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The Importance of Private Securities Litigation as a Complement to 'Worn Out' Regulators

A recent study concluded that an overburdened SEC tends to neglect the cases involving the greatest harm to investors. Accordingly, private securities litigation—where the law incentivizes investors to pursue cases that involve the largest shareholder losses—remains vital in enforcing the securities laws and serving as an important deterrent to corporate misconduct.

By **Scott Foglietta and Brittney Balser** | September 27, 2021

A recently published study confirmed what many proactive institutional investors already know: Private litigation is an integral piece of the securities enforcement puzzle. In the United States, the Securities and Exchange Commission (SEC) is the principal regulator tasked with overseeing the financial markets and the sale of securities.

As with all government regulators, the SEC suffers from limited staffing and resources, and is subject to political pressures, which forces the agency to make difficult choices about the companies and individuals it investigates. Although the need to prioritize investigations and allocate resources is not itself problematic, a recent study revealed that it is the investigations and cases that involve the largest shareholder losses that suffer most as a result of the SEC's backlog. See Samuel B. Bonsall IV et al., *Wearing Out the Watchdog: The Impact of SEC Case Backlog on the Formal Investigation Process* (https://ssrn.com/abstract=3912645) (2021).

In other words, the study concluded that an overburdened SEC tends to neglect the cases involving the greatest harm to investors. Accordingly, private securities litigation—where the law incentivizes investors to pursue cases that involve the largest shareholder losses—remains vital in enforcing the securities laws and serving as an important deterrent to corporate misconduct.

Using statistical analyses, the authors of the study sought to determine the impact that the SEC's case backlog has on the types of investigations the SEC ultimately elects to pursue. The study found, not surprisingly, that a large backlog materially decreases the likelihood that the SEC will open a new investigation.

What is surprising is that the study also found that not all investigations are treated equally when it comes to the prioritization of SEC resources. In fact, while certain cases—particularly those that involve accounting restatements or insider trading—are pursued regardless of backlog status, investigations involving misrepresentations to investors that cause the greatest shareholder harm are the most likely to be neglected by an overstretched SEC.

The study attributes the SEC's case prioritization, in part, to the fact that such investigations take longer to close and are especially costly for the SEC to conduct during periods of significant backlog.

In addition, according to the study, when the SEC is dealing with a significant backlog, companies are generally less likely to be the target of enforcement actions. Even when they are targeted, the penalties imposed are less severe and there is a lower incidence of remedial governance changes.

The study also found that SEC offices with high backlogs are less likely to investigate companies that have recently lobbied the U.S. government, a result suggesting that agency "busyness" may complement the utility of political lobbying for companies that would otherwise be the target of an SEC investigation.

While the study focused on data from 2000 through mid-2017, the SEC's case backlog has not abated. In fact, just this week, SEC Chairman Gary Gensler expressed concern that the SEC was "short staffed" and testified to Senate lawmakers that the SEC needs "a lot more people" in order to fully investigate ongoing misconduct.

Gensler also noted that the SEC is expanding its oversight of cryptocurrencies, special purpose acquisition companies or SPACs, and payment for order flow, among other things, which will only further stretch the SEC's already taxed resources. It is investors that incur the largest losses caused by corporate fraud or misconduct that will continue to suffer from a continually overburdened SEC.

Fortunately for those investors, they have other means of recourse in the form of powerful private rights of action to enforce the federal securities laws. The role of private litigants is particularly important in light of the fact that the cases they tend to pursue are the very cases most likely to be de-prioritized by the SEC.

The Private Securities Litigation Reform Act of 1995 (PSLRA) essentially deputized sophisticated shareholders to privately enforce the federal securities laws on their own behalf and on behalf of other similarly situated investors. See 15 U.S.C. §78u-4, et seq. The PSLRA does this by, among other things, granting the power to lead private securities class actions to the investors with the "largest financial interest" in the securities at issue, which is frequently understood to mean the investor that incurred the largest losses. 15 U.S.C. §78u-4(a)(3)(B)(iii)(I)(bb).

Those investors tend to be sophisticated institutions with the resources and experience necessary to seek redress from the most powerful corporations in the world. Moreover, by aligning themselves with specialized lawyers who act as private prosecutors willing to pursue these cases on contingency, proactive institutional investors are perfectly situated and highly incentivized to pursue the meritorious cases in which they have suffered the greatest losses—the exact cases that are so often overlooked by the SEC.

The findings from the study may also explain why private litigants often recover larger sums than regulators when investigating or pursuing claims against the same companies and executives. In the wake of the dot-com collapse, private securities plaintiffs obtained recoveries at least four times greater than the SEC in suits against common defendants based on identical infractions. See Nishal Ray Ramphal, *The Role of Public and Private Litigation in the Enforcement of Securities Laws in the United States* (https://www.rand.org/pubs/rgs_dissertations/RGSD224.html) (2007).

This pattern continued after the financial crisis, when private litigants recovered billions of dollars more than the SEC in cases against financial institutions that were impacted by the severe decline in the value of mortgage-backed securities. For example, compare the $150 million obtained by the SEC in an enforcement action arising from the Bank of America/Merrill Lynch merger, with the $2.4 billion recovered by investors through private litigation involving the same misconduct.

The United States boasts the strongest capital markets in the world, reported to fund nearly three quarters of all economic activity in the country. The robust regulatory environment and private investor rights are essential to maintaining the integrity of this complex financial system.

There is no question that the SEC plays a critical role in overseeing the markets and holding wrongdoers accountable, but, as the study has confirmed, the SEC cannot do this alone. Instead, it is private litigants with a track record of recovering over $106 billion for injured investors since the passage of the PSLRA—particularly in cases involving large losses, which the SEC lacks the capacity and resources to pursue—that support meaningful enforcement of the securities laws and create a deterrent effect that far exceeds what the SEC could accomplish alone. In stark contrast to the study's tag line—"Wearing Out the Watchdogs"—private litigants and their lawyers do not "wear out" so easily.

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