REMARKS OF

RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CORPORATE COUNSEL INSTITUTE
CHICAGO, ILLINOIS

OCTOBER 16, 1991

U. S. Securities and Exchange Commission
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For the past few months it has not been easy to get through the paper, or the Sunday review of new books, without reading about financial frauds and scandals in one part or another of the world. Without for a moment underestimating the seriousness of many of these problems, it is also worth reminding ourselves that the U.S. securities market produces a vast array of financing to issuers of all types and sizes. It also presents investors with an almost unlimited menu of potential investments, as well as the information needed to make sensible economic judgments. Though I am certainly biased, I believe that the U.S. market remains the most open and fair market in the world, with by far the most rigorous standards to protect investors of any major market.

The U.S. securities markets remain the largest in the world, with an unparalleled degree of participation by individual investors as well as large institutions. More than 50 million individuals own, directly or indirectly, shares traded in the U.S. equity markets. The capitalization of those markets has grown from about $1.3 trillion in 1981 to more than $4 trillion today. The total value of the equity and debt outstanding in our markets is slightly in excess of $10 trillion dollars.

More important than sheer size is the capacity of the markets to provide financing for the U.S. economy. In the first nine months of 1991, more than $510 billion has been raised in public and private offerings of securities, which is greater than the highest annual volume in history. If that pace continues throughout the fourth quarter, the aggregate volume of financings for 1991 could approach $700 billion.

Issuers have raised almost $60 billion in equity so far this year. This could lead to almost $80 billion in new equity for all of 1991. That would exceed by nearly 15% the previous historic high, and nearly double 1990's total of $44.3 billion. Though some of that $80 billion in new equity will go to strengthen weakened balance sheets rather than to finance growth, over the long term this level of financing will translate into research, development, employment and growth.

Equity offerings in 1991 have not been limited to large, established companies. By year end, almost $12 billion in initial public offerings will occur if present trends continue. That is nearly triple the volume of IPOs in 1990.

The record volume of securities offerings described above does not include the $533 billion in outstanding commercial paper. Taken together, the total of both long term and short term financing of the economy through the securities markets during 1991 could ultimately exceed $1.2 trillion. By contrast, the total of outstanding bank commercial and industrial loans is about $630 billion. Thus, whatever the causes and extent of the "credit crunch" in the banking system, the securities markets have been able to respond to the financing needs of American business despite a very difficult economic environment.

Though our markets appear to be working well to deliver the needed financing to our economy, the <u>cost</u> of financing is as important as its volume. Two broad areas of effort for the future are important in reducing the cost of capital. One is to create enhanced incentives for savings and investment for capital formation.

While it is fashionable in some quarters to disparage "supply side" economics, it remains true that the price of any commodity like capital is a reflection of its supply and its demand. Steps like the President's proposals to reduce capital gains taxes and to create new types of incentives like family savings accounts and other similar measures can certainly help increase the attractiveness of long-term investment. Reducing the truly obscene consumption of our available savings by the federal budget deficit would also make more capital available for private investment.

Political and economic developments in Eastern Europe, the Soviet Union, certain parts of Latin America and other countries have already increased demands on the world supply of capital considerably. Given the fact that savings rates have not yet shown a corresponding increase, it appears that the world supply of capital will be considerably tighter in the '90s than was true throughout the '80s. This occurs as the need to sober up and pay the bills for the "borrow and spend" policies of many companies during the last few years has become painfully apparent. This makes the national importance of generating old fashioned "savings" here in the U.S. all the more important.

In addition to increasing incentives for savings, we also need to address ways to reduce the overall costs of the process for raising capital. I would like to review with you some ways that we might be able to trim the cost of capital raising in the U.S. by reducing the tremendous costs imposed by our legal system on those who use the U.S. capital markets.

Of course one of the most helpful ways of reducing the total regulatory and legal "overhead" for the market would be to simplify our system of overlapping laws and regulatory bodies. Just in the financial area alone, we are the only nation that needs two federal agencies to regulate stocks, options and stock futures. We are about to make that problem worse by ratifying the continuation of something called the "exclusivity clause", which is a grant of monopoly powers to the nation's futures exchanges and results in a lawsuit to determine the status of every new product that combines features of both a security and a future. We have four federal agencies to regulate depository institutions like banks, and five if you count credit unions. We have three federal agencies to oversee the government securities market, to the degree that it is regulated at all. Fifty-one agencies are required to license and oversee the sale of mutual funds. Every other year we pass a few hundred new pages of statute to try and correct the problems of our banking system.

It probably isn't possible to change many of these duplicative responsibilities within government, or even to hope for reasonably specific and unambiguous statutes. So, since I try to be a realist, let us see whether there are any ways of reducing the cost of private litigation -- the increasingly heavy anchor that most U.S. companies have to drag through ever choppier economic seas.

At the outset, it should be clear that some litigation is essential to enforce laws and contracts and to ensure that those injured are adequately compensated. Private securities litigation has long been recognized as an important tool for helping to achieve the enforcement of the federal securities laws. By penalizing those who deliberately lie, falsify financial information, and commit other intentional acts of fraud, private actions perform a critical role in preserving the integrity of our securities markets.

Private actions have a very important role to play in redressing the effects of deliberate fraud on investors, and in supplementing the enforcement efforts of the SEC. This is why the Commission has supported efforts to establish an express statute of limitations for private fraud actions under Rule 10b-5. The proposal under consideration would provide investors a meaningful time period in which to discover the existence of fraud and bring any necessary lawsuit, while also placing a fixed limit on the period of time that potential defendants are exposed to contingent liabilities.

In our view, too short a time frame would simply prevent many meritorious private securities claims from ever being heard. Indeed, if a three-year statute of limitations had applied to the Commission, some of our most important antifraud cases could never have been brought. A shorter time frame would also, in some cases, encourage frivolous litigation by forcing plaintiffs to file cases without fully investigating them.

Since many securities frauds are carefully concealed, and thus are not discovered until years after they are committed, the Commission has favored the establishment of a maximum period for commencing litigation of the earlier of: two years after the discovery of a fraud, or five years from the date a security was distributed. In practical effect, any such "two and five" rule would be substantially shorter than many of the limits which applied before the Supreme Court's decision in June of this year in the Lampf case.

For example, here in Illinois until late 1990,[1] the federal courts "borrowed" a three-year limit for federal 10b-5 actions from the Illinois blue sky law. In Illinois and elsewhere, however, this time limit was subject to "equitable tolling" if a plaintiff did not discover and could not reasonably have discovered the fraud.[2] Thus, prior to 1985, there really was no outer limit at all on 10b-5 actions in Illinois. In the Peoria Union Stock Yard case, for example, the plaintiff was allowed to file its complaint ten years after the sales of securities.[3]

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[1] See Short v. Belleville Shoe Mfg. Co., 908 F.2d 1385 (7th Cir. 1990) (adopting one and three rule).

[2] See Davenport v. A.C. Davenport & Son Co., 903 F.2d 1139, 1141 (7th Cir. 1990).

[3] Peoria Union Stock Yards v. Penn. Mutual Life Ins. Co., 698 F.2d 320, 326 (7th Cir. 1983).

While Illinois added a five-year outer limit to its statute in 1985, the practice of each state was quite different. Thus, it was necessary to litigate procedural issues pertaining to equitable tolling in a great many cases.

To streamline the prior law, the SEC and the Justice Department took the position before the Supreme Court in the Lampf case that:

1. There should be a uniform federal statute of limitations for actions under Section 10(b).

2. There should be an "outer limit" of five years on any action under 10(b), regardless of any claim of "equitable tolling".

In this manner, the SEC sought to give a reasonable time to permit the discovery of fraud, while at the same time streamlining the procedural issues in such cases and reducing considerably the length of exposure to suit.

To me, it makes far more sense to address the problems of frivolous securities litigation directly, rather than indirectly through an unreasonably short statute of limitations. Frivolous securities claims should, however, warrant our attention and our efforts to control.

Many of the major securities cases in federal courts are class actions against companies whose stock prices suddenly increased or decreased. The class action plaintiffs (or more precisely their lawyers) claim that the company should have disclosed the bad or good news earlier. Professor Janet Alexander of Stanford, in a recent study of securities class actions against computer firms, found that such cases almost always settle, and that the settlements have almost nothing to do with the merits.[4] In other words, because of the risks and costs of litigation, companies settle weak or even meritless claims on essentially the same terms as they settle meritorious claims.

Settlements in securities class actions are substantial not only in percentage terms -- in many cases around 25% of the amount at issue -- but also in absolute terms. The eight settlements analyzed in the study I just referred to totalled over $70 million. Those figures, of course, do not include the litigation costs of defending securities class actions, which may be about half as much again.

A litigation system that fails to separate strong claims from meritless claims serves no one. It does not serve investors who have clear, solid claims and yet receive only a modest settlement, even more modest after payment of substantial attorneys' fees. It does not serve companies who have valid, strong defenses, and yet pay millions to settle claims to avoid the costs and risks of litigation.

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[4] Alexander, Do the Merits Matter? A Study of Settlements in Securities Class Actions, 43 Stanford L. Rev. 497 (1991).

Excessive class action settlements may deter companies from raising capital through the public markets and operating as public companies. In addition, litigation in all too many cases may be seen as the route for trying to recover what may have been market losses. In effect, some investors may seek a system of "Heads I win, tails I sue."

The challenge, then, is to devise ways to reduce unwarranted securities litigation without closing the courthouse door for victims of intentional securities fraud. Toward that end I would like to suggest a few alternatives that are worth considering.

First, we should carefully consider applying some form of the "English rule" in our securities litigation. Parties who file claims without any reasonable basis ought to be responsible for the costs and counsel fees of the defendant. This would put some risk into the equation when people are considering filing dubious claims in hopes of provoking a settlement.

Second, the Racketeer Influenced and Corrupt Organizations Act should be amended to delete securities fraud as a basis for civil RICO liability. The ability to recover treble damages and attorneys' fees under RICO make that statute a particularly powerful tool in the hands of plaintiffs who seek either to compel a settlement from an innocent defendant or to avoid adverse case law under the securities laws. At a minimum, civil RICO gives every plaintiff two bites at the apple -- once under the securities laws and once under RICO. The old Wrigley slogan "Double your pleasure, double your fun" in this area would have to be revised to "Double your exposure, double your costs."

RICO's openness and vagueness make it particularly difficult for defendants to defend themselves against baseless charges that they have engaged in a "pattern of racketeering activity." I believe that the time has come to amend the law so that standard civil securities cases cannot be turned into RICO cases.

Third, we should consider limiting the personal monetary liability of corporate directors in private securities cases that do not involve intentional misconduct or improper personal benefit. The potentially devastating financial liability of the directors is a major factor forcing companies to settle private securities claims which, as is customary, name both the corporation and its directors. Plaintiffs' counsel, in turn, have a tremendous incentive under the current system to name corporate directors whenever possible because it allows the use of director and officer insurance to fund part of a settlement. Over forty states have allowed corporations to limit the liability of their directors for non-intentional violations of their state law duty of care.

Limiting director's liability in the remaining states, and under federal law, where there is not any intentional misconduct or self-dealing could be very helpful in limiting litigation. Establishing a cap on liability equal to their compensation as a director plus the value of their shares[6] is one promising possibility suggested by no less than my good friend Stanley Sporkin.

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[6] Sporkin, A Reply to John C. Coffee, Jr., 53 Brooklyn L. Rev. 975, 976 (1988).

Fourth, we should consider a percentage limit on the fees and expenses that the court can award to plaintiffs' counsel in a settlement of a securities class action. The limit should be substantially less than the 30% that is currently customary under either the lodestar or the percentage of recovery methods.[6] The limit should not apply when a class action is litigated to its conclusion: in that case the plaintiffs' counsel should either recover their fees or not, depending upon the outcome.

Such a limit would, one hopes, discourage baseless securities class actions and the costs of such cases for corporations. It should not, one hopes, prevent plaintiffs from prevailing in class actions when they should prevail, since plaintiffs' lawyers would still be entitled to higher fees if they prevailed on the merits.

At the SEC we remain committed -- through our enforcement program, through effective private remedies, and in particular through a reasonable statute of limitations -- to protect the 50 million investors in the U.S. securities markets. It is in your interest, as well as the public interest, to provide investors an adequate private remedies for securities fraud, so that they will have the confidence to invest in your securities.

At the same time, the Commission solicits your help in identifying ways to improve the system for private securities litigation. It is in the public interest, and the specific interest of investors who are shareholders of defendant companies, to have

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[6] E.g., In re Activision Sec. Lit., 723 F. Supp. 1373, 1379 (N.D. Cal. 1989).

sensible rules so that companies can raise capital without facing unnecessary and seemingly endless litigation.

This job of overhauling our system to reduce the risk of abuse must be done with a full sensitivity to the critical importance of not immunizing those who seek to cheat and defraud investors from liability either formally or informally. Here it is our obligation to develop reforms that are carefully tailored to reducing frivolous or repetitive claims, while not tipping the scales against legitimate claims that need to be heard. This balancing will not be easy, but reducing the costs of raising capital in public markets makes the job well worth the effort. I hope that you will lend your experience and counsel to that effort.

Thank you.