Kentucky Public Pension Work Group
Securities Litigation

FINAL REPORT:
10/30/08

Attorney General Jack Conway, Chair

Subcommittee Staff
Rob Jones, Finance Administration Cabinet
Tad Thomas, Office of the Attorney General

REPORT OF THE SUBCOMMITTEE ON SECURITIES LITIGATION

I. Summary of Deliberations

On May 29, 2008, Governor, Steven L. Beshear, signed Executive Order 2008-460 which established the Kentucky Public Pension Working Group. At paragraph 5(c) the working group was charged with the following task:

> Reviewing the securities litigation policies and programs of the state-administered retirement systems, including the amount of losses recovered by the state-administered retirement systems under their current securities litigation policies and programs, reviewing the possibility of authorizing the Attorney General to act on behalf of the state-administered retirement systems regarding securities litigation, and providing recommendations to the Governor to ensure the state-administered retirement systems are recovering an appropriate level of losses due to securities fraud.

To carry out this task the Chair of the Working Group established the Subcommittee on Securities Litigation chaired by Attorney General, Jack Conway. Appointed to the subcommittee as members were: Ellen Hesen, Counsel to the Governor; Eric Wampler, General Counsel, KRS; Robert (Beau) Barnes, General Counsel, KTRS; Mary Ruble, Attorney, Kentucky Education Association; Elise Mohon, KEA; and Martha Moore, KEA.

The subcommittee conducted meetings on July 8, October 16, and October 22, 2008. During the meetings testimony was taken from seven (7) witnesses. At the July 8 meeting Eric Wampler, General Counsel, KRS and Robert (Beau) Barnes, General Counsel, KTRS, outlined and explained the existing securities litigation policies and programs conducted by KRS and KTRS to provide the subcommittee with an understanding of the area and issues to be reviewed. (Attached addenda 1 & 2 are the policies presented to the subcommittee by KRS and KTRS respectively.)

During the October 16 meeting the subcommittee received testimony from Andrea Seidt, Deputy Chief Counsel, Ohio Office of the Attorney General, who discussed the co-ordination between her office and Ohio's public pension funds to recover losses resulting from securities fraud. Mr. Keith Johnson, Reinhart Firm, also testified and described to the subcommittee the duties he would be performing for the KRS as the recently retained securities litigation evaluation counsel. (Mr. Johnson's presentation is attached as addenda 3.) His retention brings an outside review process to the Kentucky Retirement Systems' securities litigation program which had not been in place at the time Mr. Wampler spoke to the subcommittee during the July 8 meeting. Since the conclusion of testimony to the subcommittee KTRS has also retained Mr. Johnson as its evaluation counsel. (Also attached as addenda 4 is a publication of the Council of Institutional Investors entitled, "Everything you always wanted to know about Securities Litigation but were afraid to ask" referenced by Mr. Johnson in his testimony.)

In the final meeting on October 22 the subcommittee heard testimony from three witnesses. Greg Smith, General Counsel, Colorado Public Employees' Retirement Association, and Jane Hamblin, Chief Legal Counsel, State of Wisconsin Investment Board, jointly presented to the subcommittee their respective systems' policies and procedures for detecting and pursuing claims for securities fraud. (The presentations of Mr. Smith and Ms. Hamblin are attached as addenda 5 & 6 respectively.) They also provided their opinions on the fiduciary duty retirement systems have to protect trust assets, which includes the protection of shareholder rights, and best practices to which retirement systems should adhere to ensure those legal interests are protected. This included a discussion of the costs and benefits of pursuing lead plaintiff status in class action litigation. The benefits primarily stem from control of the litigation which in turn allows the lead plaintiff to: 1) retain and negotiate terms with counsel; 2) name defendants and set priorities based upon their level of culpability, and 3) negotiate settlement terms. Countervailing considerations include: 1) accepting fiduciary responsibilities to act in the best interests of the class; 2) cost in time and money associated with discovery; and 3) since the enactment of the Public Securities Litigation Reform Act "PSLRA" a lead plaintiff is not entitled to any additional recovery beyond the pro rata share it would receive as a passive participant in the class action. Under PSLRA, the Court will most often award lead plaintiff status to the investor with the largest lost and KRS and KTRS typically have much smaller losses than the larger systems such as those in California. Additionally, there are costs in making the motion to serve as lead plaintiff status even if that motion is denied.

During the same meeting, Mr. Reed R. Kathrein, Hagens Berman Sobol Shapiro LLP, presented a paper he drafted concerning the future of "opt-out" cases, a litigation strategy in which an investor may choose not to participate in a particular securities fraud class action case and instead pursue a lawsuit independently where it is believed the independent action will produce a greater recovery for the investor. He finds that "opt-out" plaintiffs have, under the right circumstances, significantly increased their recoveries over what would have been received if they had participated in the class action. However, he questions whether the phenomena will continue into the future. (Mr. Kathrein's paper entitled *Opt-outs, MFN's and Game Theory: Can the High Multiples Achieved by Opt-outs in Recent Mega-Fraud Settlements Continue,* as well as his presentation entitled *The Future of Opt-outs in Securities Fraud Class Action Litigation* are attached collectively as addenda 7.)

II. Findings and Recommendations

Presently, KRS and KTRS have in place, through their custodial banks and outside securities litigation monitoring services, systems which ensure the retirement systems identify and submit claims in all class action securities fraud cases which involve their holdings. Further, the subcommittee received no testimony to suggest that either retirement system has failed to carry out its fiduciary duty to file claims necessary to protect the shareholder rights inuring to the benefit of their members. Nevertheless, the subcommittee has identified areas in which the retirement systems can improve their securities litigation policies and procedures.

A. Establish and update official written policies.

The subcommittee believes it is fundamental to establishing consistent and reliable policies that those policies are reduced to writing and formally approved by the governing board or body. It is equally important for those policies to be reviewed and updated as events warrant. Although KTRS does have in place a functioning securities litigation program, it does not have in place a written securities litigation policy. If KTRS is to secure the rights of its members on a consistent basis into the future in the complex area of securities litigation it is imperative that the system reduce the existing program to a written policy. The subcommittee understands KTRS is currently working toward this goal. KRS does have in place an approved securities litigation policy. The subcommittee commends KRS for having taken this step but, as outlined below, recommends KRS revisit and update the policy to improve its practical application to the assets under its management.

B. Establish a much lower minimum damages threshold for consideration of active participation in securities fraud litigation.

Testimony from KRS and KTRS is that both systems rely almost exclusively upon passive participation within securities fraud class action litigation to protect the shareholder rights of their members. Given the modest size of the retirement systems in relation to other retirement systems around the country this is not unusual and the subcommittee does not find this fact to constitute a failure by the retirement systems to meet their fiduciary obligations. However, the subcommittee has identified recommendations which would create more effective policies for ensuring thorough review of cases and identifying those cases which may require active participation on the part of the retirement systems. For instance, the Committee was tasked to review the "minimum threshold" of losses which would trigger automatic review of potential active involvement in a case by way of pursuing lead counsel status or opting out of the litigation to pursue an independent action. Currently, KRS' policy mandates a $75 million threshold which exceeds the largest loss it has ever experienced ($35 million in damages in the WorldCom case) while KTRS has no such trigger in its practices.

The testimony of witnesses from the states of Ohio, Wisconsin and Colorado establishes that each retirement system has in place a damages threshold which triggers a mandatory review of the facts and circumstances surrounding a given case. It is based upon this review that those retirement systems determine whether remain as a passive member of the class, or to take an active role in the litigation either as a lead plaintiff, or as an "opt-out" litigant. The threshold ranged from a low of $5 million for the Colorado Public Employees' Retirement Association which has in excess of $40 billion in assets under management to a high of $20 million for the State of Wisconsin Investment Board which has in excess of $90 billion in assets under management. (A survey conducted by Reinhart Boerner Van Deuren s.c. is attached as addenda 8, and identifies thresholds ranging from $1 million to $25 million.) Given these thresholds, the $75 million minimum loss threshold for KRS (with assets of $17 billon) appears to be much too high. The subcommittee recommends a threshold between $5 million and $20 million. The Attorney General proposes a threshold in the lower end of the range, in the area of $10 million, and suggests that the threshold level would require mandatory review of the case but not preclude the systems from evaluating cases involving losses below the threshold on a case by case basis. The KEA proposes a $20 million threshold in addition to other recommendations. (Recommendations of the KEA are attached as addenda 9.)

With the implementation of meaningful thresholds for triggering mandatory case evaluations it is anticipated the retirement systems will have to perform more case evaluations than has been their practice in the past. Mr. Smith, General Counsel of the Colorado Public Employees' Retirement Association, stated that system's $5 million threshold required evaluation of 2 to 3 cases a month. He also indicated this did not produce a significant cost for Colorado's retirement system because it has the capability of performing the evaluations in house. Neither KRS nor KTRS have similar capacities. Further, unlike the Ohio Office of the Attorney General which performs similar services for the Ohio retirement systems, the Kentucky OAG does not have a division dedicated to securities litigation. This function will be served by evaluation counsel who has been retained by both KRS and KTRS. Therefore, Kentucky's retirement systems will have to rely on outside experts to assist with case evaluation; producing increased expense. This cost should be weighed against the benefits which may be gained from active participation in securities fraud litigation when the retirement systems set their evaluation thresholds.

C. Establish procedures for evaluating cases to pursue as an active litigant.

The subcommittee recognizes that a decision by a retirement system to actively participate in major securities litigation will be of significant value to the law firm chosen to handle the case. Therefore, securities litigation firms will have significant self interests when advising the retirement systems concerning the viability of a particular case. In this regard, recognized best practice involves defining two distinct roles for outside counsel to eliminate conflicts of interest. First, an independent "evaluation counsel" reviews a case and recommends to the retirement system to remain a passive member of the class, to seek lead plaintiff *status* or to opt-out of a case. The evaluation counsel acts as a fiduciary to the retirement system and is prohibited from serving as litigation counsel in any case. Having an independent evaluation counsel eliminates the potential self interest that litigation law firms have in recommending action on a case.

Second, the retirement systems will retain "litigation counsel" to represent the retirement system when a decision has been made to prosecute an action. The litigation counsel will be retained consistent with nationally recognized best practices concerning fees and eliminating conflicts of interest.

KRS and KTRS have already taken a first step toward this goal by retaining outside evaluation counsel which is excluded from representing the retirement systems in any litigation it recommends. The retirement systems have agreed that it would be appropriate to provide public information to the Attorney General and General Counsel for the Governor concerning activities in Securities Litigation. The retirement systems should take care to maintain attorney client privilege concerning legal advice received on particular cases.

D. Establish procedures for retaining litigation counsel.

The subcommittee believes it is of the utmost importance that the process for retaining litigation counsel precludes the possibility for even an appearance of impropriety. Therefore, where possible the procedures followed by the retirement systems should be consistent with the Model Procurement Code's provisions for a competitive request for proposals process. However, the subcommittee also recognizes that the pressures of litigation may, and often will, present time limitations which render the RFP process incongruous with a retirement system's immediate need. Consequently, the subcommittee recommends that the retirement systems develop a list of law firms that have been vetted for expertise and conflicts of interest, which will be notified and allowed to engage in an abbreviated bidding process when time constraints demand.

E. Coordination of securities litigation plans.

The subcommittee recognizes KRS and KTRS are independent retirement systems with discrete management and interests. Therefore, each system pursues a separate investment strategy and will be affected differently by a specific instance of securities fraud. Thus, it cannot be assumed the interests of the two systems will necessarily be aligned in a given piece of litigation. Still, the subcommittee encourages the retirement systems to work together in developing their securities litigation policies to take advantage of synergies which may present themselves. Doing so would be in further compliance of their fiduciary duty to protect the assets of the systems. Specific areas the subcommittee believes such opportunities may be available include: 1) communication and sharing of public information concerning potential and ongoing litigation with the Attorney General and General Counsel for the Governor, 2) retention of evaluation counsel, 3) aggregation of damages and joint pursuit of lead plaintiff status or "opt-out" litigation where evaluation counsel finds the systems interests are aligned, and 4) joint action to reduce attorney's fees either through negotiation with counsel retained through the bid process or by objecting to excessive fees in litigation in which both retirement systems are passive participants in the class action.

F. Role of the Attorney General.

Presently, enabling statutes for both the KRS and KTRS allow for the Attorney General act as their legal advisor and representative. The subcommittee recommends that the retirement systems and the Office of the Attorney General communicate regarding securities litigation when appropriate.

(Additional recommendations of the Attorney General and General Counsel to the Governor are attached as addenda 10.) (The recommendations submitted by the KRS are attached as addenda 11.) (The recommendations of the KEA are attached as addenda 12.)

ADDENDA 1

Statement of Intent

This statement of securities litigation policy and procedure is issued by the Investment Committee of the Board of Trustees of the Kentucky Retirement Systems (KRS) in connection with monitoring pending actions in which KRS is a potential member or participant.

KRS acknowledges that it has a duty to monitor and evaluate actions in which it may potentially be a member or participant. While KRS will take reasonable steps to monitor and evaluate the actions, it is also cognizant that most, if not all, of these claims will be prosecuted by the plaintiff's action bar whether or not KRS takes an active role. Therefore, the decision regarding the level of action KRS will take on a claim requires evaluating the potential of KRS to add value.

Identifying and Evaluating Potential Claims

Periodically, the Chief Investment Officer will identify actions that are filed in which KRS is a potential member or participant. A variety of sources may be used to identify the actions including, without limitation, a retained third party securities class action monitoring service, portfolio managers, the Internet, and the class action bar.

Upon identification of a potential claim, KRS trading activity will be examined by the retained securities class action monitoring firm to estimate the potential damages utilizing the average results of the two damage calculation methodologies recommended by the National Association of Public Pension Attorneys (NAPPA) in their working document Calculation of Securities Litigation Damages dated June16, 2005, which is hereby incorporated by reference.

If the potential damages are less than $75 million, the Chief Investment Officer, or designee, shall monitor the class action suit and file a claim upon its conclusion to participate in the class settlement. If the potential damages exceed $75 million, then the claim will be screened for more in-depth evaluation.

If further evaluation is warranted, the Chief Investment Officer shall, in conjunction with an external legal firm ("evaluation counsel") that has a demonstrated expertise in securities class action legal matters, perform additional due diligence on the claim. The Chief Investment Officer may utilize internal legal resources, along with the evaluation counsel, when appropriate. Additional due diligence may include, without limitation: assessment of the complaint; SEC filings and company disclosures; contacts with other investors; consideration of non-litigation alternatives; staffing, resources and other issues; impact of active claim management and; potential conflicts with other class members. If, based upon this additional due diligence it appears that KRS may add significant value by more active participation, then the Chief Investment Officer shall present this recommendation to the Investment Committee. Any firm, or its partners, that has been selected as evaluation counsel for a particular case is precluded, by this policy, from representing the Systems in any securities litigation matter for a period of three years upon completion of their assignment.

Recommendations to the Investment Committee shall take one of the three following forms:

1. Monitor the course of the class action suit and filing a claim upon its conclusion to participate in the class settlement.
2. Seek to control a class action by seeking designation as lead plaintiff, either singly or with others.
3. Opting out of a class action suit and filing a separate suit, either singly or with others.

Based on the review of the potential claim, the Investment Committee will determine whether active involvement is warranted by KRS and the nature of such involvement, if any. If active involvement is deemed to be warranted, appropriate outside counsel will be sought at that time by the Investment Committee. Notwithstanding the foregoing, managers delegated monitoring responsibilities may utilize their existing monitoring system. The manager shall prepare records, and from time to time, shall furnish information KRS may require in the discharge of its duties. KRS shall continue to monitor the claim notwithstanding the nature of its involvement.

Monitoring Claims

The Chief Investment Officer shall recommend the retention of an independent third-party securities class action monitoring firm to assist in the monitoring, filing and claims collection processes. The services of the retained firm shall be evaluated on a periodic basis and the results of the evaluation communicated to the Investment Committee. Any firm providing such monitoring services shall be precluded from representing the Systems in any litigation efforts undertaken by the Investment Committee.

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ADDENDA 2

Kentucky Teachers' Retirement System
Securities Litigation Policy & Procedures

Policy

This policy pertains to the monitoring and processing of securities class action litigation activities that directly affect Kentucky Teachers' Retirement System (KTRS). KTRS has a responsibility to reasonably monitor and evaluate these actions. The following options are available to KTRS:

- Monitoring class actions filed, ensuring that claims are filed on behalf of KTRS as a party to the class action whenever appropriate, and evaluating claims filed on behalf of KTRS.
- Taking a lead plaintiff role in a class action
- Opting out of a class action in order to file separate litigation.

KTRS will choose the option of filing a claim as a party to the class action unless there are factors present that clearly suggest that one of the other two options is more appropriate. These factors include, but are not limited to, the size of KTRS' loss, the size of KTRS' loss in comparison with other investors, the experience and ability of other investors to pursue the claim, the potential advantages to KTRS, the risk to KTRS, and the cost to KTRS.

Procedures

KTRS utilizes a variety of sources to identify filed securities litigation actions that involve securities either currently or previously owned by the system. The external sources include but are not limited to external contracted vendor(s), custodial records and services, internet research, external notifications received through legal correspondence, external portfolio managers, etc.

The services of RiskMetrics Group is utilized to monitor litigations through their Securities Class Action Services (SCAS) and the services of Bank of New York Mellon (BoNY Mellon) (custodian) is utilized to also monitor, identify, and file class action claims on behalf of KTRS. The utilization of the services of these two entities in addition to the other sources outlined above provide a thorough process to ensure that KTRS has identified litigations that are pending, filed, settled, disbursed, etc.

Through the services of Bank of New York Mellon, class actions are handled as follows:

- Notices of class actions are identified
- Proof of claims are filed in actions involving securities held by KTRS
- Reports are provided of security transactions at KTRS within the class action period
- Monthly reports are provided of class actions and their current status

Securities Class Action Services provides a monitoring service that includes:

- On-line access to an extensive database universe of securities class actions
- Daily email alerts to securities class actions (new, pending, settlements, disbursements, etc.)
- Research and analysis on all settlements
- Monthly SCAS Alert newsletter pertaining to new securities litigation developments

RiskMetrics Group is a nationally recognized company specializing in securities class action services and a leader in this field. KTRS is in the process of expanding our capabilities through this company by incorporating portfolio specific views in tracking claims, custom management reporting, and loss calculation services.

The following process is utilized on an ongoing basis in identifying potential class action claims:

- Daily email alerts, correspondence, news items, etc. are received by KTRS containing information on class actions.
- KTRS records are researched to determine if the litigated security was owned during the specific class action period and if any specified criteria to be included in the litigation are met.
- SCAS database is viewed on-line and any available summary company information regarding the litigation is produced.
- If the security was held during the class action period and if necessary criteria are met, a record is created in the "active cases" table in KTRS' litigation database to track the progress of the litigation and ensure that BoNY Mellon identifies the class action.
- Litigation that is dismissed by the courts is removed accordingly from the database.
- When litigation is settled, the record is moved from the "active cases" table into the "settled cases" table in the database.
- BoNY Mellon prepares and provides KTRS with a report of the litigated security detailing balances and transaction dates during the litigated period. This information is verified against KTRS records with any discrepancies resolved through contact with BoNY Mellon.
- BoNY Mellon files claims on behalf of KTRS and reports claims filed on a monthly basis.
- Using information from SCAS, filing deadlines are monitored and verification is performed that BoNY Mellon has filed claims timely. Contact is made with BoNY Mellon to resolve any questions.
- The SCAS database is monitored for notice of settlements and disbursements to determine the approximate time period that KTRS should receive their prorate settlement at BoNY Mellon.
- When litigation disbursements are received, the litigation records are moved from the "settled cases" table to the "disbursed cases' table in the litigation database.

ADDENDA 3

Reinhart
Boerner Van Deuren s.c. Attorneys at Law

Securities Litigation Subcommittee Kentucky Public Pension Working Group

Keith Johnson
Reinhart Boerner Van Deuren s.c.

October 16, 2008

In-House Expertise – Client Centered Service

Partnering for your success

Fiduciary Duty

- Filing to Collect on Legal Claims
- Role of Plaintiff's Bar Plaintiff's bar will be filing these, then hunt for the big losers
- Value from Systemic Improvements
- Balancing Costs and Benefits

Trustees are under a duty to beneficiaries to take reasonable steps to realize on claims which are held in trust.

[Restatement of Trusts, 2d, § 177]

Reinhart
Boerner Van Deuren s.c. Attorneys at Law

Monitoring and Selecting Cases

- Identifying Cases Where KRS Might Add Value
- Evaluating Cases
- Active Claim Management Strategies
- Serving as a Lead Plaintiff
  - Collaboration with a Joint Lead Plaintiff
- Filing a Separate Opt Out Case

Reinhart
Boerner Van Deuren s.c. Attorneys at Law

Learning From Other Public Funds

- Policy Guidance

  "It is advisable for a pension fund to craft a set of guidelines for evaluating securities litigation cases. Such guidelines can help a fund decide which position to take with respect to each case in order to be in compliance with its fiduciary obligations." [Council of Institutional Investors]

- Audit of Claim Filing Process
- Litigation Counsel Financial Interests
- Pay to Play Scandals
- Lead Counsel Selection Process
- Effective Case Management

Reinhart
Boerner Van Deuren s.c. Attorneys at Law

Best Practices

- Avoiding Scandals
- Pay to Play

  "When political contributions are made by lawyers to Individuals in charge of a state or municipal pension fund, the attorneys should not be permitted to represent the fund as a lead plaintiff in a securities class action." [Committee on Capital Markets Regulation]

  "Law firms chasing jackpot-size fees are showering money on politicians with influence at large public pension funds—which, in turn, are hiring them to file multi-million-dollar lawsuits against US companies." [USA Today]

- Securities Litigation Attorney Accountability & Transparency Act – Senate Bill 3033

Reinhart Boerner Van Deuren s.c. Attorneys at Law

Best Practices

- Selecting Cases
  - Legal Damages
  - Strength of Legal Claims
  - Potential Conflicts
  - Lead Plaintiff or Opt Out?

"A reasoned assessment of the case should address matters such as what claims are or could be asserted and the likelihood that they will be sustained, chances of recovery and sources of recovery. In addition, the investor should consider whether its interests mesh with those of the class."
[Council of Institutional Investors]

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Boerner Van Deuren s.c. Attorneys at Law

Best Practices

- Selecting Litigation or Lead Counsel
- Negotiating Fees
  - Contingency Fee Variations
- Court Review and Approval

"One legal expert advises institutional investors to consider the following principles to minimize the chance of judicial intervention in lead counsel selection and/or compensation:
- *Include a process for selection of counsel in the fund's securities litigation policies;*
- *Establish a record to justify the basis for the fund's lead counsel recommendation to the court."*

[Council of Institutional Investors]

Best Practices

- Case Management & Participation
- Litigation Strategy
- Court Filings
- Discovery
- Settlement
- Recovery Distribution

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Review of Settlements

- Opting Out

"In general, the larger and stronger the claim, the more likely it is that the costs and benefits favor opting out."
[Council of Institutional Investors]

- Objections

"A well-plead objection to an unreasonable fee request following a large settlement can yield an amount of additional money to the class which is greater than the gross amount of the settlement in any number of federal securities class actions."
[NYSTRS' General Counsel: The NAPPA Report, February 2005]

Reinhart
Boerner Van Deuren s.c. Attorneys at Law

Summary

- File Claims
- Develop Policies and Procedures
- Look for Opportunities to Add Value
- Follow Best Practices
- Report and Monitor

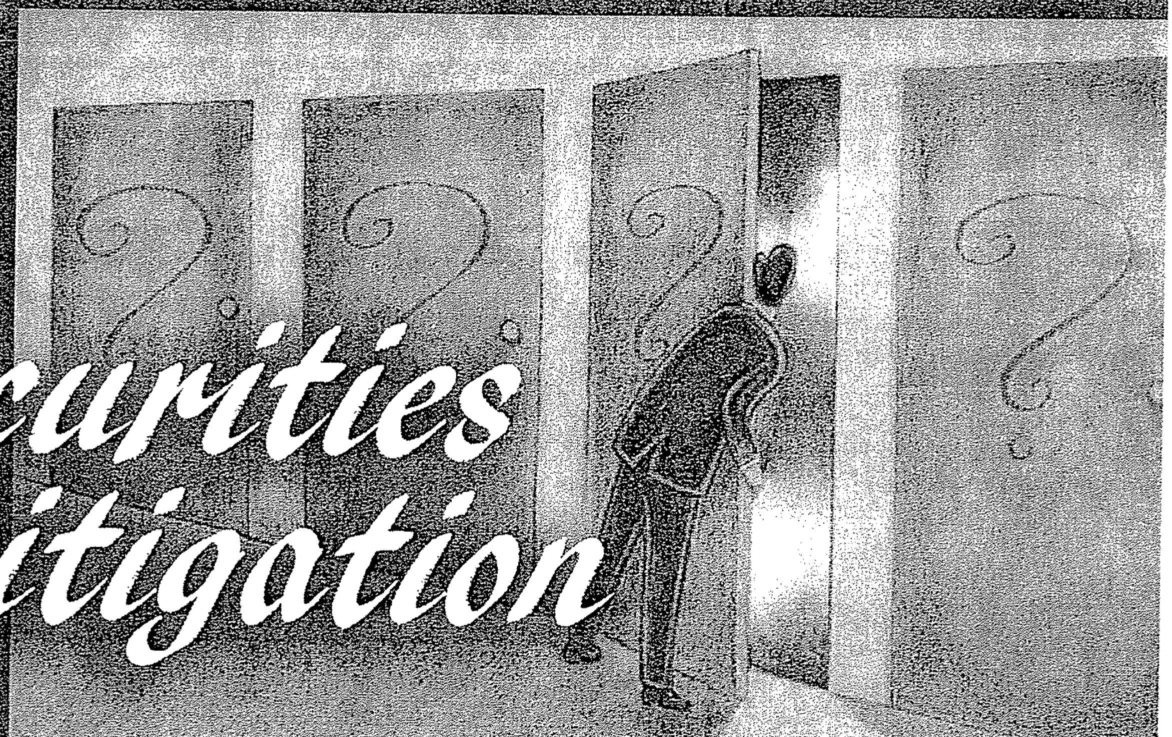
Questions?

Reinhart
Boerner Van Deuren s.c. Attorneys at Law

ADDENDA 4

COUNCIL OF INSTITUTIONAL INVESTORS

Everything you always wanted to know about...



Securities Litigation

...but were afraid to ask

The Council of Institutional Investors (CII) is a nonprofit association of public, union and corporate pension funds with combined assets that exceed $3 trillion. Member funds are major long-term shareowners with a duty to protect the retirement assets of millions of American workers.

The Council strives to educate its members and the public about good corporate governance, shareowner rights and related investment issues, and to advocate on our members' behalf. Corporate governance covers a spectrum of issues — from disclosure to enforcement — involving the relationship between shareowners, directors and managers of a company. Good corporate governance fosters transparency, responsibility, accountability and market integrity.

Acknowledgements

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The Council extends a special thank-you to Keith Johnson of Reinhart Boerner Van Deuren, for his comments, information, expert advice and suggestions. We are grateful to the National Association of Public Pension Attorneys for sharing their informative memorandums and articles on securities litigation. Finally, the Council would like to express its gratitude to Peg O'Hara for her thorough editing.

Everything you always wanted to know about...

Securities Litigation

...but were afraid to ask

Appendices

COUNCIL OF INSTITUTIONAL INVESTORS

888 17th St. NW
Suite 500
Washington DC
20006
202-822-0800
www.cii.org

What Is Securities Litigation And Why Is It Important To Pension Funds?

Securities litigation — lawsuits alleging violation of federal or state securities laws — can be a critical tool for shareowners seeking to recover assets lost through fraud or other corporate malfeasance. Recoupment is an important consideration for pension funds because of their legal obligation to safeguard retirement assets of workers and other beneficiaries.

Securities litigation sometimes is the only way that investors can recover lost assets. And securities lawsuits that are pursued cautiously and responsibly can buttress the efforts of regulators and law enforcement to pursue corporate wrongdoers and deter future violations. Frivolous claims, however, can waste corporate assets and divert management attention.

This monograph looks at securities litigation from the standpoint of pension funds. It addresses key questions that funds are likely to face when considering whether to launch or join a securities lawsuit.

Who Files Securities Lawsuits?

Increasingly, institutional investors, rather than individual investors, are taking the lead. That's not surprising: The Private Securities Litigation Reform Act of 1995 (PSLRA) provided an incentive for institutional investors to be lead plaintiffs in securities class actions. (See *Incentives for institutional investors to lead securities class actions in How has the PSLRA altered the litigation landscape for pension funds?*)

Data by Cornerstone Research shows that institutional investors were lead plaintiffs in almost 60 percent of the securities class actions settled in 2007, up from more than 50 percent of the securities class actions settled in 2006.[1] Pension funds are among the most active plaintiffs: In 1996-2006, the top five most-frequent lead plaintiff institutions were pension funds.[2]

Cases in which institutional investors are lead plaintiffs tend to result in significantly higher settlements, according to Cornerstone. And the institutions that consistently win the most are public pension funds:

> *[E]ven controlling for estimated damages (that is, case size) and other factors that affect settlement amounts (such as the nature of the allegations), the presence of a public pension plan as lead plaintiff is associated with a statistically significant increase in settlement size.*[3]

In 2007, the median settlement in securities class actions filed by public pension funds was $18 million vs. $6 million in cases with other kinds of lead plaintiffs.[4]

COUNCIL OF INSTITUTIONAL INVESTORS

Do Pension Funds Have A Fiduciary Obligation To Participate In Securities Litigation?

Yes, though their participation may range from active to passive.

A fiduciary holds property or power for the benefit of someone else. Corporate pension plans and industry-wide labor union pension funds are governed by the Employee Retirement Income Security Act of 1974 (ERISA) rules on fiduciary duties. While public pension plans are not subject to ERISA, many states and local jurisdictions have adopted standards closely modeled on its rules. Pension funds sponsored by private trusts and tax-exempt institutions (such as universities and churches) also tend to follow ERISA fiduciary standards. And federal regulations governing banks and mutual funds are essentially identical to ERISA.

Under ERISA, a person is a fiduciary of a pension fund if he or she is involved in the management of the plan or its assets; provides or has the authority to provide paid investment advice to the plan; or has discretionary authority or responsibility in administering the plan.

An increasing number of plan sponsors, litigation experts, plan counsel, academics and not-for-profit and professional organizations generally agree that, at a minimum, pension fund fiduciaries are required to monitor securities litigation and pursue recovery when securities actions are settled or judgments are awarded. Experts have generally concluded that monies owed to a fund from securities litigation are plan assets, and fiduciaries are thus required to recapture these monies as part of their larger fiduciary duty. Even though ERISA does not explicitly require funds to participate in securities suits, the common law of trusts, to which many courts would defer, requires trustees to take reasonable steps to enforce legal claims.[5] Collecting on securities fraud claims appears to fall within that requirement.

Some pension funds take a more muscular view of their fiduciary duty. Beyond simply monitoring litigation and filing claims when settlements are awarded, they believe that, in certain circumstances, they are obliged to serve as lead plaintiff in lawsuits. For example, San Diego City Employees' Retirement System's securities litigation policy states that "a public pension system has a fiduciary duty to monitor securities class actions in which the system has an interest, and to participate as lead plaintiff where such participation is likely to enhance the recovery by members of the class."

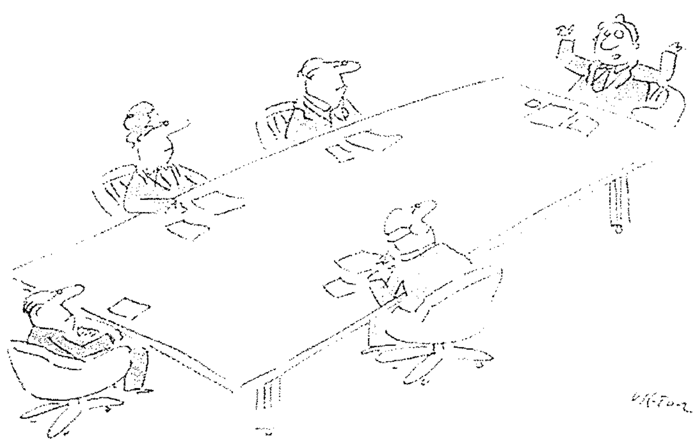
In general, it is advisable for a pension fund to craft a set of guidelines for evaluating securities litigation cases. Such guidelines can help a fund decide which position to take with respect to each case (pursue lead plaintiff status, pursue litigation independently of the class, be a passive claimant, etc.) in order to be in compliance with its fiduciary obligations. Appendices A, B and C feature examples of securities litigation guidelines used by State of Wisconsin Investment Board (SWIB), California State Teachers' Retirement System (CalSTRS) and Missouri State Employees' Retirement System (MOSERS).

COUNCIL OF INSTITUTIONAL INVESTORS

Securities Litigation

On What Grounds Can Pension Funds File A Securities Lawsuit?

The Securities Exchange Act of 1934 gives shareowners the right to bring a private action in federal court to recover damages they suffered as a result of securities fraud. The majority of securities fraud claims are brought under Section 10(b) of the Exchange Act and the accompanying Securities and Exchange Commission (SEC) Rule 10b-5.



"This might not be ethical. Is that a problem for anybody?"

The basic elements of a Rule 10b-5 claim involve:

- a claim by a purchaser of securities that
- an issuer intentionally or recklessly
- made a material misrepresentation or omission
- with scienter (intent) or an actionable degree of recklessness
- in connection with the purchase or sale of a security
- causing the plaintiff a calculable economic loss

What Are The Key Elements Of A Securities Litigation Claim?

In a typical Rule 10b-5 claim, the plaintiff will begin litigation by filing a complaint in federal court. The defendant typically responds with a motion to dismiss under Rule 12(b)(6) of the Federal Rules of Civil Procedure. This is essentially a claim by the defendant that, even if all of the facts alleged in the complaint were true, those facts would not be sufficient grounds for the claim. If the court determines that the facts alleged in the complaint are sufficient, the plaintiff can move to discovery (demand documentary evidence from the defendant concerning the facts in question) and require the defendant and other witnesses to sit for depositions. A deposition is testimony given under oath and recorded for use in court at a later date. Unlike other lawsuits, securities fraud cases bar discovery and related depositions until the court has ruled against a motion to dismiss.

Discovery can be lengthy. In some cases, corporate defendants must produce large volumes of documents. Numerous witnesses may be deposed, a process that can run up hefty legal fees and other expenses for the defendant. That is also why the outcome of a motion to dismiss is a pivotal step in securities fraud suits.

If dismissal is denied, the plaintiff may seek class certification of the case under Rule 23 of the Federal Rules of Civil Procedure. If the court grants the motion, the case becomes a securities fraud class action and the stakes rise substantially. For example, if the class covers 50,000 shareowners, each of whom claims to have lost $10 per share on an average holding of 1,000 shares, the company could face $500 million in compensatory damages.

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What Are The Legal Battles Over Grounds For Dismissal All About?

Because the motion to dismiss is a critical point, plaintiffs' and defense attorneys often battle fiercely over the interpretation of the rules governing such motions.

Plaintiffs' lawyers typically advocate weaker standards for stating a claim; defense lawyers seek more demanding standards. Stricter standards mean that plaintiffs face a higher burden of proof that the alleged misconduct caused the economic harm they suffered.

Both sides often invoke the public interest. The defense bar generally contends that lower standards lead to more frivolous lawsuits and settlements that enrich the plaintiffs' lawyers, not shareowners. The plaintiffs' bar maintains that higher standards make it easier for corporate executives to loot their companies and defraud shareowners. Congress attempted to address both sides of that critical divide when it passed the PSLRA.

How Has The PSLRA Altered The Litigation Landscape For Pension Funds?

In passing the PSLRA, Congress sought to confront what it considered the most troublesome aspects of securities class actions: abusive litigation, coercive settlements, inadequate disclosures about corporate fraud and excessive legal fees. The result was a number of fundamental changes, three of which are especially relevant to pension funds: (1) heightened pleading standards for securities claims, (2) incentives for institutional investors to lead securities class actions, and (3) the related shift in control of litigation from the plaintiffs' bar to investors.

Heightened Pleading Standards

The PSLRA requires a plaintiff to:

- identify the allegedly fraudulent statements and explain why they were misleading. This requirement allows defendants to argue that the statements were not, in fact, misleading.
- allege that the defendant knew the statement was false at the time it was made, or was reckless in not recognizing that it was false. The legal term for this state of mind is scienter, or intent. It is not enough for the plaintiff to merely presume that the defendant, by virtue of his or her senior position in the company, must have known that the statement was false. Proving the presence of intent is a high hurdle: Without the benefit of discovery, plaintiffs lack access to witnesses or documents that could provide credible evidence about the defendant's state of mind.
- prove that action by the defendant or the defendant's failure to act, not just a decline in the market, caused the loss.

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The U.S. Supreme Court's June 21, 2007, decision in *Tellabs, Inc., et al., Petitioners v. Makor Issues & Rights Ltd., et al.*, raised the threshold of evidence that investors must meet to prevent a fraud lawsuit from being dismissed. The court clarified the standard for determining whether the facts alleged in the complaint give rise to a strong inference that the defendant acted with scienter, or intent. By a vote of 8-to-1, the court set a more exacting legal standard for establishing scienter than used by some federal circuit courts. As a result of this ruling, courts must now weigh the factual allegations that seem to suggest fraudulent intent against plausible innocent explanations of the defendant's conduct. In the words of Justice Ruth Bader Ginsburg, "The inference that the defendant acted with scienter need not be irrefutable, but it must be more than merely 'reasonable' or 'permissible' — it must be cogent and compelling, thus strong in light of other explanations."[2]

Incentives for Institutional Investors to Lead Securities Class Actions

In its deliberations over the bill, Congress clearly stated its intent to "encourage institutional investors to take a more active role in securities class action lawsuits."[3] More specifically, Congress wanted to create an incentive for pension funds to take a lead role:

> *[W]ith pension funds accounting for…nearly half of the institutional assets, in many cases the beneficiaries of pension funds — small investors — ultimately have the greatest stake in the outcome of the lawsuit.*[4]

The PSLRA codifies an incentive for institutional investors to take charge by requiring that the lead plaintiff generally should be the party with the largest financial interest. The lead plaintiff is the entity appointed by the court to represent the interests of all shareowners in the same situation.

The change appears to have been a boon for shareowners. A study by Michael Perino, like the Cornerstone study referenced earlier, found that public pension fund lead plaintiffs drive the best deals: Settlements tend to be larger, attorneys are scrutinized more closely and legal and other fees are lower than in cases with other kinds of lead plaintiffs.[5]

Pension funds do not just settle for big payouts from public companies' liability insurance. As they have assumed a growing role as lead plaintiffs, funds have aggressively pursued recoveries from a wide circle of participants, including directors, officers and "gatekeepers" such as auditors and lawyers. Putting personal wealth of individual defendants on the line bolsters the deterrent effect of litigation.

A class action against Anicom (*Anicom, Inc. Securities Litigation* (N.D. Illinois 2001)) illustrates the trend. The case involved an accounting misrepresentation that cost the State of Wisconsin Investment Board (SWIB) $23 million in investment losses. Anicom eventually filed for bankruptcy. The case produced a cooperative model of litigation where the three plaintiff groups — shareowners, bank lenders and unsecured creditors — filed a joint prosecution agreement, with SWIB serving as lead plaintiff. The settlement involved payments of $21.5 million by PricewaterhouseCoopers (Anicom's auditor), $12.4 million by two CEOs and $5.6 million by the insurance company. Anicom shareowners probably recouped far more than they would have had the case followed the usual path. The recovery totaled 28 percent of the plaintiffs' estimate of damages vs. the 5 percent median recovery rate in all securities class actions. And Anicom shareowners paid legal fees that amounted to 22.5 percent of the pre-fee recovery, compared with the 32 percent median for similar cases.[10]

At issue in ***Stoneridge Investment Partners, LLP v. Scientific-Atlanta et al.*** was under what (if any) circumstances private investors could sue secondary actors — accountants, lawyers, financial advisors or other businesses — that allegedly participated in a securities fraud scheme. On Jan. 15, 2007, the U.S. Supreme Court ruled 5-3 against plaintiffs suing the two cable television equipment suppliers whose dealings with cable TV company Charter Communications allowed Charter to inflate its earnings by $17 million. This decision appears to provide protection from private lawsuits to secondary players in fraud schemes. The Supreme Court determined that third parties can only be held liable for assisting or participating in corporate fraud if investors can prove they relied on those particular third parties to make investment decisions. If investors fail to conclusively establish this, investment banks, lawyers and accountants could be liable for "aiding and abetting" fraud instead of being "primary violators." It is a critical distinction because a landmark 1994 case, ***Central Bank of Denver v. First Interstate Bank***, established that private parties cannot bring aiding and abetting suits against companies; that authority is reserved for the SEC.

Shift In Control Of Litigation From Lawyers To Investors.

The PSLRA grants the lead plaintiff the power to select and retain class counsel. This provision was aimed at preventing the "race to the courthouse" by plaintiffs' attorneys in which the first plaintiff to file usually was named lead plaintiff.

These three changes introduced through the PSLRA appear to have had the intended effect. The 166 securities class action filings in 2007 represented the third lowest annual filing level since the adoption of the PSLRA.[11] The result would likely have been much closer to the record low 116 class actions filed in 2006 had it not been for the subprime mortgage crisis and increased market price volatility.[12]

Securities Litigation

What Issues Should A Pension Fund Consider Before Deciding To Pursue Securities Litigation?

First, a pension fund should have in mind an ultimate goal. Does it aim just to recoup losses, or is it also eager to prod the company to improve its governance to deter future wrongdoing? Is the fund willing and able to devote resources to a securities class action? Lawsuits can be arduous and time-consuming, with uncertain outcomes. While successful plaintiffs can rely on a percentage of recovered funds to pay attorney fees, the cost in staff time and related expenses may be prohibitive.

Moreover, given that many public pension fund trustees and/or fiduciaries are elected officials, engaging in litigation that is controversial could lead to a political backlash. And any recovery may pale in comparison with total losses.

Pension funds that have a damage claim and are current shareowners when the settlement is paid will experience offsetting gains and losses. On the one hand, they pocket settlement payments. However, the company's payout and legal costs may reduce the value of their existing shares.[13] Funds may sue anyway because their interest in deterring fraud and improving corporate governance outweighs the compensation they stand to collect.

For example, some institutional investors increasingly use litigation as a tool to achieve governance reforms at portfolio companies. Critics call this "governance by gunpoint."

But there is potential payoff for both plaintiff and defendant: Shareowners win governance measures that the board might have resisted otherwise; the company often gets favorable publicity for embracing reforms. Some notable examples of corporations conceding to governance changes as part of securities litigation settlements with their investors include Homestore.com (now Move Inc.), Honeywell, and Sprint (now Sprint Nextel).[14]

As part of its 2004 settlement, Homestore.com paid out $100 million and agreed to establish independent directors, limit terms of directors to two years, give shareowners a right to appoint new directors, require minimum stock retention by officers after options exercise, and prohibit future use of stock options for director compensation. Also in 2004, in addition to paying $100 million, Honeywell agreed to ensure independence of its outside auditors and board of directors; adopted provisions relating to compensation of officers and directors, and the performance of internal audits. In 2003, Sprint settled for $50 million and a series of governance changes which included prohibiting executives from selling shares while the company is buying its own stock, shortening directors' terms to one year from three years, setting a $200,000 limit on payments to organizations linked to directors, establishing the role of lead independent director, and capping all payments to board members and their families at $45,000.

How Do Pension Funds Identify Potential Claims?

Since hundreds of securities class actions are filed each year, identifying potential claims can be daunting. Most institutional investors use their custodian banks, case monitors or internal staff to identify suits and determine whether the fund is eligible to participate as a member of the plaintiff class.

Custodian banks are well placed to act on behalf of trustees since they keep the fund's transaction and holding records. They can review these records to determine whether the fund is part of a class involved in securities litigation and provide notification of class membership. Custodians sometimes are also responsible for producing documents, filing proofs of claim and submitting monthly progress reports to the fund's staff. Institutional investors typically spell out these responsibilities in their contracts with custodian banks.

Case monitors are third parties that have access to a custodian bank's historical and current transactional database to determine class membership and estimate losses. Monitors also may provide basic information on cases, along with monthly or weekly reports summarizing the status of relevant cases.

Case monitors fall into two broad categories: (1) research companies that specialize in securities litigation services and (2) securities counsel generally retained at no cost to track claims and provide funds with loss calculations, litigation summaries and evaluations of cases.

Some research companies offer securities litigation services that cater to public and Taft-Hartley pension plans and provide an on-line notification, monitoring and management support service; other companies offer a range of options from portfolio-specific email alerts to monitoring tools services.

Securities counsel may provide claims monitoring and evaluation services in return for the right to represent a fund as lead counsel if the fund opts to pursue the lead plaintiff position. Some law firms involved in securities class action cases provide free information on their Web pages regarding the status of pending and settled class action suits for which they serve or served as lead or co-lead counsel.

Larger institutional investors with ample resources often track cases on their own, using internal counsel, audit staffers or internal investment managers to identify cases, determine class eligibility and monitor securities litigation.

Free On-line Services and Publications That Track Securities Filings

Stanford Securities Class Action Clearinghouse is designated by the U.S. District Court for the Northern District of California to provide extensive, nationwide securities class action information at no cost to the public (http://securities.stanford.edu). The Clearinghouse must post and make available all court filings and documents forwarded to it. Pension funds may register with the Stanford Clearinghouse to receive automatic notices of litigation developments that may affect investments in their portfolios.

PricewaterhouseCoopers offers an on-line service (www.10b5.com) containing a free database of recent cases and summary reports of securities litigation data searchable by company name, industry, district filed, date filed and type of case. Registration is required to view the site.

How Do Pension Funds Evaluate Potential Claims?

Council member funds typically require that the estimated recovery meet or exceed a specified threshold for the fund to join a securities class action. The higher the expected recovery, the more likely the fund is to assume an active role in the litigation. For example, the Iowa Public Employees' Retirement System (IPERS) uses the following guidelines based on potential losses:

> *All litigation in which the potential loss to IPERS is under $500,000 will be "passively monitored." Passively monitoring means that cases will be tracked for any notices of settlement and IPERS will participate in the litigation as a member of the class. Passively monitored also means that as notices of settlement are issued, proposed settlements will be evaluated and, absent any reasonable objections to unusual terms, IPERS will file a proof of claim so that it will receive its pro rata share of the recovery.*
>
> *Cases in which IPERS' potential losses are between $500,000 and $1,000,000 will be "actively monitored" by IPERS. "Active monitoring" includes evaluation of the pattern of losses, settlement notices, viable objections, opt-out periods and deadlines for filing, as well as monitoring the appointment of lead plaintiff counsel.*
>
> *Cases in which IPERS' potential losses are $1,000,000 or greater will receive a detailed analysis to determine the appropriate course of action — including but not limited to a motion to become lead plaintiff or co-lead plaintiff or to opt out and file an action on an individual basis in federal or state court . . .*[15]

Other funds have more generalized guidelines that distinguish between passive and active involvement in a securities class action. Below is an example, from the Employees Retirement System of Texas (ERS):

> *In most cases, the Fund's interests in securities litigation claims will be adequately addressed solely through ERS' participation as a class member, rather than taking a lead plaintiff role in such litigation. In such event, the filing of any claim shall be prepared, processed and managed by the Fund's custodian on behalf of ERS, at the direction and with the oversight and approval of investment staff.*
>
> *In securities class action cases where the materiality of the financial loss to the Fund is exceptional and/or where it is determined that the Trustees' fiduciary obligation requires active participation or separate prosecution of claims, after consulting legal staff, the case may be referred to appropriate legal counsel approved by ERS for evaluation and recommendation to the Board.*[16]

Determining whether the benefits of engaging in securities litigation would exceed the potential losses to the fund involves estimating the potential damages that have been incurred.

How Do Pension Funds Estimate The Amount Of Potential Damages?

Some funds may start with the following basic calculation:

- Determine a Baseline Price by averaging the company's trading price for the 90 days after the end of the class period, as specified by the PSLRA. The derived value is referred to *as the PSLRA 90 day mean* and it effectively limits the damages on shares retained after the disclosure of the fraud to the mean value of the security in the 90 days following the corrective disclosure.
- Estimate Losses by multiplying the number of shares purchased during the class period by the price drop, calculated by subtracting the baseline price from the purchase price;
- Determine Net Damages by reducing estimated losses by profits made selling shares during the class period, calculated by multiplying the number of shares sold by the price drop; and
- Evaluate the price drop relative to the overall movement of the market.

The calculations do not end there, however. Investors may have traded in and out of a particular stock throughout the period that is the focus of the case. Market losses may have compounded the loss due to fraud. And investors who happened to sell shares prior to disclosure of the fraud may have reaped profits before sustaining losses on shares retained after the violation was revealed. Because of these complicating factors, the National Association of Public Pension Attorneys (NAPPA) recommends applying several sophisticated damage-estimation formulas to arrive at a rough estimate of the fund's aggregate recovery value. These formulas may provide an objective, efficient way to determine whether a case is worthy of active litigation.[17]

"You appear to be suffering from the effects of secondhand litigation."

How Does A Pension Fund Decide Whether To Pursue The Lead Plaintiff Position?

The lead plaintiff is the court-appointed representative of the class charged with selecting and retaining lead counsel and managing the subsequent legal proceedings, primarily by overseeing and monitoring the case's progress and the efforts of the counsel. The advantage of being lead plaintiff is the opportunity it affords to ensure strict control of legal expenses and elicit maximum relief for the class. As mentioned earlier, Congress enacted the PSLRA with this very hope in mind.

However, taking charge of a securities class action does not mean potentially pocketing the biggest portion of the gains; the lead plaintiff receives the same benefits as other class members.

Some experts suggest key issues that investors should consider when weighing whether to seek appointment as lead plaintiff:[18]

- Would the investor add value to the case by taking charge of it?
- What will the litigation cost?
- What is at stake, including the size of the loss to be recovered and ancillary benefits such as deterring securities fraud in the future?

In essence, the main reason to seek lead or co-lead plaintiff status is the strong likelihood that the benefits — the value of the expected recovery, deterrence against future violations and any potential improvement of corporate governance practices — will exceed the expenses and staff time in relation to other available options. These alternatives include remaining a passive member of the class or litigating independently of the class.

The PSLRA requires an institutional investor to decide to pursue lead plaintiff status at the outset, before class complaints have been tested in motions to dismiss and usually before discovery has occurred. A reasoned assessment of the case should address matters such as what claims are or could be asserted and the likelihood that they will be sustained, chances of recovery and sources of recovery. In addition, the investor should consider whether its interests mesh with those of the class. There could be a divide over whether to maintain a significant stake in the target company. Or the class may be interested only in the largest possible loss recovery, while a pension fund considering lead plaintiff status may also be intent on seeking changes in corporate governance practices at the defendant company.[19]

As part of their securities litigation procedures, some pension funds address under what circumstances, if ever, they should take the lead plaintiff position. Such provisions help a fund decide whether it is up to the task of taking lead of the class action, in what circumstances, what it expects to accomplish by taking on that role and, most importantly, whether the potential benefits outweigh the risks. CalSTRS' and MOSERS' securities litigation guidelines in Appendices B and C, respectively, include explicit provisions describing how each fund evaluates whether to pursue the lead plaintiff provision.

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Questions and issues a pension fund should address in assessing whether to serve as lead plaintiff from the National Association of Public Pension Attorneys

- Is it a viable case or is it vulnerable to a motion to dismiss under the PSLRA's new pleading standard?
- What can our fund bring to the litigation to improve the outcome?
- Might our fund be seen as having a conflict with the class because we have a large ongoing position in the company?
- What are the potential sources of recovery? Do viable and collectible claims against individual officers and directors or other third parties (auditors, underwriters, etc.) appear unlikely to be vigorously pursued without active management of the case?
- How much experience participating in class actions has the fund already accumulated (i.e., are we becoming professional lead plaintiffs)?
- Is another sophisticated and reliable lead plaintiff available or going to come forward?
- How much has our fund lost?
- Are there claims against auditors or other third parties that are not being pursued?
- Is our fund the best fund to represent the class for any reason other than the monetary loss, such as lending credibility to a less obvious claim?
- Was there egregious activity within the company such that a personal recovery from the defendants appears to be the most expedient way of preventing similar future corporate behavior?
- Will participating in the suit assist in lowering the plaintiff's attorney fees and foster healthy competition within the plaintiffs' bar?
- What corporate governance changes could be considered to address the causes of the fraud?
- Will the fund's participation have a positive impact on reforming securities litigation in general?
- How strong are the causes of the action of the lawsuit?
- What are the reputations and skills of potential lead counsel candidates who have filed lawsuits?
- Are there any indications (from prior cases) that likely lead counsel would seek a fee award in excess of market rates?
- How willing is the portfolio manager to support the fund's position in litigation?
- Will the capabilities and anticipated testimony of the fund's likely witnesses strengthen the fund's position?
- Do compromising materials exist in the fund's or manager's files?
- Are there any unusual circumstances or facts that could complicate or undermine the fund's position (e.g., service as a lead plaintiff in more than five cases in the last three years, public criticism of the manager's decision to invest in the company, etc.)?
- Is there potential interference with the fund's anticipated future trading strategy if material, non-public information on the company were to be acquired during the litigation, where a firewall cannot be established to allow continued trading?
- Are there unique claims held by the fund that may not apply to other class members (e.g., section 18 claims for direct reliance on misstatements in 10-Ks, section 11 claims from purchases pursuant to a false registration statement, etc.), which might create a conflict of interest or support a larger recovery in a separate opt-out lawsuit?

COUNCIL OF INSTITUTIONAL INVESTORS

Securities Litigation

The PSLRA requires courts to choose as lead plaintiff the investor(s) "most capable of adequately representing the interest of class members." The law mandates that, in general, the investor or group that has the largest financial stake should be lead plaintiff.

While courts increasingly have rejected non-affiliated groups of individual investors as co-lead plaintiffs — citing a failure to demonstrate they could cohesively monitor the litigation and supervise counsel — they have tended to allow institutional investors to team up with other institutions as co-lead plaintiffs. In some cases, those institutions may have different ideas about aspects of the case and may be represented by separate counsel. In those cases, the parties should have procedures in place for resolving disputes.

To put a stop to "professional plaintiffs," the PSLRA allows an investor to serve as lead plaintiff no more than five times in three years. However, the House committee report accompanying PSLRA specifically exempts institutional investors:

> *Institutional investors seeking to serve as lead plaintiff may need to exceed this limitation and do not represent the type of professional plaintiff this legislation seeks to restrict.*[20]

The House-Senate conference report explicitly grants courts the discretion to allow institutional investors to exceed the ceiling. Some courts have waived the limit for institutions, while others have rejected certain institutions as lead plaintiff on occasion because of the cap. A number of experts have gathered information on district courts and their rulings on whether the professional plaintiff restriction applies to institutional investors.[21]

How Does A Pension Fund Evaluate And Select Lead Counsel?

One of the most important decisions a lead plaintiff makes is selecting lead counsel, which does much of the heavy lifting in a securities suit — researching the case, handling all the legal aspects (such as seeking discovery and filing motions), analyzing settlement proposals and litigating the case in court.

Many institutional investors manage the selection process in a way that would establish for the court (which must approve the selection) as well as for other class members that the lead counsel was chosen for its experience, expertise, litigation plan and fee proposal. To ensure competition and hold down fees, lead plaintiffs generally seek proposals from a number of qualified firms.

Although the PSLRA authorizes the lead plaintiff to choose lead counsel subject to the approval of the court, the law does not clearly delineate the roles of investors and courts in determining the lead counsel. As a result, court rulings have produced a variety of views on the proper procedure for the appointment of lead counsel.

For example, in *Quintus Securities Litigation* (filed in 2003), the U.S. District Court for the Northern District of California ruled that all lead plaintiff candidates were incapable of adequately negotiating a fee agreement with the lead counsel, ordered a competitive bidding process and reserved for itself the final decision on the lead counsel. In *Comdisco Securities Litigation* (filed in 2002), the U.S. District Court for the Northern District of Illinois decided that an institutional investor lead plaintiff could not insist on the appointment of its selected law firm as lead counsel and had to accept the lowest responsible bidder. And in IBP Securities Litigation (filed in 2004), the U.S. District Court for the District of South Dakota — Southern Division refused to order an auction for the appointment of the lead counsel; it let the lead plaintiff choose but required it to submit an affidavit explaining how its lawyers were selected and what the fee arrangements were.[23]

Court interference in the selection and appointment of lead counsel can pose problems. A judge may not have the same interests as the lead plaintiff. For example, a judge with a crowded calendar might prefer lead counsel with a reputation for settling cases rather than a firm known for its ability to win a trial. In addition, when lead counsel is selected by the judge, there may be less incentive for counsel to be responsive to the lead plaintiff. Given the potentially divergent economic interests and risk tolerance levels of the lead plaintiff and the lead counsel (maximizing payments to the class versus obtaining the largest fee), this lack of accountability to the lead plaintiff could affect how a case is handled and the ultimate result.

One legal expert advises institutional investors to consider the following principles to minimize the chance of judicial intervention in lead counsel selection and/or compensation:[25]

- Include a process for selection of lead counsel in the fund's securities litigation policies.
- Establish a record to justify the basis for the funds' lead counsel recommendation to the court, including compensation arrangements.
- Insulate the lead counsel selection decision from political influence by including independent participants in the process when such concerns are present.
- Consider the different methods for setting fees (e.g., negotiated at the beginning or end of the case, set on an increasing or decreasing schedule as the amount of recovery rises, set at a single percentage regardless of recovery amount) and be ready to explain why the method chosen is appropriate.

What Kind Of Fee Structure Can Pension Funds Negotiate With Class Counsel?

That varies, depending on the circumstances. Common examples of fee structures include:

- Increasing the counsel's fee percentage as the class recovery amount increases. This rewards counsel for maximizing recovery, while discouraging pursuit of cases with little merit.

"Would everyone check to see they have an attorney? I seem to have ended up with two."

- Increasing the fee percentage as the case proceeds.
- Retaining the right to a decrease in fees if circumstances change.
- Negotiating control over counsel's ability to retain vendors and experts.

Securities Litigation

What Are Alternatives To Serving As Lead Plaintiff Or Passive Class Member?

Opting Out

Institutional investors can sometimes win bigger recoveries by opting out, i.e. suing on their own in a state court. In two surveys of public pension funds conducted in 2005 and 2006, several opt-out plaintiffs reported recoveries that were higher (often by a multiple) than the percentage of damages obtained from investors who remained in the related class action.[24] For example, one fund obtained opt-out settlements for about 90 percent of its damages (substantially better than the class recoveries) in securities litigation cases against Enron (filed in 2002) and WorldCom (filed in 2003) and received those payments prior to the settlement of related class actions.[25] More recently, in a 2007 suit against Bristol Myers, more than one fund reported receiving settlements several times larger than the recovery won by class action members.[26]

Opting out may offer distinct advantages.[27] State securities laws are sometimes more favorable to investors, providing for broader liability (covering lawyers, investment banks and other outsiders who have aided or abetted the fraudulent conduct) or significantly less stringent pleading standards than federal actions. Lawsuits filed in state court do not have to contend with the automatic stay of discovery that the PSLRA imposes in federal actions; that can pave the way for speedier settlements and trials. And a fund that files solo retains the ability to choose its own counsel, negotiate fees and manage the litigation as it sees fit.

But there are drawbacks to individual action that make this route viable only in limited instances.[28] For instance, a settlement with a plaintiff in an individual action usually is tethered to, and follows, settlement with the class plaintiffs. Many defendants would choose not to settle an individual action first because the price per share offered to the plaintiff in the individual action would immediately become the floor for any settlement in the much larger class action. Settlements in general are less likely because the relatively smaller potential damages sought in an individual action may make a defendant more willing to risk a trial.

A plaintiff that opts out may not be able to chart its own course if its counsel represents multiple institutions that also are filing state claims. In *WorldCom Inc., Securities Litigation*, for example, one law firm filed at least 47 individual actions on behalf of more than 120 pension funds.[29] Plaintiff lawyers handling multiple opt-out cases will need to coordinate with the various clients and could be pulled in a particular direction by trustees for specific institutions.

Plaintiffs filing an individual action in state court will not be able to assert a fraud claim under SEC's Rule 10b-5, the core claim of many securities cases. Plaintiffs will be limited to making state claims and 1933 Act (non-fraud) claims only.[30]

In general, the larger and stronger the claim, the more likely it is that the costs and benefits favor opting out.[31] The decision, however, to opt out should turn on an assessment of a number of factors such as (1) the claims that are or could be asserted in the action and the likelihood of their sustainability, (2) the likelihood of recovery, (3) the sources of recovery and (4) the fund's own individual stake in the class action.

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Specific Issues to Consider When Deciding Whether to Opt Out[32]

- The size of the claim: Whether the claim is large enough to justify opting out depends on (1) a pension fund's ability to bear the extra time and resource demands associated with oversight of litigation and discovery in an opt out case and (2) the size of the claim relative to the amount of assets under the plaintiff's management. (For example, a $5 million claim is more likely to be material and merit allocation of substantial resources for a small institutional investor than for a large one.)
- The defendant's ability to pay: The more secure the source of payment, the more likely that an opt-out case will produce a worthwhile outcome.
- Whether a fund holds securities not covered by the class action: An opt-out suit might be the only avenue for recovery of damages relating to securities excluded from a class action suit.
- Whether state law claims present advantages over federal class action: Some state laws allow a broader range of parties against whom a suit might be brought, have a laxer standard for proving faults such as "negligent misrepresentation" and set a higher benchmark for punitive damages than federal laws.
- Whether a fund has claims that cannot be pursued in a class action: This might, for instance, include fraud-based claims under state law, which federal law prohibits from being brought in a class action.
- Whether a plaintiff can expedite a case by filing an opt-out in a state court: By staying out of federal court, a plaintiff might be able to get their case to trial faster than a class action suit in federal court, and thereby gain a strategic advantage. However, there are two potential problems with this approach: (1) if filing in state court, the plaintiff will have to relinquish certain claims over which the federal government holds exclusive jurisdiction (such as section 10(b) securities fraud claims, which form the core claims of many securities cases); (2) when an opt-out case is filed in state court, the defendant will invariably try to get the case put on the same schedule as the class action, including trying to move the case to a federal court.
- The presence of conflicts of interest: Situations where investors might have a perceived conflict of interest can be an indicator in favor of an opt-out. One instance of such a situation is when there is an investor with such a large continuing stake in the company that it might be reluctant to vigorously pursue a claim against the company. A difference in the level of risk that the lead plaintiff is willing to tolerate as compared to other class members may be another example of a conflict of interest that could make opting-out favorable.

Filing Proofs of Claim

This is an easy and inexpensive way to collect from a securities class action settlement; someone else has already done the litigating, and the money is just sitting on the table, waiting to be claimed. Unfortunately, many pension funds fail to pursue this most basic means of asset recovery. A 2005 study of 118 securities class actions settled between 1995 and 2002 found that 72 percent of institutional investors did not recover monies in cases in which they were eligible to collect.[33] Too often, funds neglect to monitor the custodian bank or other outside provider they rely on to file proofs of claim, to ensure that all claims are collected.

Writing Letters to the Court and/or Lead Plaintiff

Pension funds may participate in securities litigation by submitting correspondence that requests an adjudicating court or lead plaintiffs to take a number of actions with respect to the case. Specifically, a pension fund may write with the aim of obtaining court documents and other materials. For example, in a 1997 case *Rudolph v. S3, Inc.* (N.D. California), SWIB asked the court to let it receive all documents relating to the action, to be heard on the selection and compensation of lead counsel and to participate in settlement negotiations.[34] Although the lead plaintiff withdrew the claim and refiled in state court, SWIB was still able to gain access to all discovery materials, participate in settlement discussions and receive privileged status reports from litigation counsel.

A pension fund may also write in order to unofficially protest counsel fees and/or settlements. Many experts agree that a close review of the attorney's fees sought by counsel for the plaintiff class is in keeping with the fiduciary duty of pension funds.[35] Since challenges can yield considerable reductions in fees, scrutinizing fees can be a prudent alternative to serving as lead plaintiff or participating passively in a class action.

Finally, a pension fund may question the merits of a securities litigation claim all together. Take for instance *Gunther v. Moore* (N.D. California) and *Whittaker v. Moore* (N.D. California) — a 1994 class action and shareowner derivative action, respectively, filed against Intel Corporation. Four institutional shareowners of the company, including CalPERS, sent a letter to the lead plaintiff's counsel challenging the merits of the action on the grounds that it was non-meritorious, would impose substantial costs on the company and that it would not promote the interests of investors.[36] In response, the class counsel voluntarily dismissed the claim.

APPENDIX A: SWIB Securities Litigation Procedures (Updated January 2005)

General Principles

SWIB acknowledges that it has a fiduciary duty to take reasonable actions to collect on legal claims held as a trust fund asset. A process for identifying, filing and collecting on class action claims shall be maintained by legal staff. The process shall also allow SWIB to identify situations where the expected additional return or benefits from playing an active role in prosecuting a claim rise to the level that merits investment and legal staff jointly conducting a cost-benefit analysis of pursuing a proactive litigation strategy. It contemplates that input from relevant investment staff will be obtained prior to initiation of any SWIB legal action that impacts portfolio holdings or strategy.

Initial Case Evaluation

Where it appears that SWIB's damage claim in a public market corporate fraud case exceeds $20 million, internal legal staff shall perform an initial case evaluation. This evaluation should include analysis of: (a) whether the company appears to have engaged in fraud or other serious illegal conduct; (b) whether SWIB has any investment position that could be disadvantaged by the litigation; (c) legal vulnerabilities of the case; (d) potential sources of recovery; (e) expected discovery demands and distraction of investment staff from their primary function if SWIB became involved in litigation; (f) whether the case is likely to be effectively prosecuted without SWIB's active participation; (g) how much could be added to SWIB's bottom line by a proactive strategy; (h) alternative means of obtaining similar results and (i) any other relevant considerations.

Where legal staff concludes that active SWIB involvement in the litigation is expected to produce increased returns or benefits that substantially outweigh the associated costs, including the lost opportunity costs from staff time devoted to litigation, the Chief Legal Counsel shall convene an Evaluation Meeting with the Executive Director (or the Executive Director's designee) and the relevant CIO(s) and portfolio manager(s). The legal staff's case evaluation shall be reviewed, with additional factors potentially being identified by the participants for consideration.

Final Recommendation

If the Executive Director, relevant CIO(s) and Chief Legal Counsel unanimously concur that the benefits of engaging in a proactive litigation strategy substantially outweigh the associated costs or otherwise merit additional consideration, the Chief Legal Counsel may retain outside case review counsel to further evaluate merits of the case and SWIB's options for pursuing efforts to realize on its legal claims. Outside counsel's report shall be presented to and reviewed by the Evaluation Meeting participants.

Unanimous approval of the Executive Director, relevant CIO(s) and Chief Counsel are required to authorize any action to initiate, join, make an appearance in or submit a filing in any public market corporate fraud litigation. Nevertheless, in cases where SWIB is not lead plaintiff, the Chief Legal Counsel may object to excessive legal fees, support another institutional lead plaintiff candidate, or concur in a legal position taken by the lead plaintiff. Where there is not the required unanimous approval, the Executive Director, a CIO or the

Chief Legal Counsel may bring the matter to the Board for its consideration. The Board may approve litigation regardless of Evaluation Meeting action.

Board Reports and Approvals

The Executive Director shall report to the Board on each Evaluation Meeting outcome, and Trustees must be informed prior to implementation of any approved action. Whenever SWIB's legal claim exceeds $50 million, Board approval is required to initiate or voluntarily join any litigation, whether it is in the public or private markets. The filing of or active participation of SWIB in appraisal, merger challenge or other non-fraud corporate governance litigation shall require both review through the Evaluation Meeting process and Board approval.

APPENDIX B: CalSTRS Securities Litigation Procedures (Last Revision February 2008)

CalSTRS will manage its interests in securities litigation matters as assets of the trust fund with the goal of enhancing the long-term value of the portfolio consistent with the Investment Management Plan. Consistent with this goal, CalSTRS will pursue the following objectives:

- Increasing the net monetary value of settlements;
- Increasing the long-term value of shares in a company subject to shareholder litigation held in CalSTRS' portfolio;
- Deterring wrongful corporate conduct that undermines the integrity of the financial markets.

In most cases, CalSTRS' interests in securities class action litigation claims will be adequately addressed solely through passive participation as a class member. However, in select cases a higher level of involvement will be appropriate, including:

- Moving for Lead Plaintiff Status: In securities class action cases where CalSTRS' potential damages exceed $5 million, or in other cases where there is an exceptional opportunity to preserve or enhance the long-term value of a significant portfolio holding or to deter wrongful corporate conduct, CalSTRS will consider moving for lead plaintiff status. If staff concludes that a securities class action meets one or more of these criteria, the case will be referred to a law firm on the evaluation counsel panel for evaluation and recommendation to the Board.

The evaluation counsel panel shall be established under the direction of the General Counsel and shall consist of law firms that are experienced in the litigation of federal and state securities cases, including but not limited to class actions, so-called "opt-out" individual actions, and derivative cases. Such counsel shall be selected and compensated on a retainer basis to evaluate the case, make a recommendation thereto, and to represent CalSTRS in the filing of a motion for lead plaintiff status if such action is approved, but shall not otherwise be eligible to represent CalSTRS as lead class counsel in that case if CalSTRS is selected as lead plaintiff.

A determination on whether to seek lead plaintiff status shall be made by the Board based on the recommendation of the General Counsel and evaluation counsel. The recommendation of evaluation counsel should address the merits of the case, potential applicable defenses and recoverable damages. If, pursuant to Board approval, lead plaintiff status is sought and

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approved by the Court, CalSTRS will conduct a competitive selection of lead class counsel in order to secure the most qualified counsel at a fee structure that aligns the interests of the class and lead counsel.

- Alternatives to Lead Plaintiff Status Requiring Board Approval: In some instances where seeking lead plaintiff status is not sought or where the court has denied a motion therefore, CalSTRS may consider the following alternatives: 1) Participating as a co-lead plaintiff with other institutional investors; 2) Opting out of a class and filing a separate securities action in state or federal court; 3) Filing a shareholder derivative claim in state or federal court; and 4) Formal intervention in pending litigation. Such actions shall require the approval of the Board following an evaluation by the General Counsel and evaluation counsel.
- Litigation Alternatives Delegated to Staff: If, in a particular case, the seeking of lead plaintiff status or the above alternatives is either not deemed to be appropriate or is not approved by the Court, but staff believes that some active involvement by CalSTRS would be consistent with the goal and objectives of this program, on the recommendation of the General Counsel and approval of the Chief Executive Officer CalSTRS may: 1) Attempt to persuade another claimant whose interests are aligned with CalSTRS to seek lead plaintiff status; 2) File briefs or motions with the Court concerning the selection of lead plaintiff, lead counsel, or other litigation matters; 3) File a notice of appearance and more actively monitor the case; 4) Participate in settlement negotiations or consult on a proposed settlement; or 6) File objections to inadequate or otherwise objectionable class action or derivative settlements.
- Non-Litigation Alternatives: In considering the appropriate response to a company that is subject to shareholder litigation, CalSTRS will evaluate the pursuit of alternatives to litigation that address the underlying cause of the company's problem. For example, contacting appropriate regulatory and/or law enforcement agencies about potential prosecution of wrongdoers may deter similar conduct in the future that undermines the integrity of the financial markets. As another example, filing shareholder resolutions or negotiating for corporate governance changes like the addition of independent directors or the creation of an independent audit committee may address the problems that lead to the litigation and could aid in the long-term recovery of the company and the value of its stock.

APPENDIX C: MOSERS' Policy on Private Securities Class Action Litigation (Last Revision March 8, 2001)

This statement sets forth MOSERS' policy regarding potential participation as lead plaintiff in securities class action lawsuits.

Background

In carrying out its fiduciary duties to prudently invest and manage the assets of the System, MOSERS invests in the stock of various public companies ("issuers"). From time to time, class action lawsuits are brought against the issuers, their directors and/or their officers for alleged violations of federal and state securities laws relating to various disclosure obligations and, in many cases, other breaches of fiduciary or other duties. As a shareholder, MOSERS is a putative member of the alleged classes (as are most or all of the other shareholders). Frequently, MOSERS receives solicitations from attorneys who seek to represent MOSERS as a lead plaintiff in these class action lawsuits.

Appointment as a Lead Plaintiff

Under the federal Private Securities Litigation Reform Act of 1995, federal courts are required to appoint one or more members of the putative class to serve as the lead plaintiff(s) in securities class action lawsuits. See 15 U.S.C. § 78u-4(a)(3)(B). The Act provides a rebuttable presumption that the lead plaintiff is to be the investor with the largest financial interest in the relief sought by the lawsuit who wants to serve as the lead plaintiff. *See* 15 U.S.C. § 78u-4(a)(3)(B)(iii). Typically, this means that those investors with the largest holdings in the defendant issuer's stock have the right to serve as the lead plaintiff.

In most securities class action lawsuits, several other investors, including many institutional investors with substantially greater investment portfolios than MOSERS, hold more shares in the defendant issuer than MOSERS holds and, thus, have a larger financial interest in the relief sought. Accordingly, in most such lawsuits, an investor other than MOSERS will have the right to serve as the lead plaintiff.

Financial Risks of Serving as Lead Plaintiff

There are financial risks in serving as a lead plaintiff in a securities class action lawsuit. Serving as lead plaintiff or being designated lead plaintiff may have financial risks if the litigation is unsuccessful. Unless the lead plaintiff negotiates an allocation of potential financial risk with other named plaintiffs, the lead plaintiff could bear the costs, expenses or, potentially, attorneys' fees of the opponent if the litigation is unsuccessful or the court grants sanctions under Rule 11 of the *Federal Rules of Civil Procedure*. Finally, regardless of the outcome of the lawsuit, class members could potentially pursue claims against the lead plaintiff for inadequately representing their interests.

In return for assuming these financial risks, the lead plaintiff does not obtain any additional financial benefit from serving as a lead plaintiff, but, instead, shares any final judgment or settlement with the class members on an equal, per share basis (although the lead plaintiff may also recover its attorney's fees, costs, and expenses if the lawsuit is successful or a settlement is obtained). See 15 U.S.C. § 78u-4(a)(4).

MOSERS' Policy

Based on the foregoing, it is MOSERS' policy not to serve as a lead plaintiff in securities class action litigation unless MOSERS is among the largest shareholders of the defendant issuer and service as a lead plaintiff is determined to be in the best interest of the System.

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Disclaimer

This primer is designed to provide a general introduction to securities litigation. It touches on some of the issues that are most relevant to pension funds and is not a comprehensive discussion of securities litigation. While the Council exercised due care in writing this primer, it does not guarantee the accuracy of the information.

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Executive Director Council of Institutional Investors

888 17th St., NW Suite 500 Washington, DC 20006

Tel 202-822-0800 Fax 202-822-0801

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888 17th Street, NW
Washington, DC 20006
202.822.0800 www.cii.org

ADDENDA 5

Corporate Governance and Securities Litigation

Presented to the Securities Litigation Subcommittee
Kentucky Public Pension Working Group

Gregory W. Smith
General Counsel
Colorado PERA
October 22, 2008

Board of Trustees Shareholder Committee Charter

A standing committee of the Board comprised of not less than four members. The Shareholder Responsibility Committee supports the Board by overseeing management's implementation of the policies and procedures concerning PERA's rights and responsibilities as a shareholder.

Duties and Responsibilities

The Shareholder Responsibility Committee will:

- Recommend a shareholder responsibility policy to the Board for approval;
- Interact with the legal counsel and the CIO on shareholder responsibility policy matters
- Ensure that PERA manages its proxies in the most advantageous manner, and report to the Board as appropriate; and
- Review PERA's internal policies and procedures with respect to securities litigation with the objectives of enhancing loss recovery on a cost effective basis and encouraging the implementation of responsible corporate governance practices in the business community

Securities Litigation Policy

Goals:

- Fulfill PERA's fiduciary duty by effectively managing claims as fund assets
- Increase recoveries on claims
- Reduce fees paid to obtain recoveries
- Deter future frauds by imposing personal liability on bad actors
- Fix company governance issues to prevent future problems
- Encourage criminal sanctions/disbarment to remove bad actors from boards and management
- Change the litigation system to better protect interests of shareholders and meet above goals

Securities Litigation Policy

Investigation Guidance

- Loss Threshold: $5 Million
  - Closer examination:
    - Is it a viable case or vulnerable to a motion to dismiss under the Private Securities Litigation Reform Act (PSLRA)?
    - What can PERA bring to the litigation to improve the outcome?
    - Does PERA have a conflict in the class because it holds a large ongoing position in the company?
    - What are the potential sources of recovery?

Securities Litigation Policy

<u>Investigation Guidance</u>

- Closer examination (Continued):
  - Is PERA eligible to pursue lead plaintiff status?
  - Is another sophisticated and reliable lead plaintiff going to come forward?
  - How much has PERA lost?
  - What are the available internal PERA resources to undertake the active management strategy?

Securities Litigation Policy

Decision-making Process

- In a cost/benefit analysis to determine whether the benefits outweigh the costs, consideration must be given to the following goals:
  - Are there claims against auditors or other third parties that are not being pursued?
  - Is PERA the best fund to represent the class for any reasons other than the monetary loss, such as lending credibility to a less obvious claim?

Securities Litigation Policy

Decision-making Process *(Continued)*

- Was there egregious activity within the company such that a personal recovery from the defendants appears to be the most expedient way of preventing similar future corporate behavior?
- Will participating in the suit assist in lowering plaintiff's attorney fees and foster healthy competition within the plaintiff's bar?

Securities Litigation Policy

Decision-making Process *(Continued)*

- What are the corporate governance changes that could be considered to address causes of the fraud?
- Will PERA's participation have a positive impact on reforming securities litigation in general?
- Will PERA's involvement increase the likely recovery to be realized from this action?

Securities Litigation

- Claims filing
- Settlement and fee analysis
- Monitoring case
- Lead Plaintiff
- Opt Out/Direct Action

Securities Litigation Activities

- Royal Ahold
  - 2006 $1.1 Billion
- Oxford Health
  - 2003 $300 million

Opt Outs

- Qwest
  - November 2007
- McKesson HBOC
  - August 2005

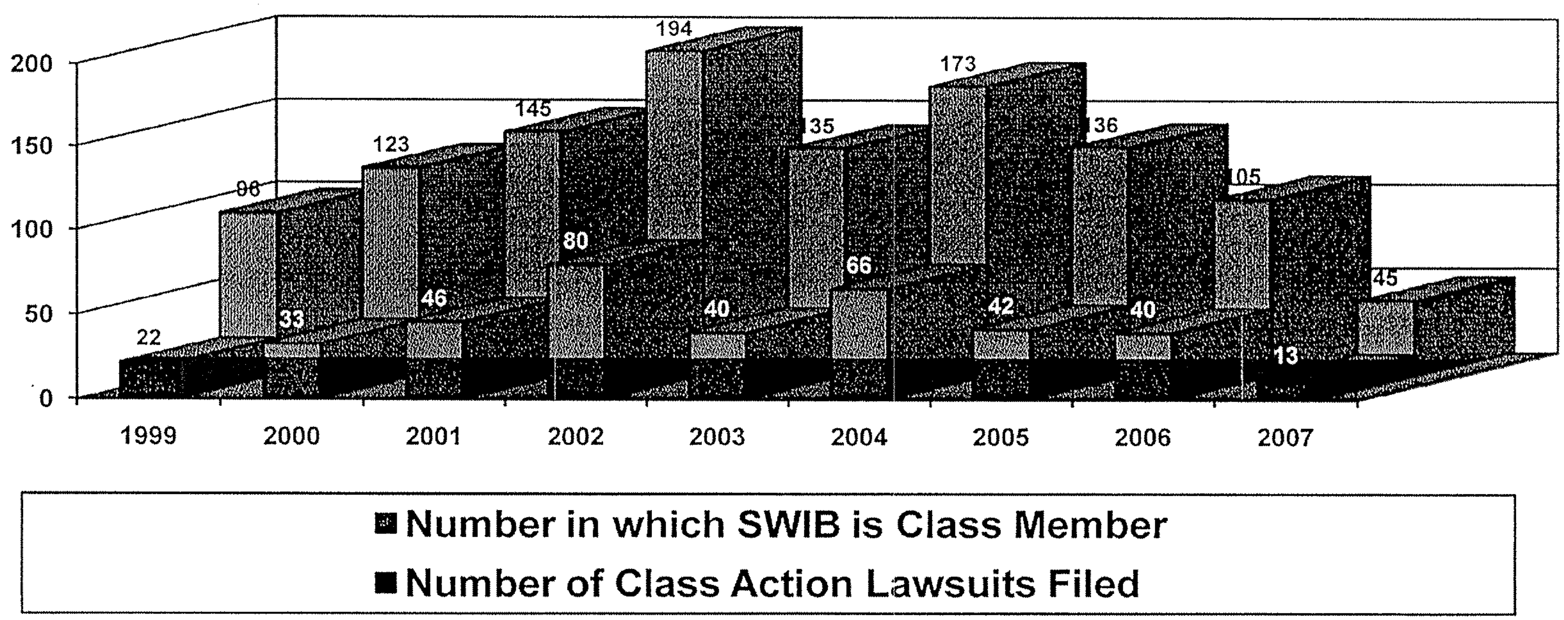
ADDENDA 6

Corporate Governance and Securities Litigation

Presented to
Securities Litigation Subcommittee
Kentucky Public Pension Working Group

Jane Hamblen
Chief Legal Counsel
State of Wisconsin Investment Board
October 22, 2008

Securities Class Action Lawsuits
January 1999 – May 2007
(As of 12/21/2007)



- Includes securities class action lawsuits filed under the Public Securities Litigation Reform Act (PLSRA). Excludes derivative actions.
- SWIB has been a class member in approximately 30% of all new securities class actions filed each year.
- SWIB is a class member in 382 pending securities class actions.
- SWIB has been lead plaintiff under PSLRA four times.

Fiduciary Duty

- Requires prudent management of assets under management
- Class action claims and shareholder rights are trust fund assets
- Prudent management requires process, process, process

Board Establishes Process

- Securities Class Action Procedures
- Corporate Governance Policy
- Proxy Voting Guidelines

Securities Litigation Process - Passive Role

Legal Staff required to maintain a process to:

- Identify class action claims
- File class action claims
- Track and collect on class action settlements

Securities Litigation Process - Active Role (summary)

Loss Threshold = $20 million

1. Initial Case Evaluation
Legal Staff conducts cost-benefit analysis

2. Staff Evaluation

Chief Legal Counsel
Chief Investment Officer

Executive Director
Relevant Portfolio Manger

Unanimous Decision

- ≤$50 million - inform Board
- >$50 million - Board approval required

No Unanimous Decision

- One Member can take to Board for approval of action
- CLC can pursue alternative strategies
- No action/ Monitor

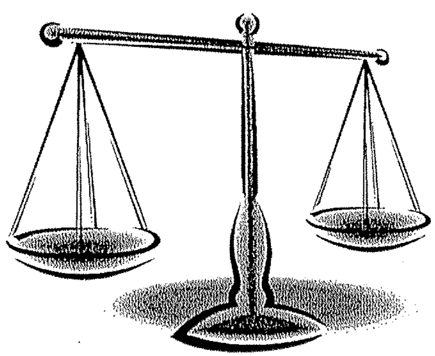
Step 1.

Initial Case Evaluation

Legal Staff

Cost-Benefit Analysis

- Fraud or other serious illegal conduct
- Ongoing investment position
- Legal vulnerabilities
- Potential sources of recovery



- Demands on investment staff
- Other satisfactory lead plaintiffs
- Bottom line considerations
- Alternative means of obtaining similar results
- Corporate governance concerns
- Others

Sources for cost-benefit analysis

- External vendor - tracks all new lawsuits, provides SWIB's transaction history and potential damage calculations
- Investment Staff – views of the company; history of reliance on management statements
- Plaintiffs counsel reports and analyses; Complaint
- Other institutional holders of the security – potential lead plaintiffs

Condition for Step 2 in Process

Legal Staff must conclude that SWIB's active involvement in the litigation is expected to produce increased returns or benefits that <u>substantially</u> outweigh the associated costs, including the lost opportunity costs from staff time devoted to litigation

Step 2.

Staff Evaluation

Initial Evaluation Meeting

- Meeting called by Chief Legal Counsel
- Participants
  - Executive Director
  - Chief Financial Officer
  - Chief Legal Counsel
  - Portfolio Manager
- Presentation and discussion of Legal Staff's findings in cost-benefit analysis

Independent Legal Advice

- **IF** members of the Evaluation Group unanimously concur either that
  - the benefits of taking an active litigation strategy substantially outweigh the associated costs **or**
  - otherwise merit additional consideration

- **THEN** Chief Legal Counsel may retain outside independent case review counsel to further evaluate merits of the case and SWIB's options and to advise the Evaluation Group

STEP 3.

Final Decision

Different claims / Different procedures

- Securities Fraud Class Action
- Non-Fraud Corporate Governance Litigation

Non-Fraud Corporate Governance Litigation

- Examples: dissenters rights, appraisal challenges, merger challenges, proxy disputes
- Board approval is required to initiate or voluntarily join litigation

Securities Fraud Class Action Litigation

- **Unanimous approval of Evaluation Group**
  - Damages ≤ $50 million - pursue active role
  - Damages > %50 million – Board approval required to pursue active role

OR

- **No unanimous approval of Evaluation Group**
  - A member of the Evaluation Group may seek Board approval, notwithstanding Evaluation Group
  - Chief Legal Counsel may pursue alternative active strategies

Active Roles

- Seek lead plaintiff status individually and with other institutional investors
- Opt out of class action / file separate law suit

Alternative Strategies

- Support another institutional lead plaintiff candidate
- Support legal position taken by lead plaintiff by letter to court or amicus brief
- Object to excessive legal fees

Selection of Counsel

- Based on informed decision
  - Request for Information
  - Analysis of information already provided
- As lead plaintiff, have fiduciary responsibility to class members
- Legal fee negotiation

SWIB's Litigation Activities

- Lead Plaintiff: Anicom (IL)
Just for Feet (co-lead plaintiff) (AL)
Cell-Star (TX)
Physicians Computer Network (NJ)
- Opt-out: Worldcom (WI) (opted back in as class member)
- Tracking/monitoring: AOL Time Warner
- Challenge to Fees: Horizons CMS (NM)
- Official Monitor: S-3 (CA)
- Corporate Governance: Peerless systems (DE)
- Other: Rainforest Café - appraisal case
Medco Research - enjoined merger because of low price

ADDENDA 7

The Future of Opt-Outs In Securities Fraud Class Action Litigation

Reed R. Kathrein
Partner
Hagens Berman Sobol Shapiro LLP
715 Hearst Avenue, Suite 202 ,Berkeley, CA 94710 ,
Telephone: (510) 725-3030 Facsimile: (510) 725-3001 Cell: (415) 683-8566
Email: reed@hbsslaw.com

2008 Overview

- Over the past ten years, the number of securities fraud class actions has hovered around 200 per year.
- By June 2008, 139 securities fraud class actions were filed. One source has 169 to date.
- In September 2008, 14 of the 24 suits filed were unrelated to the crisis, including life science and wireless companies
- By October 2008, there have been 85 alone relating to the subprime crisis. 21 are related to the auction rate securities lawsuits.

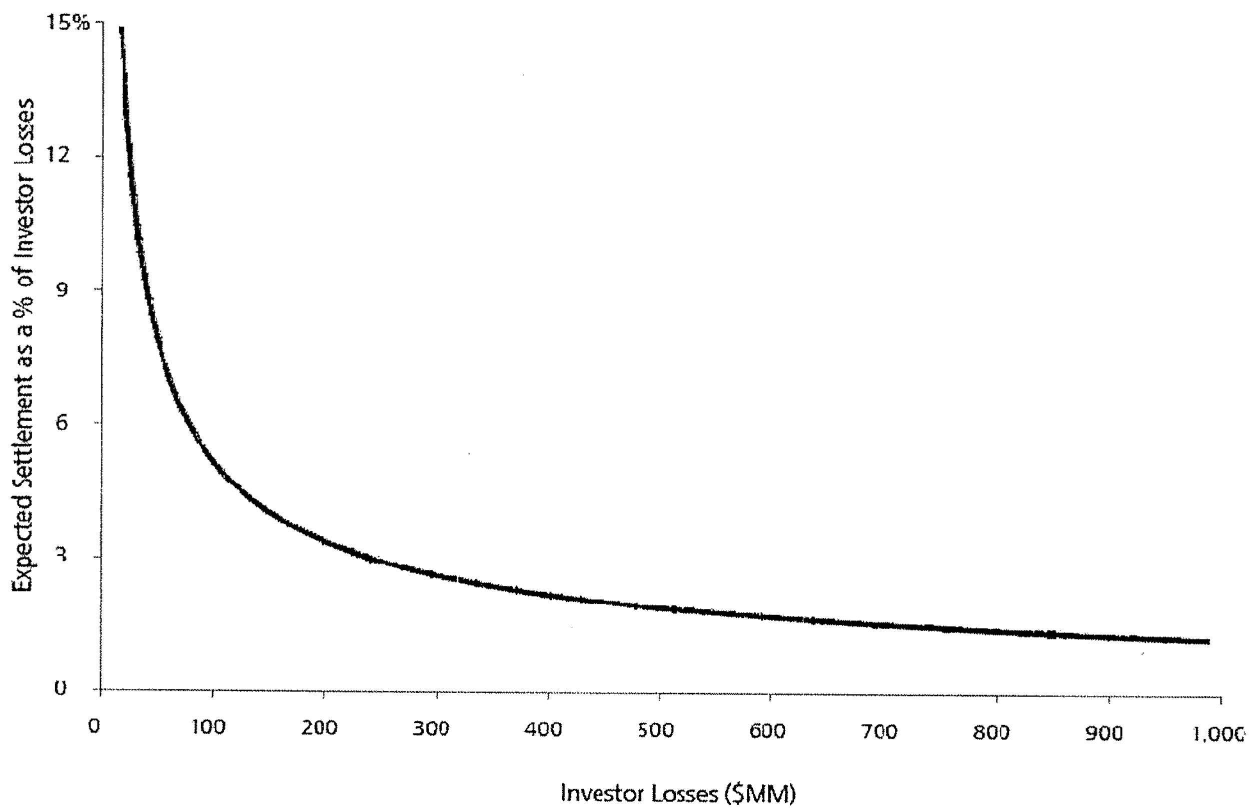
2008 Overview (Continued)

- The probability of a fraud suit increases with the size of the price decline.
  - 20-30% result in suits in 9% of the instances
  - 30-39%........................15.5%
  - 40% or more 31%
- But the current market crisis will impact these statistics

2008 Overview (Continued)

- Average settlement since 2001 is $45.4 million
- As investor losses increase, the percentage of recovery decreases on average

Nera Prediction Model



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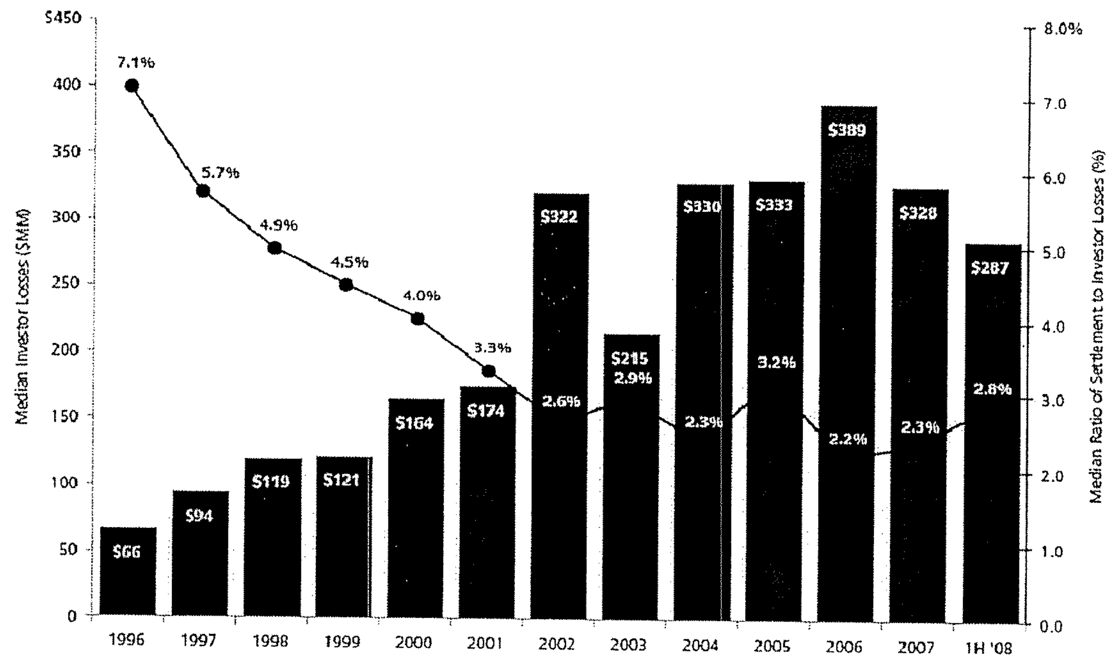
Nera Median Losses to Settlement Ratio

Figure 23. **Median Investor Losses and Median Ratio of Settlement to Investor Losses**
January 1, 1996 - June 30, 2008



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Other Factors Influencing Settlement Size

- Settlements rise dramatically with the inclusion in a settlement of securities other than common stock (bonds or options, for example).
- Increase with the potential depth of defendants' pockets. For each 1.0% increase in the defendant company's market capitalization on the day after the end of the class period, the settlement is expected to increase by 0.2%.
- If the defendant firm has declared bankruptcy or has a stock price of less than $1.00 per share at the time of settlement, the settlement is expected to be approximately 20% lower
- Professional firms as codefendants lead to larger settlements. Cases with an accounting firm as a co-defendant are associated with settlements that are more than two times larger than otherwise

Top 10 Shareholder Class Action Settlements

- 1 Enron Corp. ---2008 $7,242,000,000
- 2 WorldCom, Inc. ---2005 $6,158
- 3 Cendant Corp. ---2000 $3,561
- 4 Tyco International, Ltd. ---2007 $3,200
- 5 AOL Time Warner Inc. ---2006 $2,650
- 6 Nortel Networks (I) ---2006 $1,143
- 7 Royal Ahold, NV ---2006 $1,100
- 8 Nortel Networks (II) ---2006 $1,074
- 9 McKesson HBOC Inc. ---2008 $1,033
- 10 UnitedHealth Group ---2008 $895

Big Frauds Attract Opt Outs

- WorldCom
- AOL/Time Warner
- Quest
- Tyco
- Vivendi

WorldCom Opt-Out Results

- Class action settled for $6 billion
- One firms opt-out clients settled for $651 million
- Some firms claim to have had a 70+% recovery in WorldCom:
  - The WorldCom class settlement was much more favorable, with recoveries between 35 to 50% of some losses.
  - Because WorldCom involved bonds which lost most of their value over a short period of time, there was little loss causation risk.
  - Because the WorldCom bonds were only issued through registration statements, there was no issue of tracing.
  - WorldCom admitted that the financial statements in the registration statement were false.

WorldCom

Claimant	Settlement Amount
CalPERS, CalSTRS, LACERS	$257.4 million
Alaska Permanent Fund Corporation	$14
Five NYC Pension Funds	$78.9 million
TOTAL	$350.3 million

AOL/Time Warner

- Class action settled for $2.65 billion
- Over 100 institutions opted-out
- Total losses estimated between $200-$300 million
- Opt-Outs claimed recoveries of 14-35% compared to 1.37% for the class
- CalSTERS claimed a 6.5 multiple, Alaska 50, California Regents 16-24, Ohio 16

AOL/Time Warner(2)

Claimant	Settlement Amount
University of California	$246 million
Ohio State Pension Funds	$144 million
CalPERS	$117.5 milion
CalSTRS	$105 million
State of Alaska	$50 million
UK Pension Funds	$45 million
Los Angeles Pension Funds	$22.3 million
Stichting Pensioenfunds	$20 million
Amalgamaged Bank	$14 million
TOTAL	$763.8 million

Qwest

- Class action settled for $400 million.
- Total amount of claims opting out was $1.9 billion of class action.
- Opt-outs settled for a total of $411 million, or approximately 20%.
- CalSTERS claimed a multiple of 30

Qwest (2)

Claimant	Settlement Amount
CalSTRS	$46.5 million
Colorado PERA	$15.5 million
Alaska Permanent Fund Corp (AFPC)	$19 million
Teacher Retirement System of Texas	$61.6 million
TOTAL	$142.6 million

Qwest (3)

- Qwest also entered settlements in undisclosed amounts with the New York City Employees' Retirement System; Stichting Pensioenfunds; and the Teachers' Retirement System of Louisiana.

Quest (4)

- Colorado PERA said that its recovery in the class settlement would only have been $400,000, or less than one cent on the dollar of the fund's investment losses, meaning the fund increased its recovery more than 38 times by pursuing a separate action.

- AFPC said that the state's combined recovery in the class settlement would only have been $422,000, on combined investment losses of approximately $89 million. While the state recovered only a quarter of its investment losses through its separate action, it recovered 45 times what it would have recovered in the class settlement.

Tyco Opt-Outs

- Class action settled for $3.2 billion
- 288 persons or entities opted-out. Most are mutual funds and only a couple public pensions opted out and filed separate actions: Teacher Retirement System of Texas, Michigan
- New Jersey State Pension Funds $73.24 million (partial)

Vivendi

- Scores of foreign institutions filed individual or group actions when the court certified the class in a manner that excluded them.

Why Are Recoveries Greater For Opt-Outs?

- The Securities Act of 1933 (unlike the Securities Exchange Act of 1934) confers concurrent jurisdiction on state courts
- Contains an anti-removal provision that prevents the defendant from returning the case to federal court.

Why Are Recoveries Greater For Opt-Outs?(2)

- State court, plaintiffs escape the Private Securities Litigation Reform Act ("PSLRA"),
  - No stay on discovery,
  - No heightened pleading standards, and

Why Are Recoveries Greater For Opt-Outs?(3)

- Class certification standards have been significantly tightened in federal court
- Proving reliance does not rely on the "fraud on the market" doctrine where must prove the market not to be efficient in particular stocks

Why Are Recoveries Greater For Opt-Outs?(4)

- A More Favorable Forum---Home Town
- No Insolvency Constraints---Size of claim will not bankrupt the company.

Why Are Recoveries Greater For Opt-Outs?(5)

- Agency Costs. Selects its own counsel and can monitor it closely, demanding at least as good a settlement as the other opt outs receive. If unsatisfied, it can go to trial. An absentee class member has no similar choice.
- Economic Leverage and Voting Power. Institutional investors typically hold significant voting power.

Does ERISA Obligate Opting-Out?

- ERISA's "exclusive benefit" standard requires the fiduciary of an "employee benefit plan" to "discharge his duties with respect to a plan solely in the interests of the participants and beneficiaries and for the exclusive purpose of: (1) providing benefits to participants and their beneficiaries; and (2) defraying reasonable expenses of administering the plan." See Section 404(a) of the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1104(a).

- A fiduciary does not breach its duty to the pension fund by failing to enforce a claim if the fiduciary reasonably believed that to do so would be futile. See, e.g., McMahon v. McDowell, 794 F.3d 100, 110 (3d Cir. 1986).

Does ERISA Obligate Opting-Out? (2)

- Public pension funds are not subject to ERISA, which expressly excludes them. See 29 U.S.C. § 1003(b) (excluding "governmental plans" from ERISA's coverage).
- But In 1997, the National Conference of Commissioners on Uniform State Laws adopted the Uniform Management of Public Employee Retirement Systems Act (the "Act"), which is in the process of being widely adopted. The Act's provisions were modeled after ERISA, and it contains its own "exclusive benefit" rule.

Does ERISA Obligate Opting-Out? (3)

- Public pension fund fiduciaries are still subject to the common law standards for fiduciaries, and these standards are probably not significantly different. At a minimum, they require that the trustee "use reasonable care and skill to preserve the trust property." See Restatement (Third) of the Law of Trusts. Section 227

Benefits

- Substantially increased recoveries
- Corporate governance voice
- Valuable publicity giving suit credibility
- May be necessary for class certification reasons
- Not left behind other institutions
- Fulfills fiduciary duty

Threats

- Increases over-all litigation costs on both sides
- Class litigants will try to deter opt-outs by :
  - Increasing settlements
  - Trigger standard "blow-up" provisions where a class settlement is set aside when when opt-outs reach a certain percentage

Will the Multiples Continue--Game Theory

- Prisoners Dilemma
- Reiterated Prisoners Dilemma
- Blow Provisions
- Most Favored Nations Clauses

Steps

- Put procedure in place to govern future opt-out decisions
- Monitor class definitions and treatment of subclasses
- Monitor all purchases of new securities that drop a set threshold or dollar amount
- Hire personnel to monitor and recommend
- Have approved counsel ready to go

Reed R. Kathrein
Partner
Direct 510.725.3030
Cell 415.683.8566
reed@hbsslaw.com

HAGENS BERMAN
SOBOL SHAPIRO LLP

ATTORNEYS AT LAW

510.725.3000 F 510.725.3001
715 HEARST AVENUE • SUITE 202 • BERKELEY, CA 94710
www.hbsslaw.com

OPT-OUTS, MFNS AND GAME THEORY: CAN THE HIGH MULTIPLES ACHIEVED BY OPT-OUTS IN RECENT MEGA-FRAUD SETTLEMENTS CONTINUE

A DISCUSSION DRAFT

By Reed R. Kathrein

I. INTRODUCTION

Securities fraud class actions have seen a new phenomena during the past couple of years—opt-outs by large institutional investors to pursue individual lawsuits.

In the past, opt-outs were confined to investors who protested securities fraud actions or those related or sympathetic to defendants. Large investors stood on the sidelines and cashed in on the settlements as free riders who benefited from the efforts of the small investor and its attorneys. Several factors have changed the game. The passage of the Private Securities Litigation Reform Act of 1995 put the investor with the largest losses and its counsel in charge of a securities fraud class action. Other class action attorneys who had clients with large losses, but not the largest loss, found themselves cut out of the action. At the same time, after years of courting large institutional investors and educating them, the institutions are now in a position where they have relationships with eager plaintiffs' securities counsel ready and willing to give advice. Finally, with the

Public Retirement System, ("CalPERS"), California State Teachers' Retirement System ("CalSTERS"), and the Los Angeles County Employee Retirement Association ("LACERA") announced a combined settlement of $257.4 million. The settlement appears to be part of a larger settlement of $652 million by a group of state and local retirement funds and insurance companies, which its attorneys claimed was 83% higher than the class action settlement. For some of the funds involved, this opt-out settlement represents more than 70 percent of their losses. Five New York pension funds announced a combined settlement with a multiple of 3 times over the class action. Moreover, the funds claimed that this settlement represented over 60% of their losses.

In 2007, in *AOL Time Warner*, CalSTERS claimed a 6.5 multiple on a settlement of $105 million out of damages of $135 million. The State of Alaska claimed a multiple of 50. The University of California claimed a multiple range of 16-24 on a settlement of $246 million out of a loss of $550

Ronald I. Miller, Dr. Stephanie Plancich, NERA Economic Consulting Group, *Recent Trends in Shareholder Class Action Litigation: Filings Plummet, Settlements Soar,* Jan. 2, 2007 at 7-9, *available at* http://www.nera.com/publication..asp?pID+3028.

Institutional investors, who have filed these actions or who are considering filing in the future, must ponder whether the large multiples over the class recoveries by opt-outs will continue in future cases. If so, their fiduciary duty or business judgment would dictate that they hold out for the prospect of filing separately as an opt-out, at least for as long as the statute of limitations, or any tolling period the statute allows. *See In re WorldCom Sec. Litig.*, No. 05-6979-cv, slip op. (2nd Cir. Jul. 29, 2007 Similarly, counsel would necessarily advise large institutional investors to opt-out of class action settlements, as long as their damages or those of other joining institutions are large enough to provide counsel with sufficient incentive to take the case through trial and maybe good portion of their practice to representing large, typically institutional, opt-out clients, thereafter negotiate a huge settlement with the defendants (and their D&O insurer?), and then collect whatever amount they have pre-negotiated with the client(s). Equally inviting to prospective opt-out counsel, they oftentimes would be relieved from having to devote the time, resources and money typically necessary to prosecute a securities fraud claim, as all of the work, including paper discovery and depositions, already will have been completed by the class action counsel in the context of the class action litigation. In other words, work much less and recover much more. Now that's capitalism!

In short, a new opt-out regime may be upon us, and companies and their D&O insurers alike, as well as class counsel and their class members, should be sensitive to the possibility that the number of litigated opt-out cases could escalate and cause heretofor non-existence problems for all of them, absent a reasonable and realistic solution. It may be that nothing can be done, short of legislated changes to Rule 23 of the Federal Rules of Civil Procedure governing class actions, and complimentary judicial activism. But people need to begin talking about the problem now, before the whole team of horses has left the barn.

Richard Bortnick in Kevin M. LaCroix, D &O Diary , *Class Action Opt-Outs: The New Frontier*, Feb. 21, 2007., As a final caveat to the discussion below, an opt-out is not really an opt-out, for purposes of this discussion, if the investor has significantly different claims from those of the class. For example, in AOL Time Warner, the University of California stated that "[o]pting out of the federal class action allowed the University to assert unique claims that were unavailable to the class."

II. GAME THEORY AND SECURITIES FRAUD SETTLEMENTS

Game theory is the use of mathematical models to predict the behavior of the participants in a bargaining or conflict situation -- the game. Examples include war, peace negotiations, where to go on a date, selling or buying goods, and a duel. Common features of these games are conflicting parties, each player has choices, information and desired results or preferences, each player's choice will result in an outcome dependent on the actions of all other participants. No player can force an outcome. *See* Brian Martin, *The Selective Usefulness of Game Theory* Social Studies of through the end of trial. One well known game that closely resembles the behavioral choices of securities fraud class action settlements, where a defendant is negotiating simultaneously with class counsel and "opt-out" counsel is known as the Prisoners' Dilemma.

Professor John Coffee, Jr. applied the Prisoners' Dilemma model to securities fraud settlement negotiations several years ago in *Class Wars: The Dilemma of the Mass Tort Class Action*, 95 Colum. L. Rev. 1343, 1367 (1995). In that article he described the game as follows:

> In the standard example, two individuals, who are factually guilty of a felony, are interrogated by a prosecutor who seeks a confession from each. If neither confesses, the prosecutor will be unable to obtain more than a misdemeanor confession that would result in a one-year sentence for each. If only one confesses, the prosecutor will reward that individual with a plea bargain resulting in a six-month sentence, but the other defendant will receive a ten-year sentence. If both confess, they will each be convicted of a felony and receive five years each. See R. Duncan Luce & Howard Raiffa, Games and Decisions: Introduction and Critical Survey 9497 (1957). Under this structure, it is logical for both prisoners to

> The outcome of each choice depends on the choice of the accomplice, but each prisoner must choose without knowing what his accomplice has chosen to do.
>
> In deciding what to do in strategic situations, it is normally important to predict what others will do. This is not the case here. If you knew the other prisoner would stay silent, your best move is to betray as you then walk free instead of receiving the minor sentence. If you knew the other prisoner would betray, your best move is still to betray, as you receive a lesser sentence than by silence. Betraying is a dominant strategy. The other prisoner reasons similarly, and therefore also chooses to betray. Yet by both defecting they get a lower payoff than they would get by staying silent. So rational, self-interested play results in each prisoner being worse off than if they had stayed silent. In more technical language, this demonstrates very elegantly that in a non-zero sum game a Nash Equilibrium need not be a Pareto optimum.

Prisoner's dilemma, (Jul. 9, 2007). Wikipedia, The Free Encyclopedia., *available at*: http://en.wikipedia.org/wiki/ Prisoners_dilemma (last visited Jul. 11, 2007).

Professor Coffee found the Prisoners' dilemma useful in explaining the outcome of settlements where counsel for a copy-cat class action plaintiff, which could not be consolidated with the original federal plaintiff, would seek to by their corporation to a plaintiffs' attorney who has not performed any valuable service." Coffee, Jr., *supra* at 1367.

One "old" form of collusion... involves what this Article will call a "reverse auction," namely a jurisdictional competition among different teams of plaintiffs' attorneys in different actions that involve the same underlying allegations. The first team to settle with the defendants in effect precludes the others (who may have originated the action and litigated it with sufficient skill and zeal that the defendants were eager to settle with someone else). A recent recurring scenario involves an inactively litigated action in state court being brought and settled so as to preclude a decision in a more aggressively litigated federal action....

...Assume a meritorious class action raising federal claims (for example, securities fraud) is brought in federal court and plaintiffs decline to settle it on terms that are attractive to the defendants. At this point, a parallel or "shadow" action parroting some of the factual allegations in the federal action may be filed in a state court. Because federal courts have exclusive jurisdiction over the Securities Exchange Act of 1934, a state court cannot adjudicate the federal law issues. Although claim preclusion of the federal claims is thus not possible, issue preclusion poses a grayer question. In principle, issue preclusion applies only to those issues that could have been litigated in the action, but an adverse judgment in the state court on claims

> In overview, the critical factor essential to collusion is competition among teams of plaintiffs' attorneys that the defendants can exploit. Here, it happens because the parallel action in state court cannot be consolidated by the JPML with the federal action or actions. Once rival plaintiff teams are in competition with each other, and each is able to agree to a binding settlement of a nationwide class action, the "reverse auction" can begin. No explicit agreement among the participants is needed; all that is necessary is that each team of plaintiffs' attorneys sees that it can be divested of any participation in the action unless it reaches a settlement with the defendants first.

Id., at 1370-1373.

Professor Coffee's example works because the competing groups of securities class actions have the potential of wiping out all or part of the other's case. In the opt-out situation that is not necessarily true.

Since the passage of the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), most state securities fraud class actions are blocked or removable to federal court where they can be consolidated with the federal action. SLUSA exempts from its preemption coverage certain

In fact, a near perfect example of this appears to be occurring at the time of this writing. According to reports and public announcements by the parties involved, settlement discussions were proceeding in what was described by plaintiffs attorneys as a huge securities fraud action against Royal Dutch Shell ("Shell") by the federally appointed lead plaintiff. Shell had already paid $120 million in fines to the SEC for "overstating reserves" and later revealed it was prepared to offer up to $500 million to settle the class action. The plaintiffs claimed the case was worth $13 billion. Thus, $500 million would be less than 5% of damages.

Settlement talks stalled. At the same time, the federal court was concerned about the adequacy of representation for non-U.S. investors who purchased Shell's stock on foreign exchanges. With trouble of representation of a large portion of the federal class action, Defendants saw an opportunity: Using a variant of the Prisoners dilemma identified by Professor Coffee to reverse auction the federal class, defendants "colluded" with eager counsel of foreign plaintiff by finding parties, whose attorneys were otherwise cut out of earning a fee since their clients had not been appointed lead plaintiff, who were willing to take the settlement offer rejected by the lead plaintiff.

Considering the amount of damages claimed by the U.S. lead plaintiff, the settlement appears to have resulted in an amount which is less than Pareto optimal, as would be predicted by the Prisoner's dilemma. It is no more than what Shell either offered or was prepared to offer the U.S. lead plaintiff. But, the attorneys who were otherwise cut out of the deal were able to steal more than half the class and the fee that goes with those claims.

Even worse, in a play taken from antitrust class actions, Shell agreed to a MFN clause with the non-U.S. investors, which guarantees should a settlement in the U.S. class action result in a larger distribution at a later date, Shell will pay the European investors the upside difference from any amounts paid to the U.S. Class Action. Thus, the U.S. lead plaintiff has to assume all the risk of continuing outs as a way to pressure the class action plaintiffs into settling early and cheap. If so, the opt-outs who held out benefited greatly by the early settlement and were able to negotiate high multiples.

Another variant of the Prisoner's dilemma helps us predict, however, that these multiples will not continue.

The Prisoner's dilemma game assumes that the players that play the game are not repeat players. In securities fraud class actions that is not necessarily true, especially in the mega-cases. There is a relatively small universe of plaintiffs' class action counsel and defense counsel. They communicate with each other and, as witnessed by this PLI program, share knowledge of the strategies. Similarly, there are a limited number of large institutional investors, and they too share knowledge of strategies through organizations such as the National Association of Public Pension Attorneys. Where the players of the game know they will play it more than once in succession, and know they will remember the

Free Encyclopedia, available at: http://en.wikipedia.org/wiki/Repeated_game. There are numerous rational strategies, known as trigger strategies, for non-cooperative repeated games. *Id.* A player utilizing a trigger strategy initially cooperates but punishes the opponent if a certain level of defection (i.e., the trigger) is observed. The level of punishment and the sensitivity of the trigger vary with different trigger strategies. Trigger strategies include Tit for Tat (the punishment continues as long as the other player defects), Tit for two Tats (a more forgiving variant of Tit for Tat), and Grim Trigger (the punishment continues indefinitely after the other player defects just once). *Trigger strategy*, Mar. 25, 2007), *available at* http://en.wikipedia.org/wiki/Trigger_strategy, last visited July 12, 2007

Robert Aumann, who was awarded the 2005 Nobel Memorial Prize in Economics for "having enhanced our understanding of conflict and cooperation through game-theory analysis," showed in his 1959 paper, rational players repeatedly interacting for indefinitely long games can sustain and make threats, rather than constantly inflict harm on each other.

If the iterated form of the Prisoner's dilemma is applicable to the competing interests of the known body of institutional investors who are likely to be repeat players in securities fraud class actions, then in the future we are likely to see the plaintiffs cooperate to obtain the greatest results overall, and decrease the disparity in settlement multiples to damages. Once embarrassed by higher multiples achieved by opt-outs, neither class counsel nor the lead plaintiff is likely to want to be embarrassed again. How is this likely to play out?

In the past, before the opt-out craze, defense counsel protected their clients by insisting on a blow provision in the settlement agreement. Having been burned by the recent spate of opt-outs, we are likely to see defendants begin to insist on more stringent blow provisions, and perhaps even giving early opt-outs the opportunity to opt in and save what stock elects to opt-out and go it alone in private litigation (or in combination with a sufficient number of other shareholders so as to constitute a "mass action," but not a "class action"). What are a company and its D&O insurer to do? How about a non-settling accounting or law firm? At present, there is no simple solution, no "magic bullet" to avoid additional, and potentially severe, exposure both for defense and indemnity.

Moreover, such a situation could have implications on the proposed class action settlement, as the company and its D&O insurer (as well as, where applicable, settling accountants, attorneys, etc.) may invoke the settlement agreement's "blow provision," and elect simply to "roll the dice" and try the class action, although that may be the least attractive option to someone who likes certainty and hates surprises. Of course, a decision to blow up a settlement could have wide-ranging business (and marketing) implications, particularly for a D&O insurer which develops a reputation of being a company which blows up settlements and leaves its insureds exposed to personal liability by way of a jury trial or otherwise. And, in any event, from where will the money to defend and ultimately settle the opt-out case come? The company? The D&O insurer which had not exhausted its policy's limit as part of the class action settlement? The company's outside accountants, attorneys, and whoever else had a hand in the transaction that gave rise to the lawsuit? Or, perhaps, the D&O's themselves. In the few

IV. THE IMPACT OF THE MOST-FAVORED-NATION CLAUSE IN MEGA-FRAUD SETTLEMENTS

"Most-Favored-Nation" clauses are used in a variety of bargaining contexts to provide an early bargainer with comfort that others that follow will not get a better deal. Rather than hold out negotiations, an MFN can promote an early deal. In the settlement context, MFNs have been used to in copyright infringement, bankruptcy, antitrust and employment cases. *See In re Domestic Air Transportation Antitrust Litigation*, 148 F.R.D. 297, 310 (1993); *In re Corrugated Container Antitrust Litigation*, 756 F.2d 411 (5th.Cir.1985)137; *A Cintech Indus. Coatings*, 85 F.3d 1198, 1999 (6th Cir 1996); *In re Chicken Antitrust*, 560 F. Supp. 943, 946, (N.D. Ga. 1979); and *In re Vitamins Antitrust Class Actions,*, 342 U.S.App. D.C. 26, 28 (2000). Also see the settlements in the *Coke* race discrimination, the *MP3.com* copyright case and the settlements by Mississippi, Florida and Texas in the tobacco cases reported by Spier, *infra*. To date, other than the *Royal Dutch Shell* case discussed above, *Litigation*, This Document Relates to: All Actions, 1999-2 Trade Cas. [CCH] 72,726). *The Manual for Complex Litigation*, a reference manual for judges, gives a balanced view: "[MFN] clauses can provide an incentive for early settlement as well as an obstacle to later settlement (*Manual for Complex Litigation* 1995, sec. 23.23, p. 182).

The purpose of this paper is to understand why a defendant who faces multiple plaintiffs (or a plaintiff who faces multiple defendants) would adopt an MFN clause and whether this serves the broader public interest. The private motives for MFN clauses in settlement contracts fall into two broad categories: (1) MFN clauses mitigate problems of asymmetric information, and (2) **MFN clauses can be used as a tool for extracting value from future plaintiffs**. These private motives are not perfectly aligned with the interests of society.

First, I will argue that MFN clauses economize on delay costs when plaintiffs have "private information" about what they are willing to settle for. Plaintiffs who have weak cases will engage in posturing, trying to convince the defendant that they are strong. We will see that **MFN clauses lead cases that would have settled on the courthouse steps to settle early instead** (Spier 2003). While early settlement is socially desirable, there can be undesirable side-effects of MFN clauses. In particular, the defendant may choose a more aggressive settlement strategy in which more cases go to trial than before.

> early plaintiff receives an additional payment. The less obvious route is that the early plaintiff's incentives for information revelation can be enhanced by the potential for a future payment, so that the defendant can resort to trial on a less-frequent basis. Using a signaling model, **we find that the repeat player (the defendant) is indifferent about the MFN, while the later plaintiff is always worse off when an MFN constrains her settlement bargaining with the defendant**. Although MFNs can never provide a Pareto improvement in this model, we demonstrate that plausible circumstances exist under which total surplus is increased by an MFN.

Andrew F. Daughety & Jennifer F. Reinganum, *Exploiting Future Settlements: A Signaling Model of Most-Favored-Nation Clauses in Settlement Bargaining*, Depart. of Econ. and Law School, Vanderbilt Univ., Working Paper No. 221, Oct. 2002. The authors then conclude that the use of MFN's have important considerations for judges in that they do not promote equitable solutions:

> What guidance can these models provide for a judge who must decide whether to permit and/or enforce an MFN? If a judge's primary concern is with reducing expected trial costs, then both of these models suggest that MFNs are likely (though not

the "Tit for Tat" trigger strategy use to punish prior defectors used successfully in the iterated Prisoners' dilemma. While a lead plaintiff player using the MFN knows that it will result in a lead to a less than Pareto optimal settlement, it protects the lead plaintiff this time around form embarrassment, and acts as punishment to the opt-out institution to deter opting-out or the lack of cooperation next time around. All assumptions being equal, including the relative bargaining power, this tool should lead to smaller multiples achieved by future opt-outs.

V. CONCLUSION

This discussion draft attempts to predict whether an institutional investor would be well advised to opt out of securities fraud class actions, in the future, because of the high multiple earned by opt-outs in the short, but recent experience of the last few years. While the unique circumstances of most cases were not considered, game theory, and, especially those games involving repeat players such as the iterated-Prisoners' dilemma, would appear to able to jump into the game, such as in those few situations where securities fraud class cases cannot be consolidated and parallel suits compete, or where the repeat players (institutional investors) remain on the sidelines in the lead plaintiff battle, Pareto optimal results will not follow. In such circumstances, the use of the MFN by the non-repeat player is not punishing defectors. It is simply a defection optimizing the recovery of the early settler at the expense of the latter settling player. When used by a weak, first time or non-repeat class plaintiff in competing class actions, courts might scrutinize the class action settlement. The refusal to approve the use of an MFN in such circumstances may be in the interests of justice to allow opt-outs (or the competing class) to seek higher returns unhindered by suspect bargaining and "tied to the mast" pressure at the expense of Pareto optimality.

If institutional investors remain involved in securities fraud class actions, the above models predict that they will recognize each other as repeat player, that MFNs will be

ADDENDA 8

Public Pension Fund Class Action Evaluation Threshold Levels

Reinhart Boerner Van Deuren s.c.

October 2008

Most public pension funds that have securities litigation policies include a dollar loss threshold which triggers evaluation of how to best manage loss recovery efforts when the fund has a substantial interest in a case. Threshold amounts vary substantially from one fund to another and reflect a balancing of the expected costs and benefits associated with case evaluations.[1] Factors that influence the loss level at which a fund is willing to devote resources to reviewing a case can include:

- The amount of additional recovery that it views as significant enough in the context of the fund's total assets to merit potential devotion of several hundred staff hours to case management time as an active litigant;[2]
- Staffing levels and competing responsibilities that would be affected by time doing case evaluations and follow-on activities;
- In-house expertise in case evaluations and any related costs associated with external resources used for conducting reviews;
- The fund's experience and success in improving recoveries as an active litigant;
- Appropriateness of applicable counsel procurement and contracting procedures to contingency fee litigation;
- Risks that the fund's ability to effectively serve as a fiduciary in selecting counsel, negotiating fees and overseeing the case would be compromised by other factors.

A limited survey by Reinhart of public pension fund securities litigation policies that are available on the internet found significant variation in threshold levels between funds.

Pennsylvania School Employees ($69 billion)	$25 million
State of Wisconsin Investment Board ($92 billion)	$20 million
Michigan State Retirement System ($68 billion)	$10 million
Ohio State Teachers Retirement System ($78 billion)	$10 million
Marin County California ERS ($1.5 billion)	$10 million
California State Teachers Retirement System ($176 billion)	$5 million
California Public Employees Retirement System ($255 billion)	$2 million
Los Angeles County ERA ($42 billion)	$2 million
Iowa State Employees Retirement System ($24 billion)	$1.25 million
State of Illinois Universities Retirement System ($17 billion)	$1 million

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[1] Thresholds do not necessarily represent the level at which a fund would seek to become a lead plaintiff or fill a separate case. They only trigger a closer evaluation of how the fund's claim should be managed.

[2] Note that this is not the fund's threshold amount. Instead, it is the portion (usually 10 – 20%) of the loss threshold amount which represents an estimate of how much the fund's recovery could be increased by taking an active role in the case. Funds vary in regard to how conservative or aggressive they are in estimating the effect they could have on improving case recoveries. Case recoveries have generally averaged less than ten percent of losses.

ADDENDA 9

KEA

KENTUCKY EDUCATION ASSOCIATION

TO: Jack Conway, Attorney General, as Chair of the Securities Litigation Subcommittee
Members of the Securities Litigation Subcommittee

FROM: Mary Ruble, Attorney, Kentucky Education Association ("KEA")
Elise Mohon, KEA
Martha Moore, KEA

RE: Recommendations for Securities Litigation policy changes at KRS and KTRS

DATE: October 22, 2008

Dear Chairman Conway and Members of the Subcommittee:

As we all know, the charge of this Subcommittee was to review the Securities Litigation policies of KTRS and KRS and make recommendations for change, if any. After reviewing the current policies of the respective retirement systems and reflecting on the various testimony proffered to us, the Kentucky Education Association does believe that "best practices" in securities litigation require some changes be made. However, we hasten to add that those changes <u>do not</u> require legislative action; rather, they can be accomplished through amendment and adoption of more specific internal policies by the Board of Trustees of each fund. Generally, the methods currently used by KRS and KTRS to monitor securities litigation and to identify claims seem to be working well. In most cases, passive participation as a class member is wholly appropriate and cost efficient. There has not been any evidence offered to suggest that any claims have been missed or that either of the pension funds has left any significant money "on the table" as a result of their management of these claims. Therefore, in consideration of the charge of this Subcommittee, and in light of best practices, KEA makes the following proposals for consideration by KTRS and KRS in drafting revisions to their respective internal policies:

1) Establish a specific dollar amount of loss that will trigger consideration of lead plaintiff status. For instance, when losses in a securities fraud case exceed $20 million, policy could require General Counsel to consider moving for lead plaintiff status.

2) Establish an independent "evaluation counsel panel" consisting of three (3) or more outside law firms with expertise in analysis of securities claims who have been approved by the Board for each fund. Firms should be screened to insure no conflicts of interest. Cases that meet the threshold amount for consideration of lead plaintiff status must be referred to a member of the evaluation counsel panel for review.

3) Upon completion of outside review, evaluation counsel shall make a recommendation to the General Counsel and the Investment Committee or its equivalent. The Investment Committee shall determine a course of action and shall report its decision to the Board. The Board shall make the final decision regarding active participation by the fund as lead plaintiff in any case.

Legal Services
401 Capital Avenue
Frankfort, KY 40601
1 502/875-2889 or 1 800/231-4532
Fax:1 502/227-7985
Internet: www.kea.org

4) None of the firms that act as evaluation counsel shall be eligible to represent the fund in any subsequent litigation that may be pursued.

5) When losses in a securities fraud case do not meet the threshold amount to require consideration of lead plaintiff status, General Counsel of each fund may consider the following alternatives to passive participation as may be appropriate: A) participation as co-lead plaintiff; B) opting out and filing a separate claim; C) actively monitoring the progress of litigation by formally entering an appearance in the action, or; D) any other appropriate method of heightened participation. Cases in this category may be referred to evaluation counsel for analysis.

6) Establish a dollar amount of loss for which passive participation as a class member is always appropriate, except in extraordinary circumstances. For instance, policy could state that passive participation is always appropriate for losses less than $5 million.

7) Each Board shall establish a pre-approved panel of securities litigation counsel consisting of at least three (3) firms experienced in federal securities litigation. KTRS and KRS shall insure that none of the selected firms have any conflicts of interest. Participation of each firm on the panel shall be approved by the Board.

8) In order to guard against "pay for play" conflicts, members of the evaluation counsel panels and the litigation counsel panels shall not have contributed, directly or indirectly, to the political campaigns of any candidate for statewide constitutional office or to any legislative candidate in Kentucky for at least three (3) years prior to inclusion on the panel. Individual attorneys and firms on the panel shall agree not to make such contributions as a condition of their active participation on the panel(s).

Respectfully submitted,

Mary W. Ruble

Mary W. Ruble, Attorney
Kentucky Education Association

Elise Mohon

Elise Mohon, Member
Kentucky Education Association

Martha Moore

Martha Moore, Retired
Kentucky Education Association

ADDENDA 10

ADDITIONAL COMMENTS OF THE ATTORNEY GENERAL AND GENERAL COUNSEL TO THE GOVERNOR

In addition to those points agreed upon by the subcommittee the Attorney General and General Counsel to the Governor submit that the office of the Attorney General should take a more formal role in certain aspects of the litigation process. While the enabling statutes for both KRS and KTRS permit the Office of the Attorney General to be an advisor and representative of the systems this has been significantly underutilized to date.

It is the position of the Attorney General and General Counsel to the Governor that the Attorney General should take an active role in the selection of litigation counsel for both systems. The Office of the Attorney General brings with it expertise in the selection of qualified outside counsel and working with outside counsel in complex litigation. This relationship would in no way compromise the attorney client privilege or other confidentiality protections otherwise available under the law. The Attorney General also believes that his office should take an active role in the evaluation of cases presented to the retirement systems' boards where the minimum threshold is met or in cases where the boards or their evaluation counsel deem it necessary to evaluate a matter for active litigation when the threshold is not met. Finally, it is the position of the Attorney General that other experts throughout state government could provide valuable information to the retirement systems in the evaluation process and the retirement systems should seek out this assistance where doing so would not endanger the confidentiality of information used in the decision making process.

ADDENDA 11

KENTUCKY RETIREMENT SYSTEMS
Perimeter Park West
1260 Louisville Road
Frankfort, Kentucky 40601

Kentucky Employees Retirement System
County Employees Retirement System
State Police Retirement System

Robert M. Burnside
Executive Director
Phone 502-696-8800
Fax 502-696-8822
www.kyret.com

October 31, 2008

Jack Conway
Kentucky Attorney General
The Capitol, Suite 118
700 Capitol Avenue
Frankfort, KY 40601-3449

RE: Comments on the Report of the Subcommittee on Securities Litigation

Dear General Conway:

Please include this letter as an addenda to the report of the Subcommittee on Securities Litigation. Kentucky Retirement Systems has implemented or is in the process of implementing the following best practices in regard to securities litigation:

1) <u>Compliance with Fiduciary Duty</u>

Pension funds recognize that they have a fiduciary duty to take reasonable steps to enforce legal claims associated with trust fund assets. (See Restatement of Trusts, 2d, § 177.) In order to determine what constitutes "reasonable steps" in regard to securities fraud claims, most public pension funds have adopted policies that identify the costs and benefits associated with pursuit of securities litigation and establish a process for analyzing cases in which they have a claim.

2) <u>Claim Filing and Monitoring</u>

In Addenda 4 to the report, *Everything You Always Wanted to Know about Securities Litigation but Were Afraid to Ask*, by the Council of Institutional Investors (CII), CII notes that "pension fund fiduciaries are required to monitor securities litigation and pursue recovery when securities actions are settled or judgments are awarded." It notes that custodians are well-placed to be able to identify cases where funds are eligible to submit proofs of claim to participate in case recoveries. Funds generally use third party service providers, securities counsel or (for larger funds) internal staff to monitor when new cases are filed, determine whether the fund is a member of the putative class and estimate the funds losses.

3) Threshold for Considering Active Participation in Specific Cases

In Addenda 4, CII reports that most funds typically require that the estimated recovery exceed a specified dollar threshold for the fund to evaluation whether it should play an active role in the litigation. The threshold usually reflects a cost-benefit analysis based on consideration of the fund's size, available resources for managing litigation, potential conflicts of interest and an evaluation of the benefits from active participation. KRS' independent review counsel has surveyed public funds and determined that, while thresholds vary considerably from one fund to another, most fall within the $5 million to $20 million range.

4) Evaluation of Cases for Active Participation

In Addenda 4, CII lays out criteria developed by NAPPA that are generally used by public funds in evaluating cases that meet their threshold. They include things like strength of the suit's legal grounds, amount of legally recoverable damages, sources of recovery, potential conflicts with other class members and whether active participation would be likely to add significant value to the outcome. A summary of the criteria is included in Addenda 4.

5) Case Evaluation Process

Public funds generally either use independent review counsel to evaluate cases, conduct the evaluations with internal legal staff, or rely on plaintiffs' bar law firms to advise on evaluation of cases which appear to meet their threshold. Some funds that use independent review counsel preclude that firm from serving as litigation counsel in order to avoid any incentive to skew advice toward the firm's own financial interests.

6) Active Case Participation Options

In Addenda 4, CII lists a number of options that were identified by NAPPA for active participation. They include filing to become lead plaintiff, passively monitoring a case, supporting another sophisticated lead plaintiff's candidate, filing a separate opt out case in state court or obtaining an agreement from lead plaintiff to permit the fund to participate in or actively monitor key parts of the case.

7) Decisions on Active Management and Selection of Lead/Litigation Counsel.

Other public funds use different processes for making the decision on whether to pursue an active strategy (e.g., file to become lead plaintiff or file a separate opt out case) depending on applicable laws and delegated authority. CII identifies the following as best practice:

- Describe the process in the fund's policy;
- Establish a written record to justify the basis for the decision;
- Include independent participants in the process to protect from political influence.

8) Negotiation of Fees.

The National Association of Public Pension Attorneys (NAPPA) identified arms-length negotiation of a contingency fee agreement as part of the counsel selection process as best practice. This maximizes the client's ability to negotiate the best fee and helps to avoid later misunderstandings or fee disputes. Because the most favorable fee levels and structures will vary from one case to another (depending upon size of the expected recovery, strength of the claims, reputation of defense counsel, etc.), best practice is to solicit proposals from several firms in order to "test the market price" when negotiating a fee agreement for each case.

9) Process Integrity

Best practice in regard to ensuring that the litigation counsel selection process at public funds meets ethical standards is evolving. Current best practices have been set by recent adoption of prohibitions in California and New Jersey on retention of law firms that have recently made substantial political contributions or provided gifts to public officials with authority over the pension fund. This is intended to protect integrity of the fund, avoid potential challenges during court approval of lead counsel and preclude related problems.

10) Review of Settlements

Best practices include several public funds that regularly review class action settlements for above market legal fees.

11) Reports and Audits.

Best practices identified by NAPPA include regular reporting of recoveries and status of active participation in litigation to the supervising fiduciary (and public, if not confidential or privileged). Periodic audits of the custodian or other claims filing agent are also recommended.

If you have any questions or concerns regarding the above comments, I am happy to speak with you. It has been an honor and a privilege to serve on this subcommittee.

Kentucky Retirement Systems appreciates the work done by the members of the Pension Working Group, its subcommittees, and the Governor.

Sincerely,

Eric Wampler /jaj

Eric Wampler
General Counsel

C: Members of the Subcommittee:
Mary Ruble
Tad Thomas
Beau Barnes
Ellen Hesen
Elise Mohon
Martha B. Moore

Kentucky Retirement Systems:
Mike Burnside
Adam Tosh
Jennifer A. Jones

ADDENDA 12

October 31, 2008

Attorney General Jack Conway
The Capitol, Suite 118
700 Capital Avenue
Frankfort, Kentucky 40601-3449

VIA HAND DELIVERY

RE: Addenda to the Report of the Subcommittee on Securities Litigation

Dear Attorney General Conway:

Please include this letter as an addendum to the Report of the Subcommittee on Securities Litigation. In addition to the remarks contained in the Report, the members of the Subcommittee representing KEA wish to make the following points:

1) As indicated in the Report, there was no evidence presented to the Subcommittee to indicate that the methods currently used by KRS and KTRS to monitor and respond to securities litigation were inappropriate in any way or have caused any undue losses to the members of either system. Since the practices in place are apparently working well, the KEA members of the Subcommittee believe there is no need to dramatically overhaul these structures. Clearly, the respective Boards and General Counsel are fulfilling their fiduciary duties to their members and we have every reason to believe that will continue to be the case. However, we do believe it is important that each system have written securities litigation policies reviewed and approved by their respective Boards, and we commend KRS and KTRS for the steps they have already taken toward that goal.

2) KRS 61.645(11) and KRS 161.370(1) currently grant the Attorney General the power to act as advisor to the respective Boards of the retirement systems. Traditionally, the AG's office has not fully exercised that option. The KEA members of the Subcommittee encourage the OAG to exercise the advisory authority granted to it by statute, as we believe doing so will enhance communication between the agencies and will provide the retirement systems greater access to the legal expertise available within the Office of the Attorney General. The respective Boards should certainly consult with the AG as they deem appropriate, and should consider the advice received during those consultations when exercising their final decisionmaking authority on any particular issue.

3) Notwithstanding our opinion in paragraph 3, we note that during our deliberations, Attorney General Conway stated that the OAG has not historically had, and does not currently have, a Securities Litigation section. It also does not have the resources to establish a section for this purpose. Therefore, although the AG can certainly offer assistance to the respective Boards by generally assessing the credentials, fee structures and litigation strategies of outside counsel that may be retained by the retirement systems, it is not in a position to offer legal advice with regard to the specific issues that arise in the highly specialized area of Securities Litigation.

4) There was no evidence offered to the Committee to suggest that there is any other expert anywhere in Kentucky state government that could provide valuable information to the retirement systems with regard to any aspect of securities litigation. If those experts are available, we encourage them to identify themselves to the retirement systems so they may be consulted by the respective Boards as may be appropriate.

5) Finally, and most importantly, the KEA members of the Subcommittee believe it is imperative that the respective Boards of the retirement systems retain final decisionmaking authority with regard to retaining outside counsel for any purpose. Although it may be appropriate for the Boards to seek advice during that process, ceding their authority to any third party would clearly be a violation of their fiduciary duties.

We appreciate the opportunity to serve on this Subcommittee.

Sincerely,

Mary W. Ruble, Attorney
Kentucky Education Association

Cc: Gov. Beshear, via hand delivery
Members of the Subcommittee, via e-mail
Rob Jones, via e-mail
Tad Thomas, via e-mail
Dana Mayton, via e-mail
Greg Haskamp, via e-mail