities offerings, the licensing of securities professionals, and significant enforcement work. Enforcement cases brought by my office have addressed some of the most substantial and timely problems in the financial marketplace: false and misleading analyst reports from national brokerages, market timing of mutual fund shares, abusive practices in the sales of annuity products, and fraudulent conduct by investment advisers.

I must stress that the great majority of financial firms conduct an honest business, and most issuers of stock are not defrauding investors. However, my office has repeatedly seen that small investors are at a serious disadvantage when they deal with dishonest sellers of securities and dishonest companies. It is imperative that investors at all levels have effective remedies in cases when they are defrauded. Class action litigation has been an effective remedy especially for small investors.

My office also incorporates Massachusetts corporations and charters business entities in Massachusetts. I am very sympathetic to the needs of legitimate business people and their companies. But business corporations ultimately belong to their shareholders. Corporate executives and directors owe fiduciary obligations of care and loyalty to the corporation and its shareholders.

I speak today for the interests of investors. If investors are to defend themselves from misconduct and fraud by officers and directors, we must preserve their remedies under the securities laws. Ultimately, giving investors strong and effective remedies will help prevent misconduct by company managements. The way I see it the right to civil litigation is an essential part of the free market. It is a free market force that guarantees that there will be financial consequences for fraud and wrongdoing and it operates as a deterrent in the marketplace to continuing misconduct.

My Office has committed significant resources to enforcement. We are a strong cop on the beat. However, the resources of any regulatory agency will always be limited. Regulators cannot police the financial markets alone. Since the 1930's, investors' private rights to sue have also operated to police and deter investment fraud. Both of these tools are essential to maintaining the integrity of our financial markets.

We are concerned that provisions of the Securities Litigation Attorney Accountability and Transparency Act will stifle the ability of plaintiffs to obtain recourse when the securities laws are violated. While my office has returned more than twenty

million dollars directly to investors, I am still concerned that many times so-called “fair funds”, or pooled compensation funds do not effectively reach defrauded investors. Civil actions offer a more precise remedy.

“Loser Pays” Provision. This provision may be seriously detrimental to the interests of retail investors because their attorneys will be required to take on great financial risk in a class action. This provision would reverse the longstanding “American rule” that each party in an action should be responsible for its costs, unless the action involves abuse of the legal process.

Potentially imposing a defendant’s costs on a plaintiff will chill investors and their attorneys from pressing legitimate claims.

Litigation involves many uncertainties; if there is a risk that the costs of defense counsel may fall on plaintiff’s counsel, lawyers and parties who cannot afford that risk exposure will back away from even meritorious investor suits.

I note that federal Rule 11 already requires that court filings not be made for any improper purpose and that the legal arguments be warranted and that a party violating those requirements will be subject to court sanctions including paying defendants costs and legal fees. The “loser pays” provision of the legislation may add very little value over the current court rules.

Conflict of Interest Disclosure. I have no comment on this section except to ask whether legislation that targets the practices of a particular law firm is the proper way to approach these issues. I note that the law firm in question is currently the subject of a federal indictment for the practices this section would address.

Court’s Role in Selecting Counsel for the Plaintiff Class. It is not clear why this section is necessary, and it appears not to be advisable.

The Private Securities Litigation Reform Act of 1995 created a presumption that the investor with the largest financial stake in a case should serve as lead plaintiff, and that it should choose and negotiate with class counsel. This law has led to more institutional investors acting as lead plaintiffs in class actions, so these cases are often led by sophisticated plaintiffs with meaningful resources. If the proper party is acting as lead plaintiff, the selection of counsel should rest with them.

Section 4 of the bill goes beyond requiring that the court should simply approve or disapprove counsel for the plaintiffs; and it instead embroils the court in the selection of plaintiff’s counsel. The legislation will allow the court to employ alternative means in the selection and retention of counsel for the plaintiff, including a competitive bidding process.

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

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

I urge that this legislation should not be adopted. Even after the passage of the Sarbanes-Oxley Act, we continue to see disturbing examples of fraud in the financial markets. From the failure and bankruptcy of the Refco commodity firm just a few months after its IPO, to the unfolding stories relating to the backdating of executive stock options, there still fresh examples of fraud and misconduct in the financial marketplace. But there is often a common thread running through these scandals and that is the application of two sets of rules – one set for connected insiders which allow them to extract unjust profits from the marketplace and the other set of rules for average American investors that has them pay the price for the fraud of connected insiders.

Private suits play an important role in keeping companies honest. As successive Congresses have encouraged and often required American families to assume the risk of the marketplace for their pensions and other aspects of their financial future.

I urge you to protect, and not diminish, this important tool to fight fraud and abuse against investors.