

Regulation

SOX May Temper Call for New Legislation

By Christopher Duca

While past performance is no guarantee of future results, our legal system is likely to react to the 2008 global economic turmoil and stock market crash. There will likely be a spike in securities class-action lawsuits. However, a call for new legislation mandating increased transparency and expanding investors' rights may be tempered by the sweeping corporate governance measures of the Sarbanes-Oxley Act (SOX).

We've heard the quote "history tends to repeat itself." Euphoria rises in the stock market due to the new economy or rules that change the game. Warning bells are sounded by a discerning few. Industry

improve transparency and investor rights since the landmark anti-fraud legislation of the 1930s. These laws brought transparency to investors with expanded private rights of action, personal liability, and accountability to directors and officers, along with regulatory enforcement powers and the establishment of the Securities and Exchange Commission.

Shortly after the 1987 stock market crash, the courts expanded shareholder rights. In 1988, the Supreme Court established the "fraud on the market theory" in *Basic Inc. v. Levinson*. The result was a boon for the opportunistic plaintiffs' bar.

ruled: "An inflated purchase price will not by itself constitute or proximately cause the relevant economic loss needed to allege and prove 'loss causation.' The basic elements of a private securities fraud action—which resembles a common-law tort action for deceit and misrepresentation—include, as relevant here, economic loss and loss causation."

In *Tellabs*, the Supreme Court ruled the pleading standard to be that "an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of non-fraudulent intent." The frequency rate of filings stabilized again in 2006 to 2007, in line with historical levels of 1 in 50 publicly traded firms sued.

Now, the 2008 global economic crisis has triggered investor losses, with the Dow, Nasdaq, Russell 2000, and S&P 500 indices eroding approximately 35 percent in value. In October, SEC Chairman Christopher Cox noted that the agency was founded 75 years ago to restore investor confidence: "Today, we are continuing to build on that essential premise: that investors have a right to know the truth—and the risks—about the securities that trade in our public markets."

While it's too early to determine what form the legal remedies will take, it's a good idea to buckle your chinstrap and program the number of your securities defense attorney into your speed dial.

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gurus and market mavens dismiss the naysayers as Chicken Littles who "don't get it." The consistent false promise espoused—"this time will be different"—is supported by myriad statistics promising a soft landing. Excess and greed build. Then the bust occurs and stock prices fall.

We saw it happen before with the dot-com bust of 2001, followed by the corporate scandals in 2002. A record number of securities class-action lawsuits occurred, with 1 in 14 publicly traded firms sued in 2001, and 1 in 28 sued in 2002. The investing public demanded resolute action and beseeched lawmakers to restore confidence in the capital markets, resulting in the passage of SOX in 2002. SOX expanded shareholder rights and brought more accountability to directors, officers and the corporations' gatekeepers.

SOX was the most expansive law to

From 1988 to 1991, the frequency of securities class-action suits tripled and 1 in 14 publicly traded firms was sued.

The legal environment pendulum was brought back into balance with the passage of the Private Securities Litigation Reform Act of 1995, which sought to reduce frivolous securities class-action litigation with provisions including the safe harbor for forward-looking statements, a heightened pleading standard, and new rules for establishing the lead plaintiff and stay of discovery. The frequency rate of filings from 1996 to 2000 stabilized and came back in line with historical levels of 1 in 50 publicly traded firms sued.

The legal environment pendulum brought SOX back into balance with the Supreme Court's 2005 decisions in *Dura Pharmaceuticals* and its 2007 decision in *Tellabs*. In *Dura*, the Supreme Court