THE WHITE HOUSE

WASHINGTON

October 16, 1996

MEMORANDUM FOR JACK QUINN
BRUCE LINDSEY
KATHY WALLMAN

FROM: ELENA KAGAN EK

SUBJECT: DRAFT LETTER ON PREEMPTING STATE SECURITIES LAW

Attached is a draft letter to Senator Dodd on legislation to preempt state securities law. You'll recall that John Doerr and others involved in fighting Prop 211 urged us to make such a statement in lieu of pushing legislative language to go on the CR.

The fourth paragraph of the letter contains three bracketed sentences; these are meant to be alternatives, from which we should pick one:

- Sentence (1) is a slight simplification of the NEC's (or at least Ellen Seidman's) current position: preemption is appropriate when a company that must register under the 1934 Securities Act (i.e., a company with more than 500 shareholders and $10 million in assets) issues a security that is traded on a registered national securities exchange (or an automated quotation system of a registered securities association) and the suit relates to the purchase or sale of that security. An even broader formulation, also suggested by the NEC, would encompass securities that, though not traded on a national exchange, are subject to regulation (e.g., registration requirements) under the 1933 Securities Act -- that is, securities offered interstate to any and all investors in an amount exceeding $5 million.

- Sentence (2) is a slight simplification of the SEC's (or at least its counsel's and chief of staff's) current position. The SEC is very uncomfortable with the NEC's proposal -- or with any other proposal that would significantly revise the current balance between state and federal securities law. The SEC is looking for a way to go after what it sees as the worst aspect of Proposition 211, while leaving other state securities law in place.

  To be more specific: What seems most dangerous to the SEC about Prop 211 is that it effectively would replace federal securities law by allowing nationwide securities class actions to go forward in California courts under very pro-plaintiff California law. (Who would ever bring such an action in federal court again?) The SEC believes that the

way to prevent this from happening -- while at the same time retaining the current role of state securities law -- is to pass legislation preempting any state securities action that is not based on privity. (You'll recall from law school days that a suit is based on privity when the plaintiff has bought something from or sold something to the defendant.) According to the SEC, a privity requirement effectively would foreclose state courts from hosting nationwide class actions. And since more than 40 states now have privity requirements, a preemption proposal of this kind would leave intact most current state securities law.

Of course, this proposal would not satisfy Doerr and others in the Silicon Valley community. For one thing, it would leave much of Prop 211 still standing. More broadly, it would leave securities a law a joint federal-state system, rather than the almost exclusively federal realm that Doerr and others (including the President and Leon in some of their most recent public comments) seem to envision.

- Sentence (3) is the coward's -- or perhaps the wise man's -- way out. This sentence says nothing about the specifics of a preemption proposal, leaving us to deal with those issues as they come up (but also perhaps making it harder for us to object to proposals that we believe to be too extreme).

What do you all think?

I still like the way this reads. -- B

TO THE HOUSE OF REPRESENTATIVES:

I am returning herewith without my approval H.R. 1058, the "Private Securities Litigation Reform Act of 1995." This legislation is designed to reform portions of the Federal securities laws to end frivolous lawsuits and to ensure that investors receive the best possible information by reducing the litigation risk to companies that make forward-looking statements.

I support those goals. Indeed, I made clear my willingness to support the bill passed by the Senate with appropriate "safe harbor" language, even though it did not include certain provisions that I favor -- such as enhanced provisions with respect to joint and several liability, aider and abettor liability, and statute of limitations.

I am not, however, willing to sign legislation that will have the effect of closing the courthouse door on investors who have legitimate claims. Those who are the victims of fraud should have recourse in our courts. Unfortunately, changes made in this bill during conference could well prevent that.

This country is blessed by strong and vibrant markets and I believe that they function best when corporations can raise capital by providing investors with their best good-faith assessment of future prospects, without fear of costly, unwarranted litigation. But I also know that our markets are as strong and effective as they are because they operate -- and are seen to operate -- with integrity. I believe that this bill, as modified in conference, could erode this crucial basis of our markets' strength.

Specifically, I object to the following elements of this bill. First, I believe that the pleading requirements of the Conference Report with regard to a defendant's state of mind impose an unacceptable procedural hurdle to meritorious claims being heard in Federal courts. I am prepared to support the

high pleading standard of the U.S. Court of Appeals for the Second Circuit -- the highest pleading standard of any Federal circuit court. But the conferees make crystal clear in the Statement of Managers their intent to raise the standard even beyond that level. I am not prepared to accept that.

The conferees deleted an amendment offered by Senator Specter and adopted by the Senate that specifically incorporated Second Circuit case law with respect to pleading a claim of fraud. Then they specifically indicated that they were *not* adopting Second Circuit case law but instead intended to "strengthen" the existing pleading requirements of the Second Circuit. All this shows that the conferees meant to erect a higher barrier to bringing suit than any now existing -- one so high that even the most aggrieved investors with the most painful losses may get tossed out of court before they have a chance to prove their case.

Second, while I support the language of the Conference Report providing a "safe harbor" for companies that include meaningful cautionary statements in their projections of earnings, the Statement of Managers -- which will be used by courts as a guide to the intent of the Congress with regard to the meaning of the bill -- attempts to weaken the cautionary language that the bill itself requires. Once again, the end result may be that investors find their legitimate claims unfairly dismissed.

Third, the Conference Report's Rule 11 provision lacks balance, treating plaintiffs more harshly than defendants in a manner that comes too close to the "loser pays" standard I oppose.

I want to sign a good bill and I am prepared to do exactly that if the Congress will make the following changes to this legislation: first, adopt the Second Circuit pleading standards and reinsert the Specter amendment into the bill. I will support a bill that submits all plaintiffs to the tough pleading

standards of the Second Circuit, but I am not prepared to go beyond that. Second, remove the language in the Statement of Managers that waters down the nature of the cautionary language that must be included to make the safe harbor safe. Third, restore the Rule 11 language to that of the Senate bill.

While it is true that innocent companies are hurt by frivolous lawsuits and that valuable information may be withheld from investors when companies fear the risk of such suits, it is also true that there are innocent investors who are defrauded and who are able to recover their losses only because they can go to court. It is appropriate to change the law to ensure that companies can make reasonable statements and future projections without getting sued every time earnings turn out to be lower than expected or stock prices drop. But it is not appropriate to erect procedural barriers that will keep wrongly injured persons from having their day in court.

I ask the Congress to send me a bill promptly that will put an end to litigation abuses while still protecting the legitimate rights of ordinary investors. I will sign such a bill as soon as it reaches my desk.

William J. Clinton

THE WHITE HOUSE,

December 19, 1995.