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IS "PAY-TO-PLAY" DRIVING PUBLIC PENSION FUND ACTIVISM IN SECURITIES CLASS ACTIONS?

AN EMPIRICAL STUDY

DAVID H. WEBBER*

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The recent emergence of public pension funds as frequent lead plaintiffs in securities class actions has prompted speculation that the funds' litigation activism is driven by "pay-to-play." Pay-to-play alleges that politicians drive the high rate of public pension fund lead plaintiff appointments; the politicians purportedly direct the funds to pursue securities class actions in return for campaign contributions made to them by plaintiffs' lawyers. This Article provides a comprehensive analysis of the securities litigation activity of 111 such funds from the years 2003 through 2006. Three of the Article's findings cast doubt on the pay-to-play theory, including that: (1) politicians and political control negatively correlate with lead plaintiff appointments; (2) beneficiary board members – and outright beneficiary control of the board – positively correlate with such appointments; and (3) the degree of a pension fund's underfunding positively correlates with lead plaintiff appointments, particularly when the fund is controlled by beneficiaries. This evidence suggests that beneficiary board members (not politicians) drive these cases for reasons having to do with the financial soundness of the fund. The Article analyzes the substantial role played by these members in securities class actions in light of prior research comparing such board members to corporate managers with an equity stake in a corporation. The Article also finds no support for the theory that unions drive beneficiary board members to obtain lead plaintiff appointments, and offers evidence that resistance by politicians to lead plaintiff appointments correlates with the degree of business influence in the politicians' home states.

INTRODUCTION

Over the past year, the prospect of pay-to-play in securities class actions has generated worrying headlines and scolding editorials. The *Wall Street Journal* alone has run a front-page article and two lead op-eds on the subject since November 2009.[1] This alarmist press has complemented a furious lobbying effort in Washington; the U.S. Chamber of Commerce has pressed for securities litigation reform, and against the recently established consumer

[1] *See, e.g.*, *Pay-to-Play Torts*, WALL ST. J., Oct. 31, 2009, at A18 (calling for investigation of purported pay-to-play between plaintiffs' law firms and public pension funds); Mark Maremont et al., *Trial Lawyers Contribute, Shareholder Suits Follow*, WALL ST. J., Feb. 3, 2010, at A1 (describing campaign contributions made by plaintiffs' law firms, including contributions to politicians on public pension fund boards who pursued securities class actions with contributing law firms); *Progress on Pay to Play*, WALL ST. J., Feb, 12, 2010, at A22 (praising reforms designed to reduce purported pay-to-play).

finance protection agency[2] – citing pay-to-play concerns. The substantial role public pension funds play as lead plaintiffs in these cases lies at the core of this frenzy. In recent years, such funds, or their sister union funds, have obtained as much as forty percent of lead-plaintiff appointments in securities class actions.[3] The pay-to-play theory suggests that politicians who serve on these public pension fund boards, or appoint members to these boards, collect campaign contributions from plaintiffs' lawyers.[4] In turn, the politicians cause the funds to obtain lead-plaintiff appointments and to appoint the contributing lawyers to lucrative lead-counsel positions.[5] This accusation – promoted by defense lobbies such as the U.S. Chamber of Commerce and others, but not by shareholder advocacy groups – has cast a pall of corruption over what was previously viewed as the welcome participation of public pension funds in these cases. Prior research has demonstrated that public pension funds have performed admirably in the leadership role: they have increased recoveries for the class, procured corporate governance reforms, improved board independence, and reduced attorneys' fees.[6] This Article empirically tests the pay-to-play claims made about the funds. It concludes that such claims have been overstated; in fact, public pension fund participation in securities class actions is driven by beneficiary board members (board members who are themselves fund beneficiaries and who peer beneficiaries elect to the board) – not politicians. These beneficiary board members are primarily motivated to

[2] UNITED STATES CHAMBER INSTITUTE FOR LEGAL REFORM, SECURITIES CLASS ACTION LITIGATION REFORM 11-12 (2007), *available at* http://www.instituteforlegalreform.com /issues/docload.cfm?docId=1071 (calling for reform of pay-to-play in securities class actions); Press Release, Institute for Legal Reform, *U.S. Chamber Institute for Legal Reform Calls for Transparency in State AG Enforcement Provisions Contained in Consumer Financial Protection Agency Proposal* (Sept. 22, 2009) (statement of Lisa A. Rickard, President of the U.S. Chamber Institute for Legal Reform), *available at* http://www.litigationfairness.org/component/ilr_media/30/pressrelease/2009/472.html (citing pay-to-play as a reason to oppose passage of the Consumer Financial Protection Act).

[3] GRACE LAMONT & PATRICIA ETZOLD, PRICEWATERHOUSECOOPERS LLP, 2007 SECURITIES LITIGATION STUDY 33 (2008), *available at* http://10b5.pwc.com/PDF/2007 %20SECURITY%20LIT%20STUDY%20W-LT.PDF.

[4] *In re* Cendant Corp. Litig., 182 F.R.D. 144, 147-49 (D.N.J. 1998), *rev'd on other grounds*, 264 F.3d 201 (3d Cir. 2001) (stating competing class counsel's argument that at least one of the institutional lead plaintiffs selected by the court had received campaign contributions from its chosen lead counsel, "creat[ing] an appearance of impropriety because the contributions may have played a role in the selection of the [institution's] lead counsel – a practice known as 'pay-to-play'").

[5] *Id.* The pay-to-play theory has also been applied to other aspects of securities class actions, such as the lead plaintiff's selection of lead counsel, or the payment of attorneys' fees. This Article focuses exclusively on the form of pay-to-play which suggests that campaign contributions are what drive public pension funds to obtain lead plaintiff appointments in the first place, which has been widely alleged and is the most prominent of the various pay-to-play theories.

[6] See *infra* Part I.B.

bring suit by concerns about the fraud's impact on their own financially vulnerable retirement savings, and those of their peer beneficiaries. "Pay-to-play," to the extent it occurs, plays at most a minor role in motivating public pension fund lead plaintiff appointments.

Public pension funds are usually defined-benefit funds that invest the retirement savings of public employees, such as teachers, police and fire department employees, sanitation workers, clerical workers, and judges. Participation by these funds as lead plaintiffs in securities class actions marks at least a partial fulfillment of one of the primary purposes of the Private Securities Litigation Reform Act of 1995 (the "PSLRA" or the "Act"), which was to empower institutional investors to obtain lead-plaintiff appointments in securities class actions.[7] Congress believed that institutional investors, sophisticated investors with significant losses at stake, would carefully select and monitor plaintiffs' lawyers to the benefit of the class of aggrieved shareholders, in contrast to individual lead plaintiffs with meager shareholdings and little leverage over their counsel.[8] To accomplish this, Congress created rules favoring the selection of institutional investors as lead plaintiffs and enabled these lead plaintiffs to select counsel for the class.[9]

This is the first Article addressing the pay-to-play question that employs a methodology to account for all types of public pension funds that participate in securities class actions, including both state and local public pension funds and pension funds controlled by politicians versus those controlled by beneficiaries.[10] It also uses the largest sample of public pension funds among

[7] S. REP. NO. 104-98, at 10-11 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 689-92 ("The Committee believes that the lead plaintiff – not lawyers – should drive the litigation. . . . The Committee intends to increase the likelihood that institutional investors will serve as lead plaintiffs by requiring the court to presume that the member of the purported class with the largest financial stake in the relief sought is the 'most adequate plaintiff.' . . . [T]he Committee permits the lead plaintiff to choose the class counsel. This provision is intended to permit the plaintiff to choose counsel rather than have counsel choose the plaintiff.").

[8] In adopting the PSLRA, Congress noted that "[i]nstitutions with large stakes in class actions have much the same interests as the plaintiff class generally; thus, courts could be more confident settlements negotiated under the supervision of institutional plaintiffs were 'fair and reasonable' than is the case with settlements negotiated by unsupervised plaintiffs' attorneys." S. REP. NO. 104-98, at 9 n.34 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 690 (quoting Elliot J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2060-61 (1995)).

[9] 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(bb) ("[In general,] the court shall adopt a presumption that the most adequate plaintiff in any private action arising under this chapter is the person or group of persons that . . . in the determination of the court, has the largest financial interest in the relief sought by the class.").

[10] *Cf.* Stephen J. Choi et al., *The Price of Pay to Play in Securities Class Actions* (Univ. of Mich. Law & Econ. Empirical. Legal Studies Ctr. Paper No. 09-025, 2010), *available at* http://ssrn.com/abstract=1527047. Focusing on attorneys' fees, this paper argues that above-median asset size state public pension funds lower attorneys' fees regardless of

Articles that have examined this issue, and is also the first to examine pension funds that do not participate in these cases. The methodology employed here addresses the fact that campaign contribution data is effectively unavailable for almost all local public pension funds (and some state funds); local funds compose nearly two-thirds of all public pension fund lead plaintiffs and thus any methodology that excludes the local funds fails to account for the majority of public pension fund activity in securities class actions. What is universally available is the board structure of public pension funds. In particular, this Article focuses on the role of politicians and fund beneficiaries as board members, finding that the percentage of board seats controlled by politicians – and outright control of the board by a politician or politicians – correlates negatively with lead plaintiff appointments, whereas the percentage of board seats controlled by beneficiaries – or outright beneficiary control of the board – correlates positively with such appointments. This Article also finds that the degree of the funds' underfunding correlates positively with lead plaintiff appointments, particularly when the funds are controlled by beneficiaries.

These results suggest that pay-to-play is a less significant driver of public pension fund participation than is widely believed, and is less important than forces related to beneficiary influence over public pension funds. If pay-to-play were driving lead plaintiff appointments, one would expect politicians and political control to correlate positively with lead plaintiff appointments; plaintiffs' lawyers would not pay politicians who could not deliver the "play." Instead, as is discussed at length below, a fund's litigation activism is linked to the degree of its underfunding and is driven by beneficiaries, who have been identified by previous researchers as superior managers of public pension funds.[11] Beneficiary board members of underfunded public pension funds may

whether the funds received campaign contributions, although the paper concludes that this advantage disappears when the funds have received a "high contribution." *Id.* at 35-36. The small number of funds falling into this latter category is consistent with the claims in this paper that, at most, pay-to-play is a marginal phenomenon in securities class actions. The Choi et al. paper makes no assessment of pay-to-play among local funds. *See also* Drew T. Johnson-Skinner, Note, *Paying-to-Play in Securities Class Actions: A Look at Lawyers' Campaign Contributions*, 84 N.Y.U. L. REV. 1725, 1728 (2009) (finding that some law firms contribute to the investment funds that select them as class counsel).

[11] Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 826-27 (1993) (reporting that beneficiary board members who are elected by beneficiaries correlate with superior financial performance, but that beneficiary board members who are appointed by elected officials – like the officials themselves and their other appointees – correlate negatively with financial performance, although the correlation is not statistically significant); David Hess, *Protecting and Politicizing Public Pension Fund Assets: Empirical Evidence on the Effects of Governance Structures and Practices*, 39 U.C. DAVIS L. REV. 187, 216-17 (2005) ("[Member-elected trustees] are motivated, accountable to plan beneficiaries, and independent of political influence. . . . Member-elected trustees' dedication to their duties also appears to be beneficial to plan financial performance.").

be particularly interested in bringing securities fraud class actions not only because they (and their families and co-workers) personally suffer losses in securities frauds – losses that may be more acutely painful for funds that are already under-resourced – but because these beneficiary board members are directly accountable to their funds' beneficiaries and can be voted off the board. They therefore have a greater incentive both to take action to remedy losses, and to be viewed as zealously guarding and advancing their fund's bottom line.

This Article also suggests an obvious, if previously overlooked, point: that politicians are as susceptible to campaign contributions and political pressure from business interests as they are from plaintiffs' lawyers, and that such activity, instead of increasing public pension fund litigiousness, may be decreasing it. I define politicians' responsiveness to business interests, whether because of campaign contributions from such interests or responsiveness to pro-business constituents generally, as "pay-not-to-play." Finally, this Article examines the impact of other structural features on the funds' litigiousness, including whether the presence of financial experts on the board or social investment criteria impact lead plaintiff appointments.

The Article proceeds as follows: Part I discusses the lead plaintiff and lead-counsel provisions of the PSLRA, which established the presumption favoring large institutional investors as lead plaintiffs in securities class actions. Part I also discusses the subsequent emergence of public pension funds as significant players in such class actions, and some of the theories that have described this emergence, including "pay-to-play." Part II sets forth the methodology employed in gathering and analyzing the data on public pension fund lead plaintiff appointments from January 1, 2003 to December 31, 2006 for two samples of funds: the largest funds by asset size (the "Largest Funds") and the funds that obtained at least one lead plaintiff appointment (the "Litigating Funds"). Part III presents and analyzes the data from the two samples. Part IV examines the prominent role beneficiary board members played in securities class actions, including the connections among such board members, lead plaintiff appointments, and the degree of the fund's underfunding. Part V analyzes the negative correlation between politicians and lead plaintiff appointments and discusses the possibility that business interests are successfully reducing litigation activism by politically controlled pension funds.

I. THE LEAD PLAINTIFF PROVISION OF THE PSLRA AND THE EMERGENCE OF PUBLIC PENSION FUNDS AS FREQUENT LEAD PLAINTIFFS IN SECURITIES CLASS ACTIONS

A. *The Lead Plaintiff Provision of the PSLRA*

Congress enacted the PSLRA to address the pervasive belief that securities class actions failed to aid investors and enriched plaintiffs' lawyers who filed

frivolous strike suits that cost defendants more to defend than to settle.[12] Adopted over President Clinton's veto, though with substantial Democratic support,[13] the PSLRA fulfilled a political commitment to securities litigation reform enshrined in the Contract with America, a document the Republican Party released six weeks before the November 1994 mid-term election that all but two of the party's House candidates signed.[14] Among other things, the PSLRA sought to shift control of securities class actions from plaintiffs' lawyers to institutional investors.[15] Inspired by an argument Elliott Weiss and John Beckerman originated in their article, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*,[16] Congress concluded that "institutions with large stakes in class actions have much the same interests as the plaintiff class generally; thus, courts could be more confident settlements negotiated under the supervision of institutional plaintiffs were 'fair and reasonable' than is the case with settlements negotiated by unsupervised plaintiffs' attorneys."[17] Prior to passage of the PSLRA, courts would usually appoint whichever plaintiff filed the first lawsuit as the lead plaintiff.[18] This "race to the courthouse" led to perceived abuses, whereby plaintiffs' lawyers relied on "professional plaintiffs" or law-firm employees who owned at least one share, sometimes fractions of shares, in a broad array of companies; this permitted law firms to

[12] S. REP. NO. 104-98, at 9 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 688 ("Most defendants in securities class action lawsuits choose to settle rather than face the enormous expense of discovery and trial.") To what extent plaintiffs' lawyers filed frivolous cases in the pre-PSLRA (and post-PSLRA) periods has been the subject of much scholarly debate. *See generally* Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465 (2004) (surveying conflicting literature on whether passage of the PSLRA increased or decreased shareholder welfare).

[13] Neil A. Lewis, *Securities Bill Becomes Law as the Senate Overrides Veto*, N.Y. TIMES, Dec. 23, 1995, at Section 1, 39 (noting that the House of Representatives overrode President Clinton's veto 319 to 100, while the Senate overrode the veto 68 to 30).

[14] As part of the "Republican Contract with America," incumbent Republican members of the House of Representatives, and non-incumbent Republican candidates for a seat in the House of Representatives, pledged to bring to the floor of the House ten bills within the first 100 days of the 104th Congress, which met from January 3, 1995 to January 3, 1997. *Republican Contract with America*, UNITED STATES HOUSE OF REPRESENTATIVES, http://www.house.gov/ house/Contract/CONTRACT.html (last visited Sept. 17, 2010). The ninth of these bills was entitled "The Common Sense Legal Reform Act," which included provisions for the reform of securities class actions. *Common Sense Legal Reform Act of 1995*, UNITED STATES HOUSE OF REPRESENTATIVES, http://www.house.gov/house/Contract/ legalrefb.txt (last visited Sept. 17, 2010).

[15] S. REP. NO. 104-98, at 10-11, *reprinted in* 1995 U.S.C.C.A.N. 679, 689-90.

[16] Weiss & Beckerman, *supra* note 8, at 2060-61.

[17] S. REP. NO. 104-98, at 11, *reprinted in* 1995 U.S.C.C.A.N. 679, 690 (quoting Weiss & Beckerman, *supra* note 8, at 2061).

[18] S. REP. NO. 104-98, at 11, *reprinted in* 1995 U.S.C.C.A.N. 679, 690.

file a quick lawsuit in the event of an alleged fraud.[19] In some extreme instances, plaintiffs' attorneys illegally bribed their lead plaintiffs.[20] The pre-PSLRA process also effectively gave the lead counsel total control over the class action. By representing a lead plaintiff client with minimal stake in the outcome of the case, lead counsel operated without meaningful supervision.

Two provisions of the PSLRA, the lead plaintiff and lead counsel provisions, transformed the lead plaintiff process from a "race to the courthouse" to an orderly procedure. The PSLRA established a presumption that the lead plaintiff would be the class member with the largest claimed loss who sought the position. The lead plaintiff provision states: "In general . . . the court shall adopt a presumption that the most adequate plaintiff in any private action arising under this chapter is the person or group of persons that . . . in the determination of the court, has the largest financial interest in the relief sought by the class."[21] In turn, the lead-counsel provision states that "the most adequate plaintiff shall, subject to the approval of the court, select and retain counsel to represent the class."[22] In adopting these provisions, Congress endeavored "to increase the likelihood that institutional investors will serve as lead plaintiffs."[23] With more assets invested more widely in the market, institutional investors were more likely to be exposed to fraud, and more likely to suffer the largest loss.

Despite the newfound powers they obtained under the PSLRA, institutional investors were slow to accept Congress's invitation to participate in securities class actions. Initially, the number of institutions seeking lead plaintiff appointments remained quite small. In the first complete year after passage of the PSLRA, institutional investors attained lead plaintiff status in just 8 of 105 filed cases; in the second year, they led 9 of 175 cases.[24] An institutional

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[19] *Id.* at 9, *reprinted in* 1995 U.S.C.C.A.N. at 688; *see also* Weiss & Beckerman, *supra* note 8, at 2061.

[20] *See, e.g.*, Jonathan D. Glater, *Class-Action Lawyer Given a 30-Month Prison Term for Hiding Kickbacks*, N.Y. TIMES, June 3, 2008, at C3 (reporting sentencing of plaintiffs' lawyer Melvyn Weiss to thirty months' imprisonment for paying kickbacks to clients who served as lead plaintiffs in his cases); Michael Parrish, *Leading Class-Action Lawyer is Sentenced to Two Years in Kickback Scheme*, N.Y. TIMES, Feb. 12, 2008, at C3 (reporting sentencing of plaintiffs' attorney William Lerach to two years' imprisonment for paying kickbacks to clients who served as lead plaintiffs in his cases).

[21] 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(bb) (2006).

[22] § 78u-4(a)(3)(B)(v).

[23] S. REP. NO. 104-98, at 11, *reprinted in* 1995 U.S.C.C.A.N. 679, 690.

[24] Stephen J. Choi et al., *Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Litigations Securities Litigation Reform Act*, 83 WASH. U. L.Q. 869, 877 (2006) (citing OFFICE OF THE GENERAL COUNSEL, SEC. & EXCH. COMM'N, REPORT TO THE PRESIDENT AND CONGRESS ON THE FIRST YEAR OF PRACTICE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995, 51 (1997)); Elayne Demby, *Ducking Lead Plaintiff Status*, PLANSPONSOR (May 1999), http://www.assetpub.com/archive/ps/99-05psmay/may99PS58 a.html.

investor served as lead plaintiff, either singly or as co-lead plaintiff with an individual, in only 46 of 259 post-PSLRA securities class actions filed from 1996-2002.[25] Institutional investor participation as lead plaintiffs, and, in particular, public pension fund participation, rose modestly from zero percent pre-PSLRA to over ten percent between 1996 and 2000.[26] By contrast, the percentage of private institutional investors actually dropped slightly from 0.5% to 0.3% in the post-PSLRA period.[27] But more recently, public pension funds and union funds have begun to step forward in significant numbers to lead securities class actions. In both 2006 and 2007, these funds served as lead plaintiff in 40% of securities class actions.[28] The prolonged delay in institutional investor participation, followed by a spike in institutional participation attributable almost exclusively to public and union pension funds, has led some commentators to divide the post-PSLRA era into two periods: the "'initial' post-PSLRA period," from 1995-1999, which predated public pension fund involvement, and the "'mature' post-PSLRA period," from 2000 to the present, in which public pension funds have assumed a dominant role in securities class actions.[29]

B. *The Emergence of Public Pension Funds As Players in Securities Class Actions*

The emergence of public pension funds as active players in securities litigation has been treated as puzzling and controversial, in part because it is unclear why institutional investors of any kind would want the job. Obtaining a lead plaintiff appointment confers virtually no specialized benefit on the appointed individual or entity. Lead plaintiffs cannot be paid for their service to the class, except in very limited circumstances related to reimbursement of certain limited expenses. They merely collect their pro rata share of the settlement. Therefore, they have a strong incentive to free ride. Because evidence has emerged that public pension funds are better lead plaintiffs, as discussed below, the ideal scenario from the point of view of a public pension class member is to have another public pension fund serve as lead plaintiff. That way, the class member fund benefits from the motivation and

[25] James D. Cox & Randall S. Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587, 1622-23 (2006) [hereinafter *Does the Plaintiff Matter?*].

[26] Choi et al., *supra* note 24, at 889 (reporting that public pension funds in their sample went from zero representation as lead plaintiffs in the pre-PSLRA period to over 10% in the post-PSLRA period. In contrast, private institutions in the same sample dropped slightly from 0.5% representation as lead plaintiffs in the pre-PSLRA period to 0.3% in the post-PSLRA period).

[27] *Id.*

[28] LAMONT & ETZOLD, *supra* note 3, at 33.

[29] Stephen J. Choi & Robert B. Thompson, *Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA*, 106 COLUM. L. REV. 1489, 1519 (2006).

sophistication of an institutional lead plaintiff without itself having to bear the admittedly minimal burden of serving as lead plaintiff.

Free-riding aside, in many instances, the losses institutional investors suffer in securities frauds may be large enough to qualify for a lead plaintiff appointment but are still trivial relative to the investors' total assets. For example, a recent study concluded that the average claimed loss for an institutional investor lead plaintiff in a securities class action is $3.9 million.[30] Such a loss is inconsequential for the institutional investors with billions of dollars in assets that Congress envisioned as its ideal lead plaintiffs. For this reason, at least one fund, the California State Teachers' Retirement System (CalSTRS), has established a policy of seeking lead plaintiff appointments in cases where it suffered at least $5 million in losses (still just a fraction of its $103 billion in assets), while reserving the right to seek an appointment in the event of an "exceptional opportunity to preserve or enhance the long-term value of a significant portfolio holding or to deter wrongful corporate conduct."[31] In addition to small relative losses, some skeptics have concluded that absolute recoveries in successful class actions are typically very slight. NERA Economic Consulting has calculated that in 2002, 2003, and 2004, the ratio of settlements to investor losses was a shocking 2.7%, 2.9%, and 2.3%, respectively.[32] Another source has placed average recoveries at 12.7% of investor losses,[33] and CalSTRS itself has placed the figure as high as 14%.[34]

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[30] Stephen J. Choi, *Motions for Lead Plaintiff in Securities Class Actions*, 44 (NYU Law and Econ. Res. Paper No. 08-53, June 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1293926 [hereinafter *Motions for Lead Plaintiff*].

[31] *See Teachers' Retirement Board Policy Manual*, CALSTRS (Sep. 2010), http://calstrs.com/About%20CalSTRS/Teachers%20Retirement%20Board/BoardPolicyManual.pdf#page=153. The manual states:

> 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.

Id.

[32] John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1545 (2006) (citing Elaine Buckberg et al., *Recent Trends in Shareholder Class Action Litigation: Are WorldCom and Enron the New Standard?*, NERA ECONOMIC CONSULTING 6 (2005), http://www.nera.com/extImage/Recent_Trends_07.2005.pdf). NERA calculates that the ratio of settlements to investor losses has dropped from 7.1% in 1996, the year immediately following passage of the PSLRA. *See* Stephanie Plancich & Svetlana Starykh, *2008 Trends in Securities Class Actions*, NERA ECONOMIC CONSULTING 14 (December 2008), http://www.nera.com/extImage/ PUB_Recent_Trends_Report_1208.pdf.

[33] *Does the Plaintiff Matter?*, *supra* note 25, at 1621 n.132.

Such small recoveries on relatively small losses undoubtedly contributed to at least some institutional investors' lack of enthusiasm for participating in securities class actions. A surprisingly large number of institutions have been so indifferent to these cases that they failed even to file claims for funds to which they were entitled from settled securities class actions, at least until two articles by James Cox and Randall Thomas exposed this negligent practice as a breach of the funds' fiduciary duties to their beneficiaries.[35]

Still, there are reasons for institutional investors to participate in securities class actions apart from compensation for losses. For example, as repeat and long-term market players, institutional investors, including public pension funds, have an interest in the deterrence aspects of securities fraud class actions generally. Perpetrators of the classic securities fraud cause a corporation to violate the securities laws and receive gains equal to only a small percentage of investor losses.[36] They may be deterred easily from committing fraud by being forced to compensate investors for only a small share of the investors' losses, as long as that compensation exceeds what the perpetrators would have gained from the fraud.[37] Thus, even small recoveries by institutional investors in individual cases can have a deterrent effect across the markets broadly. These recoveries may be at least partially covered by directors and officers insurance, which undermines their deterrent effect, but, in response, some public pension funds have begun insisting that individual defendants make payments out of

[34] *See Draft of Securities Litigation Policy*, CALSTRS 4 (Jan. 5, 2000), http://www.calstrs.com/about%20calstrs/Teachers%20Retirement%20Board/AGENDAS/bod0100pdf/cg0104.PDF.

[35] James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 STAN. L. REV. 411, 413 (2005) (calculating that fewer than thirty percent of institutional investors with demonstrated losses filed claims against funds settling securities class actions); *see also* James D. Cox & Randall S. Thomas, *Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?*, 80 WASH. U. L.Q. 855, 871 (2002) (citing a survey by National Association of State Auditors, Comptrollers and Treasurers showing that about one-third of the thirty-three respondent institutions had made no recovery of any asset losses in the prior five years, a time period in which more than 700 securities class action cases were settled). Weiss & Beckerman argued that institutional investors' failure to pursue lead plaintiff appointments could be interpreted as a breach of their fiduciary duties to their beneficiaries. Weiss & Beckerman, *supra* note 8, at 2125-26.

[36] Coffee, *supra* note 32, at 1547-48.

[37] *Id.* Note that Coffee argues that the deterrent effects of securities class actions are increasingly inhibited by the fact that insurance companies – and not the perpetrators of the fraud themselves – frequently compensate investors for alleged frauds. *Id.* Moreover, Jennifer Arlen and Bill Carney have argued that, for purposes of deterrence, a rule of agent liability supplemented by criminal enforcement is better than the current system of enterprise liability for securities class actions. *See generally* Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691 (1992).

their own pockets as a condition of settlement. Also, notwithstanding the prevalence of small recoveries, public pension funds still have an interest in maximizing recoveries for themselves, and by extension, for the class. Recent studies support the conclusion that securities class actions led by public pension funds correlate with higher recoveries, lower attorneys' fees, fewer dismissals, and greater post-litigation board independence.[38] For example, a recent paper concludes that public pension funds not only increase monetary recoveries, even when one controls for cherry-picking of the best cases but they also decrease the probability of dismissal and increase board independence at the defendant companies.[39] In a recent survey of public pension funds, the funds themselves assert that the size of their losses is the most important reason for seeking a lead plaintiff appointment.[40] And at least some funds believe that they are capable of obtaining higher recoveries when serving as lead plaintiff. For example, CalSTRS's own securities litigation policy states that while most securities class actions recover 14% of losses, it anticipates recoveries can increase to 25% of losses when CalSTRS serves as lead plaintiff.[41] Additional evidence suggests that these funds reduce attorneys' fees and increase attorney hours worked. The weight of the evidence suggests that public pension funds are simply better lead plaintiffs, which benefits both the funds themselves as well as the rest of the class.

It is also true that there is little reason for public pension funds to be deterred by the costs of serving as lead plaintiff. The vast majority of

[38] C.S. Agnes Cheng et al., *Institutional Monitoring Through Shareholder Litigation*, 95 J. FIN. ECON. 356, 356-62 (2010) (using a database from 1996 to 2005 and controlling for case determinants of having an institutional lead plaintiff, finding that institutional investors, including public pension funds, decrease the probability of a case being dismissed, increase monetary recoveries, and improve the independence of boards at defendant companies); *Does the Plaintiff Matter?*, *supra* note 25, at 1636-39 (finding that institutional investors increase settlements by 0.04% for every 1% increase in provable losses); Michael Perino, *Institutional Activism Through Litigation: An Empirical Analysis of Public Pension Funds Participation in Securities Class Actions*, 24, 30-31 (St. John's Legal Studies Research, Working Paper No. 06-0055, 2006), *available at* http://ssrn.com/abstract=938722 ("Cases with public pension fund lead plaintiffs settle for greater amounts, even when controlling for institutional self-selection of larger, more high profile cases. Cases with public pension leads are also positively correlated with at least one proxy for attorney effort, the number of docket entries in the case, suggesting that institutional monitoring may be effective in reducing attorney shirking."). Some scholars have suggested that institutional investors may be "cherry picking" the best cases. Choi et al., *supra* note 24, at 870, 892 (reporting some statistical evidence consistent with the "cherry-picking" theory); *Does the Plaintiff Matter?*, *supra* note 25, at 1636-39 (finding that higher settlements by institutional investors in securities class actions may reflect that institutions "take the better cases").

[39] Cheng et al., *supra* note 38.

[40] Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315, 339 (2008).

[41] *See* CalSTRS Subcommittee on Corporate Governance, *supra* note 34, at 1-2.

securities class actions are brought by lead counsel who assume the cost of the litigation and are compensated by contingency fees. At most, lead plaintiffs incur costs when employee time allotted to managing the class action could otherwise be allotted to another function. Thus, the emergence of public pension funds as lead plaintiffs may be explained by the fact that institutions are superior lead plaintiffs who increase recoveries and benefit from deterrence, at little cost to themselves, and that such funds lack the disabling conflicts that keep other institutional investors on the sidelines of securities litigation.[42] Weiss and Beckerman predicted that public pension funds would be likely candidates for lead plaintiff appointments under what became the PSLRA, emphasizing that such funds were disproportionately active in corporate governance reform efforts prior to the Act's passage.[43]

Others have argued that the emergence of public pension funds as lead plaintiffs is attributable to the relatively high recoveries in high profile cases that brought considerable press coverage to the funds that participated in the suit. Some scholars have traced the beginning of significant public pension fund activism in securities class actions to the success of *In re Cendant Corporation Securities Litigation*, in which CalPERS, the New York State Common Retirement Fund, and the New York City Pension Funds obtained a $3.2 billion recovery for aggrieved shareholders. In 1999, this was a record recovery for investors, which purportedly recovered 40% of investor losses.[44] Subsequent recoveries by public pension funds of $7.2 billion and $6.15 billion in the Enron and WorldCom shareholder lawsuits, respectively, in addition to the favorable publicity the funds obtained from such recoveries, may have only magnified the trend. Blockbuster recoveries aside, the most persistent and controversial explanation for public pension fund litigation activism offers a more cynical perspective: "pay-to-play."

C. *The "Pay-to-Play" Theory of Public Pension Funds Securities Litigation Activism*

pay-to-play allegations were first prominently aired in the context of public pension funds as lead plaintiffs in *In re Cendant Corporation Securities*

[42] For example, it has been argued that mutual funds shun securities litigation because a significant portion of their business comes from managing the retirement funds of Fortune 500 company employees. Suing such companies would jeopardize their business relationships with the companies. *See, e.g.*, *Does the Plaintiff Matter?*, *supra* note 25, at 1609 (observing that mutual funds avoid lead plaintiff appointments because of their commercial relationships with corporations and accounting firms). Moreover, lead plaintiffs must frequently sue the underwriters and possibly the accountants, with whom they may have ongoing business relationships. *Id.*

[43] Weiss & Beckermann, *supra* note 8, at 2111.

[44] Demonstrating Significant Recoveries, BERNSTEIN LITOWITZ BERGER & GROSSMANN LLP, http://www.blbglaw.com/our_record_results/significant_recoveries (last visited Aug. 24, 2010).

Litigation.[45] In *Cendant*, competing class counsel argued that at least one of the institutional lead plaintiffs had received campaign contributions from its chosen lead counsel, "creat[ing] an appearance of impropriety because the contributions may have played a role in the selection of the [institution's] lead counsel – a practice known as 'pay-to-play.'"[46] The *Cendant* court dismissed the allegation as "speculative" and not violative of any law.[47] Since *Cendant*, some scholars have questioned the pay-to-play theory. James Cox and Randall Thomas have noted that the pay-to-play in which plaintiffs' securities class action firms allegedly engaged, "appears to be just part of a larger tapestry of 'pay-to-play' practices by law firms generally."[48] Stephen Choi and Jill Fisch have questioned the pay-to-play theory in light of some evidence suggesting that there is no correlation between public pension fund litigation activism and the involvement of public officials.[49] The public pension funds themselves reported to Choi and Fisch that their primary reason for seeking appointment as lead plaintiff was the size of their claimed losses.[50]

pay-to-play allegations – in particular, the allegation that public pension funds bring securities class actions in exchange for campaign contributions – have recently re-emerged. In part, allegations of pay-to-play in the securities class action context have been triggered by incidents of pay-to-play in the investment adviser context; these latter incidents have little to do with

[45] Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 966 n.277; *see also Does the Plaintiff Matter?*, *supra* note 25, at 1610-15.

[46] *In re* Cendant Corp. Litig., 182 F.R.D. 144, 147-49 (D.N.J. 1998), *rev'd on other grounds*, 264 F.3d 201 (3d Cir. 2001).

[47] *Id.*

[48] *Does the Plaintiff Matter?*, *supra* note 25, at 1614. While noting that the pay-to-play purportedly engaged in by securities class action firms is part of this general "tapestry" of pay-to-play practices generally, including campaign contributions by law firms employed by states to elected officials in those states, Cox and Thomas suggest three potential reforms that would eliminate the "odor of corruption" such allegations cause. Cox and Thomas suggest barring lead plaintiff funds from selecting lead counsel who have made political contributions to a government official with influence over the fund, placing the lead counsel decision in the hands of nonpartisan board officials instead of elected officials (as some states have already done), or mandatory disclosure to federal courts of campaign contributions made by proposed lead counsel to any institutional investor seeking the lead plaintiff position. The court could then weigh these contributions as part of its discretion over the appointment of lead counsel. *Id.* at 1614-15.

[49] Choi & Fisch, *supra* note 40, at 346. *But see* Randall Thomas, *Public Pension Funds as Shareholder Activists: A Comment on Choi and Fisch*, 61 VAND. L. REV. EN BANC 1, 3 (2008) (questioning the weight to be given to the Choi & Fisch study because of survey methodology and low response rate).

[50] Choi & Fisch, *supra* note 40, at 339. On a related note, a recent draft paper by Choi and others concludes that pay-to-play may lead to higher attorneys' fees for certain politically-controlled public pension funds. *The Price of Pay to Play*, *supra* note 10 at 14-16.

campaign contributions[51] and have led to calls for further reform in securities class actions. For example, the *Wall Street Journal* prominently re-aired pay-to-play allegations in a lead editorial, arguing that "plaintiffs' lawyers . . . make campaign contributions to public officials with the goal of being selected by those same officials to represent the pension fund in securities litigation."[52] More recently, the *Wall Street Journal* ran a front-page article in which it identified a public pension fund that had served as lead plaintiff twelve times – which would make it an extreme outlier in this Article's dataset – and had collected significant contributions from plaintiffs' lawyers.[53] The article also identified out-of-state campaign contributions made by plaintiffs' lawyers, assuming that such contributions could only have been made for pay-to-play purposes, even if the politician who received the contributions did not serve on a pension fund board.[54] The perception that public pension fund participation in securities class actions is fundamentally driven by pay-to-play has spurred calls for comprehensive reform, such as a proposal to eliminate public pension fund participation by the Institute for Legal Reform, an affiliate of the U.S. Chamber of Commerce:

> Many government pension funds are controlled by elected officials. Frequently, it turns out that the law firm selected to represent a pension fund in class action litigation has been the source of campaign contributions to the public officials running the fund. Several years ago, to address a similar problem in the selection of underwriters for government bond offerings, the SEC adopted a rule prohibiting "pay to play" by banning such contributions. Congress should enact a similar prohibition, barring a law firm from becoming lead counsel if any lawyer at the firm has contributed to the campaign of any public official who in any way oversees the fund (by serving on the fund's board, selecting those who serve on the board, supervising those who serve on the fund's board, etc.).[55]

The Chamber of Commerce's call for reform has resulted in proposed legislation in Congress, specifically the Securities Litigation Attorney Accountability and Transparency Act, introduced in the House of

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[51] Craig Karmin & Peter Lattman, *'Pay to Play' Probe Ensnares Another*, WALL ST. J., May 12, 2009, at C1 (discussing a pay to play pension probe concerning whether "investment decisions regarding retirees' money were guided by improper influence peddling").

[52] *Pay-to-Play Torts*, *supra* note 1, at A18.

[53] Mark Maremont et al., *Trial Lawyers Contribute, Shareholder Suits Follow*, WALL ST. J., Feb. 3, 2010, at A1.

[54] *Id.*

[55] United States Chamber Institute for Legal Reform, *Securities Class Action Litigation Reform* 1, 11-12 (Nov. 6, 2007), *available at* http://www.instituteforlegalreform.com/issues/docload.cfm?docId=1071.

Representatives as H.R. 5491 by Representative Jeb Hensarling (R-Tx)[56] and in the Senate by Senator John Cornyn (R-Tx) as S. 3033. The bill requires disclosure of "all political contributions made to elected officials with authority or influence over the appointment of counsel in the case."[57] Similarly, Senator Bennett (R-UT) has called for a SEC probe of pay-to-play practices.[58] Others have called for forbidding plaintiffs' law firms from representing public pension funds when the firms have contributed money to a politician on the funds' boards. The U.S. Chamber of Commerce has also used the pay-to-play issue to oppose other types of reform, such as the establishment of a consumer financial protection agency.[59]

II. METHODOLOGY

This Article tests a number of hypotheses related to public pension fund activism in securities litigation, specifically: (1) that the Largest Funds obtain the most lead plaintiff appointments; and (2) that, assuming the pay-to-play theory is true, politicians on public pension fund boards (and political majorities on such boards) will correlate positively with lead plaintiff appointments.

I began by examining the board structure of the top fifty-three U.S. public pension funds by asset size (the "Largest Funds") from a dataset compiled by Oxford University researchers in 2004 (the "Oxford database"), which in turn was based upon a ranking of public pension funds by asset size conducted by *Pensions and Investments* magazine.[60] Following Congress's reasoning in

[56] *What Can Investors Expect in 2009?*, RISKMETRICS GROUP (December 8, 2008 11:21 AM), http://blog.riskmetrics.com/gov/2008/12/what-can-investors-expect-in-2009-submitted-by-ted-allen-publications.html.

[57] News Release, Cornyn Introduces Bill To Strengthen Transparency & Accountability In Securities Class-Action Litigation, (May 19, 2008), *available at* http://cornyn.senate.gov/public/index.cfm?p=NewsReleases&ContentRecord_id=02923533-802a-23ad-4e94-a4a2109dfca5&ContentType_id=b94acc28-404a-4fc6-b143-a9e15bf92da4&Group_id=24eb5606-e2db-4d7f-bf6c-efc5df80b676&MonthDisplay=5&YearDisplay=2008.

[58] Lee Davidson, *'Pay to Play' Probe Sought*, DESERET NEWS (Salt Lake City, Utah), July 8, 2009. http://www.deseretnews.com/article/705315425/Pay-to-play-probe-sought.html.

[59] Press Release, Institute for Legal Reform, U.S. Chamber Institute for Legal Reform Calls for Transparency in State AG Enforcement Provisions Contained in Consumer Financial Protection Agency Proposal (September 22, 2009), *available at* http://www.instituteforlegalreform.com/component/ilr_media/30/pressrelease/2009/472.html (citing pay-to-play as a reason to oppose passage of the Consumer Financial Protection Act).

[60] The dataset I used to determine the board structure of the Largest Funds by asset size was compiled by researchers at the School of Geography & the Environment at the University of Oxford as part of Pension Funds and Urban Revitalization, a joint project of the School of Geography, Oxford University Centre for the Environment, and the Pensions

adopting the PSLRA's lead plaintiff provision, the Largest Funds have the greatest probability of (a) being victimized by an alleged fraud and (b) sustaining the largest loss of the alleged fraud's victims, thus making these funds strong candidates for appointment as lead plaintiffs under the PSLRA presumption that the most adequate plaintiff is the movant with the largest claimed loss.[61] The Oxford database reveals significant variation in the governance structure of the Largest Funds' boards. I identified several features of the funds' board structures that could bear on a board's decision to seek lead plaintiff status, including: (1) the number and percentage of politicians on the fund's board; (2) the number and percentage of political appointments to the fund's board; (3) the number of politicians on the board or with appointing power to it; (4) the number and percentage of financial experts on the fund's board; (5) the number and percentage of fund beneficiaries on the board; and (6) whether the board considers social investment criteria in its investment decisions.[62] I also examined the pension funds' (7) asset size and (8) board

and Capital Stewardship Project of the Harvard Labor and Worklife Program at Harvard Law School. KENDRA STRAUSS ET AL., U.S. PUBLIC SECTOR PENSION FUNDS AND URBAN REVITALIZATION: AN OVERVIEW OF POLICY AND PROGRAMS (2004), *available at* http://urban.ouce.ox.ac.uk/overview.pdf. The purpose of the Strauss et al. paper was to analyze the largest U.S. public pension funds by asset size to determine which funds would be most interested in targeting investments in urban economic development projects. As part of this analysis, Strauss et al. reviewed the structure of the pension fund boards. I independently reviewed a sample of the Largest Funds board structures identified in this paper by visiting fund websites. On the rare occasion that data was missing or incomplete, I gathered the relevant information from the websites of the respective public pension funds. The Oxford Database was based upon a ranking of the top 200 public pension funds by asset size printed in *Pensions & Investments*. *See Top Pension Fund Profiles, Charts and Tables*, PENSIONS & INVESTMENTS, Jan. 26, 2004, at 16-19.

[61] Asset allocation varies somewhat between funds, with most funds investing between forty-five and fifty-five percent of their assets in domestic securities. Therefore, some funds may have less exposure to fraud than other funds that are smaller by total assets.

[62] One possible argument against this methodology is that the board may be controlled by a politician regardless of its composition. Under this view, "star struck" beneficiary board members simply defer to a politician on major fund decisions, even if the beneficiaries control the board. Prior research demonstrating that beneficiaries correlate with higher fund returns than politicians contradicts this view. *See infra* Part IV. Still, if this view is correct, one would expect that the methodology employed here would not produce statistically significant results; if board composition does not matter because the politician is always in control, then it will not predict lead plaintiff appointments. Conversely, an ex ante argument in favor of this methodology is that board composition matters greatly because beneficiary and politician board members have different agendas for public pension funds, and therefore control of the board by one faction or the other matters for its management. In addition to the contrasting incentives between politicians and beneficiaries discussed throughout this piece and the prior research just noted, this view is further buttressed by interviews the author conducted with pension fund board members and lawyers practicing in the field. Such interviews reveal a view of the relationship between

size.[63] Using a dataset of securities class actions ("SCAS Dataset") provided to me by Securities Class Action Services, a division of Riskmetrics Group,[64] I identified the number of lead plaintiff appointments obtained by each of the Largest Funds for the four-year period from January 1, 2003 to December 31, 2006.

Using the same SCAS dataset, I then assembled a separate database of all of the public pension funds that obtained at least one lead plaintiff appointment from 2003-2006, seventy-eight funds in sum (the "Litigating Funds").[65] I then hand-collected data on the structure of the funds using the same variables noted above, which I obtained almost exclusively from materials available on the funds' websites.[66] In a few instances where the information was not available on the internet, I gathered it either through telephone or email interviews.[67] I then ran statistical tests on the Largest Funds and the Litigating Funds databases to determine if certain structural features correlate with a fund's likelihood of obtaining lead plaintiff appointments. I did not look at campaign contributions directly because such data is readily available and searchable at the state level, but not at the local level. Two-thirds of the Litigating Funds are local funds, mostly domiciled in midsized cities or large counties. There are numerous barriers to obtaining data on campaign contributions to mayors, city treasurers, or county executives, the types of politicians who are represented on most of the funds that participate in securities class actions.

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politicians and beneficiaries as an employer-employee relationship. The politicians or employers sit on the board to oversee the state, county, or municipality's contributions to the fund, in part because the politicians and employers may have to contribute more resources to the funds if they falter. The beneficiaries, on the other hand, may resent the presence of the politician; the funds are part of the beneficiaries' compensation and therefore an employer or politician should have no further say over their use. The statistical significance of the results presented below suggests that the latter view of the relationship between politicians and beneficiaries is the more accurate of the two.

[63] Where these criteria were absent from the Oxford Database, I compiled them from the websites of the pension funds themselves. *See supra* note 60.

[64] SCAS dataset (on file with author).

[65] I found eighty-one public pension funds that obtained at least one lead plaintiff appointment in the four-year period under study. I excluded the Ontario Teachers' Pension Plan Board because it is not based in the United States. I could not find sufficient information for two other funds, leaving me with a sample size of seventy-eight.

[66] All of the information in this Article pertaining to the structure of the Filer Funds, including asset size and board structure, was gathered from the websites of the respective public pension funds, and from interviews conducted with public pension fund staff. I gathered financial data from the years 2003-04, to match the data I gathered from the Oxford database.

[67] I could not obtain sufficient structural information for two funds, so I excluded them from the sample, reducing my sample size from eighty-one to seventy-eight funds, including my exclusion of the Ontario Public Pension Fund.

To empirically test the impact of business interests on public pension funds securities litigation activism, I regressed certain measures of business influence within a state against lead plaintiff appointments obtained by funds within the state. I hypothesized that public pension funds from pro-business states would obtain fewer lead plaintiff appointments than public pension funds from states with less business influence. I used the following measures of business influence within a state: (1) the U.S. Chamber of Commerce's state litigation ranking and (2) a state-by-state "business friendliness" ranking by *Forbes Magazine*.

III. DISCUSSION AND ANALYSIS OF THE DATA

A. *Who Controls the Largest Public Pension Funds?*

In 2004, there were 2,659 public pension funds in the United States,[68] with total assets of $1.93 trillion under management.[69] The fifty-three Largest Funds held $1.8 trillion[70] in assets, or 92% of the total, leaving just $160 billion to be managed by the remaining 2,606 funds. The largest fund, CalPERS, held $148.8 billion in assets,[71] almost equal to the assets held by the 2,606 small funds combined. Therefore, over time, cohering with Congress's reasoning, one would expect the Largest Funds to be more exposed to fraud and more likely to suffer the largest losses, qualifying them for the most lead plaintiff appointments, should they seek them.[72] Table 1, below, reports basic statistics on the Largest Funds.

[68] JUN PENG, STATE AND LOCAL PENSION FUND MANAGEMENT 13 (CRC Press 2008).

[69] JULIA K. BONAFEDE ET AL., 2004 WILSHIRE REPORT ON STATE RETIREMENT SYSTEMS: FUNDING LEVELS AND ASSET ALLOCATION (Mar. 12, 2004),13, app. A *available at*: http://www.wilshire.com/Company/2004_State_Retirement_Funding_Report.pdf. (reflecting sum of actuarial values of retirement systems' assets).

[70] Unless otherwise noted, all dollar figures used in this Article are from 2003-04.

[71] *The Top 200 Pension Funds/Sponsors*, PENSIONS & INVESTMENTS, Jan. 26, 2004, at 16.

[72] Pension funds often team up with other pension funds to seek co-lead plaintiff appointments. These coalitions, frequently organized by lead counsel trying to maximize the chances of their clients obtaining lead plaintiff appointments, could allow two or more funds with smaller losses to aggregate those losses and "leapfrog" a single lead plaintiff candidate whose loss is larger than either of the smaller pension funds' losses. This fact should not undermine the hypothesis that one would expect the Largest Funds to obtain the most lead plaintiff appointments, as they are also the most attractive clients for plaintiff lawyers and are most attractive as aggregation partners.

Table 1
Summary Statistics for the Largest Public Pension Funds
N=53

Variable	Mean	St. Dev.	Minimum	Median	Maximum
Asset Size[73]	$33,896	$29,031	$9,051	$24,710	$148,840
Board Size	9	3.69	1	9	18
Politicians	1.189	1.594	0	1	7
Polit. Appts.	3.708	2.619	0	4	10
Beneficiaries	3.858	3.27	0	4	14
# Appointers	2.17	1.566	0	2	8
# Finan. Exp.	0.66	1.58	0	0	7
Soc./Pol.	1.038	1.754	0	0	6

The mean asset size for these Largest Funds is approximately $33.9 billion, and the median is approximately $24.7 billion. The mean, and median, board size for the Largest Funds is nine members. The median number of politicians is one, and the mean number of political appointees ("Political Apps") and beneficiaries are both four. On average, politicians and their appointees outnumber beneficiaries on the boards of the Largest Funds five to four.[74] The number of appointers variable ("# Appointers") is distinguishable from politicians and political appointees. It is a reference to the number of politicians who are either on the board or have appointing power to it; further, it is separate from the percentage of political control of a board. Rather, it measures the dispersal of political influence on the board. For the Largest Funds, the minimum number of appointers to the board is zero, the maximum is eight, and the median is two. The "Fin. Exp." variable is the number of individuals with experience in the financial industry who are required to serve as a member of the board. Board members with financial expertise are a rarity, and the median number of such experts on the boards is zero. Finally, the "Soc./Pol." variable is the score I assigned to the fund based on the number of social investment initiatives it maintains, on a scale of zero to eleven, with zero being no social investment initiatives (or an explicit prohibition on such initiatives) and eleven being the total number of different social initiatives I

[73] "Asset size" reported in millions of dollars, unless otherwise noted.

[74] Fourteen of the fifty-three Largest Funds contained at least one board member who was both a political appointee and a beneficiary. I coded such beneficiary appointees as half of an appointee, and half of a beneficiary. For the remaining thirty-nine Largest Funds, the categories of political appointees and beneficiaries were mutually exclusive. Interestingly, my data suggests that beneficiary appointees behave more like political appointees than like beneficiaries. See *infra* Part III.B.

have seen across all funds. No entity in the sample received a score higher than six on this scale.

Table 2 provides a breakdown of the Largest Funds by board orientation:

Table 2
Largest Funds by Orientation of the Board of Trustees
N=53

Majority Politicians and Their Appointees	32
Majority Beneficiaries	12
Majority Neither[75]	9

Thus, among the Largest Funds, those dominated by politicians outnumber those dominated by beneficiaries, thirty-two to twelve, while nine funds have majorities of neither elected officials nor beneficiaries.

B. *Lead Plaintiff Appointments of the Largest Public Pension Funds*

There were 824 securities fraud class actions filed between January 1, 2003 and December 31, 2006.[76] During this time period, public pension funds served as lead plaintiffs in 127 (15% of) cases.[77] If one counts co-lead plaintiff appointments, public pension funds obtained 187 lead plaintiff appointments in these 127 cases.[78] Just 49 of the 187 lead plaintiff and co-lead plaintiff appointments were obtained by Largest Funds,[79] representing only 26% of all public pension fund appointments. These 49 lead plaintiff appointments were obtained by just 20 of the Largest Funds – the remaining 33 of the Largest Funds obtained no lead plaintiff appointments at all.

The relatively small number of lead plaintiff appointments obtained by the Largest Funds suggests that these funds frequently forego the opportunity to be appointed lead plaintiff. Such funds have losses that are large enough to qualify them for a lead plaintiff appointment, or at least large enough to make them attractive as co-applicants for a lead plaintiff appointment with other

[75] Some funds have majorities of neither elected officials nor beneficiaries. In some instances, some board members have ex officio positions that they owe to neither elected officials nor beneficiaries, such as the head of a state or local board of education, or a state or local hospital. In addition, some boards may have an even number of elected officials or appointees and beneficiaries, and these board members jointly choose the tie-breaking vote-caster. Only two of the Largest Funds fall into the "neither" category. As will be seen below, some of the Filer funds also fall into this category.

[76] SCAS Dataset (on file with author).

[77] *Id.*

[78] *Id.*

[79] I excluded the Ontario Teachers Retirement System from the Largest Funds, because it is based in Canada.

funds, but they choose not to seek it. It may also be the case that some of the Largest Funds have simply failed to obtain lead plaintiff appointments after repeated efforts to do so.[80] The Largest Funds could also be forgoing participation in securities class actions either because they are avoiding litigation entirely, or, less likely, because they are opting out of the class to pursue a separate action against the defendants.[81]

Table 3 contains eight regression models for the Largest Funds, which regress several board variables against the number of lead plaintiff appointments obtained by the funds, ranging from zero to eight appointments. The variables include: the percentage of each board that consists of politicians, political appointees, beneficiaries, and financial experts; whether the board is composed of a political or beneficiary majority; the number of politicians on the board or with appointing power to it; and the number of social investment initiatives maintained by each fund, if any. I also used the fund's board size and the natural log of its asset size as control variables. Again, assuming that pay-to-play occurs, one would expect that the coefficients for politicians and their appointees would correlate statistically significantly with lead plaintiff appointments.

[80] Choi and Fisch report that 37.5% of the largest public pension funds in their sample attempted unsuccessfully to obtain a lead plaintiff appointment at least once. Choi & Fisch, *supra* note 40, at 331.

[81] For a comprehensive discussion of the growing practice of institutional investors opting out of securities class actions, see John C. Coffee, Jr., *Accountability and Competition in Securities Class Actions: Why "Exit" Works Better Than "Voice"*, 30 CARDOZO L. REV. 407, 409-10 (2008) [hereinafter *Accountability and Competition*]. Note that Coffee suggests that the first major securities case in which investors, including some public pension funds, opted out was the *WorldCom* case. *Id.* at 426. After losing the *WorldCom* lead plaintiff appointment, plaintiff lawyer William Lerach persuaded sixty-five of his clients to opt out of the class, including several public pension funds. Lorraine Woellert, *Fractured Class Actions: "Opt Outs" Are a Growing Headache for Companies*, BUS. WK., Feb, 27, 2006, at 31. The *WorldCom* opt out actions were settled in 2005. *Accountability and Competition*, *supra* at 426. Coffee further describes the opt-out "floodgates" opening for the *AOL Time Warner* securities class action, for which the opt-out actions were settled in 2007. *Id.* at 427. Most opt outs occur after a settlement in the class actions has been reached. *Id.* at 430. In *Time Warner*, Lerach persuaded ninety-three state public pension funds to opt-out. Woellert, *supra* at 31. Thus, the ostensible new trend towards opting-out appears to have begun at the tail end, or even after the time period studied in this Article, 2003-2006. Choi and Fisch report that of the twenty-four funds (not limited to just the largest funds) that responded to their opt-out question, sixty percent responded that they opted out. Choi & Fisch, *supra* note 40, at 331. These results may be explained by the *WorldCom* and *AOL Time Warner* opt outs.

Table 3, Model 5 demonstrates that the coefficient for boards with a political majority is both negative and significant at the ten percent confidence level. The coefficients for politicians and their appointees are, again, both negative, at Models 1 and 3, although not statistically significant. In contrast, Table 3 demonstrates that the number of beneficiary board members correlates positively and statistically significantly with lead plaintiff appointments, at the 5% confidence level in Models 2 and 4, and at the 1% confidence level in Models 6 and 7. The coefficient for boards with a majority of beneficiary board members is both positive and significant at the 1% confidence level in Model 6. Finally, the coefficient for the number of appointers to the board is both positive and statistically significant at the 5% confidence level in Models 6 and 7, and the 10% confidence level in Models 5 and 8. For each additional politician with appointing power to the board, which is a measure of the dispersal of political influence, and not control, (see below), the fund's lead plaintiff appointments increase.[82]

These regressions show that the presence of politicians and their appointees correlates negatively and statistically significantly with lead plaintiff appointments when this population constitutes a board majority; the percentage of beneficiaries correlates positively and statistically significantly with lead plaintiff appointments in all models. While the implications of this finding for the pay-to-play theory will be discussed in further detail below, in light of additional data, the regressions described above contradict the second hypothesis that politicians on public pension fund boards will correlate positively with lead plaintiff appointments. As noted, if pay-to-play were driving pension fund securities litigation activism, one would expect political influence to positively, not negatively, correlate with lead plaintiff appointments. Indeed, this data suggests a new theory that has not been discussed in the securities class action literature, a theory I will call "pay-not-to-play." Just as politicians can, and do, receive significant campaign contributions from, or are otherwise influenced by, plaintiffs' lawyers, they also receive contributions from, and are influenced by, Fortune 500 companies, accounting firms, technology firms, investment banks, and pro-business lobbies such as the U.S. Chamber of Commerce. Politicians may choose to encourage or discourage the litigation activism of public pension funds that they influence or control, depending upon their personal political ideology, the identity of their donors, and the political pressures they face. I will further discuss both pay-to-play and pay-not-to-play[83] below, in light of additional data.

[82] See *supra* Table 1 and accompanying text for a description of this appointment power.

[83] By "pay-not-to-play," I am not suggesting that politicians receive campaign contributions from potential or actual defendants expressly in return for protection from litigation. Instead, I suggest that politicians of both political parties are highly dependent on campaign contributions from the business community and are sensitive to actions that are deemed hostile to that community, including litigating against its members.

The correlation between the number of politicians either on the board or with appointing power to it and lead plaintiff appointments is intriguing. It is important to distinguish this variable from measures of political control over the board. Unlike the politicians and political appointee variables, the number-of-appointers variable is not a measure of elected official control but of the dispersal of elected official influence, as noted above. The results for this "# Appointers" variable mean that, for example, a board with four of its members appointed by four separate politicians (Board A) will seek more lead plaintiff appointments than a board with four of its members appointed by one politician (Board B). It may be that funds with a greater dispersal of elected official influence are less able to thwart lead plaintiff appointments sought by beneficiaries. It may also be that politicians become increasingly indifferent to obtaining or forgoing lead plaintiff appointments once "blame" for such appointments becomes shared by other politicians. A politician who can point to the other politicians with influence on Board A who voted to pursue a lead plaintiff appointment is better able to deflect criticism from unhappy constituents or campaign contributors than a politician on Board B who is solely responsible for Board B's decisions.

This correlation between the number of appointers and lead plaintiff appointments further undermines the pay-to-play theory. Assuming pay-to-play were the driving force in the funds' pursuit of lead plaintiff appointments, one would expect that the ideal board from the perspective of a plaintiffs' lawyer would be one that is majority-controlled by one politician, as the lawyer would save money on campaign contributions and time spent in developing political relationships, while offering a more certain return on investment. Put cynically, Board B is more cheaply bought than Board A. The fact that Board A is more active than Board B suggests that pay-to-play is not what motivates boards to obtain lead plaintiff appointments. As discussed below, pay-not-to-play could be restraining politically-dominated funds from obtaining lead plaintiff appointments.

Finally, as a subsidiary point, the boards of fourteen of the Largest Funds contained at least one political appointee who was also a beneficiary.[84] For the remaining funds, political appointees and beneficiaries are mutually exclusive. Interestingly, of these fourteen funds, eleven obtained no lead plaintiff appointments, suggesting that, on balance, an appointed beneficiary behaves more like an appointee than a beneficiary. Therefore, she is more likely to follow the appointing politician in shunning lead plaintiff appointments than to follow beneficiaries in pursuing them. This result coheres with research suggesting that beneficiary appointees behave more like appointees than like beneficiaries.[85] Similarly, of the seventy-eight Litigating Funds discussed below, only four contained at least one board member who was an appointed

[84] Because such beneficiary appointees fall into both the beneficiary and appointee categories, I split such board members by coding them as a 0.5 in each category.

[85] Romano, *supra* note 11, at 826-27.

beneficiary. On average, these four funds obtained 1.75 lead plaintiff appointments, compared to 2.5 appointments for the Litigating Funds overall, again suggesting that appointed beneficiaries tend to follow the trend of elected officials in resisting lead plaintiff appointments.

C. *Who Controls the Litigating Funds?*

As noted above, I report results for seventy-eight funds that obtained at least one lead-plaintiff appointment from 2003-2006.[86] The Litigating Funds obtained as few as one and as many as nine lead-plaintiff appointments. The Police and Fire Retirement System of the City of Detroit (Detroit P&F), with assets of $3.8 billion, obtained nine lead-plaintiff appointments in the four-year period, more than any other fund. The Mississippi Public Employees Retirement System, with assets of $15.4 billion, obtained eight appointments in the same time period, second only to Detroit P&F.[87] Table 4 below contains descriptive statistics for the Litigating Funds.

[86] In fact, eighty-one public pension funds obtained lead plaintiff appointments from 2003-2006. I excluded Ontario because it is based in Canada. I further excluded two other funds because I could not find sufficient data for them.

[87] The PSLRA added a "professional plaintiff" restriction to the Securities Exchange Act of 1934, stating that a person may be a lead plaintiff in no more than five securities class actions during any three year period, "[e]xcept as the court may otherwise permit." 15 U.S.C. § 78u-4(a)(3)(B)(vi) (2006). Detroit P&F, MSPERS, the City of Dearborn Heights Police & Fire Retirement System, the Teachers Retirement System of the State of Ohio, and the City of Dearborn Heights General Employees Retirement System all appear to have been appointed more than five times in a three year period. According to a House of Representatives Conference Report:

> Institutional investors . . . may need to exceed this limitation and do not represent the type of professional plaintiff this legislation seeks to restrict. As a result, the Conference Committee grants courts discretion to avoid the unintended consequence of disqualifying institutional investors from serving more than five times in three years.

H.R. REP. NO. 104-396, at 35 (1999). *See also In re* Critical Path, Inc. Sec. Litig., 156 F. Supp. 2d 1102, 1112 (N.D. Cal. 2001) (selecting an institutional investor as lead plaintiff even though the institution had served as lead plaintiff in more than five actions within the last three years). Some scholars have also argued that it is appropriate to exempt plaintiffs from the professional plaintiff restriction, especially where an institutional investor has developed a strong track record as a lead plaintiff. *See, e.g.*, *Does the Plaintiff Matter?*, *supra* note 25, at 1638.

Table 4
Litigating Funds Descriptive Statistics
(N=78)

	Mean	St. Dev.	Minimum	Median	Maximum
Asset Size	$11,724	$23,249	$28	$2,029	$148,840
Board Size	9.141	4.330	1	9	27
Politicians	1.385	1.789	0	1	12
Polit Appts.	3.032	2.502	0	2.75	13
Benefs.	4.340	3.157	0	4	15.5
# Apptrs.	1.974	1.377	0	2	8
# Fin. Exp.	0.385	1.416	0	0	10
Soc./Pol.	0.603	1.188	0	0	6

Influenced by the massive size of CalPERS, the mean asset size for the Litigating Funds is over $11 billion or slightly less than one-third of the mean asset size for the Largest Funds, which is $34 billion. The median asset size is more telling: at $2 billion, it is just eight percent of the median asset size for the Largest Funds.[88] Thus, the funds that obtain lead plaintiff appointments are significantly smaller than the funds Congress expected would obtain lead plaintiff appointments. For example, the diminutive Deerfield Beach Non-Uniformed Municipal Employees Retirement System, with just $51 million in total assets, obtained three lead plaintiff appointments, more than CalPERS, which is 2902 times larger and was only appointed twice. While Deerfield Beach is an extreme example, as is CalPERS, Largest Funds compose just twenty-six percent of the Litigating Funds.

Likewise, while median board size for both the Litigating Funds and the Largest Funds is nine, the composition of that board differs. The median Largest Fund board contains five politicians or political appointees versus four beneficiaries; the median Litigating Funds board contains four beneficiaries to 3.75 politicians, with between one and two unaffiliated board seats. Table 5 compares the board orientation of the Largest Funds to the Litigating Funds.

[88] *See supra* Table 3.

Table 5

Largest Funds Versus Litigating Funds
by Orientation of the Board of Trustees

	Largest Funds N=53	Litigating Funds N=78
Majority Politicians and Their Appointees	32	33
Majority Benefs.	12	23
Majority Neither[89]	9	22
Chi-Square Test P-Value		0.116

A two-way table chi-square test, demonstrates that there is no statistically significant difference between the two datasets in the distribution of funds by orientation of the boards of trustees.

D. *Lead Plaintiff Appointments of the Litigating Funds*

As aforementioned, the 78 public pension funds in my Litigating Funds sample obtained 187 lead plaintiff appointments between January 1, 2003 and December 31, 2006, out of 824 securities class actions.[90] Table 6 contains the same model regressions for the Litigating Funds that appear in Table 3 for the Largest Funds.

[89] Some funds have majorities of neither elected officials nor beneficiaries. In some instances, some board members have ex officio positions that they owe to neither elected officials nor beneficiaries, such as the head of a state or local board of education, or a state or local hospital. In addition, some boards may have an even number of elected officials or appointees and beneficiaries, and these board members jointly choose the tie-breaking vote. Just two of the Largest Funds fall into the "neither" category. As will be seen below, some of the Filer Funds also fall into this category.

[90] Usually, they would be appointed as co-lead plaintiffs with other public pension funds, so the number of cases with at least one public pension fund as lead plaintiff is less than 187.

As with the Largest Funds, the regressions for the Litigating Funds in Table 6 show that the number of beneficiary board members positively and statistically significantly correlates with lead plaintiff appointments in all models at the one percent confidence level. The number of politicians and political appointees correlates negatively with such appointments, statistically significantly so in Models 1 and 3 at the 10% and 5% confidence levels. The negative correlation between politicians, political appointees, and lead plaintiff appointments is even stronger for the Litigating Funds than it is for the Largest Funds, although the negative coefficient for boards controlled by a political majority was not statistically significant. As with the Largest Funds, the number of appointers to the board positively and statistically significantly correlates with lead plaintiff appointments, in all models, and presumably for the same reasons. Unlike the Largest Funds, here, board size is negative and statistically significant in all models containing a beneficiaries variable. The Pearson correlation[91] of board size and beneficiaries percentage on the board is 0.338 with a p-value of 0.002. Thus, board size becomes negative and statistically significant once beneficiaries are considered.

To examine the Litigating Funds in further depth, I also ran ordinal logistic regressions, dividing the funds into subcategories of those that obtained (a) one lead plaintiff appointment; (b) two to four lead plaintiff appointments; and (c) five or more lead plaintiff appointments between 2003 and 2006. The regressions below in Table 7 measure the chances of (a) becoming (b) and (c), and of (a) and (b) becoming (c).

[91] Christopher L. Peterson, *Usury Law, Payday Loans, and Statutory Sleight of Hand: Salience Distortion in American Credit Pricing Limits*, 92 MINN. L. REV. 1110, 1147-48 (2008) ("Pearson's Correlation is a way of summarizing the strength of a linear relationship between two variables with a single figure that ranges between 1 and +1. The stronger the relationship between the variables the closer the correlation is to +/-1.") (citation omitted).

Table 7 echoes Table 6 in almost all respects, with beneficiaries positively and significantly correlated with lead plaintiff appointments, and politicians negatively and significantly correlated with lead plaintiff appointments. Model 5 is the only model of all the regressions in this Article in which the number of appointers variable is not statistically significant. Of particular note in this regression is that two of the social investment criteria are positive and statistically significant, which will be analyzed below in Part III.F.

E. *The Never-Appointed Funds*

Thirty-three of the fifty-three Largest Funds obtained no lead plaintiff appointments. Based on the above conclusions, one would hypothesize that the Never-Appointed Funds would have more politicians and their appointees on their boards, fewer appointers to the board, and fewer beneficiaries on the board. Table 8 illustrates basic statistics for the Never-Appointed Funds, as compared with the Largest Funds that obtained lead plaintiff appointments (the "Largest Appointed Funds").

Table 8

Board Attribute	Largest Funds That Never Obtained Lead Plaintiff Appointment (LP = 0)	Largest Funds That Obtained Lead Plaintiff Appointment(s) (LP > 0)	P Value*
Board Size (mean)	8.364	10.050	0.107
Asset Size (mean/median)	31,082/20,272	38,540/26,995	0.370
% Politicians (mean)	15.3% (1.0)	21.3% (1.5)	0.472
% Political Apps (mean)	43.9% (3.758)	37.0% (3.625)	0.424
% Total Political (mean)	59.2% (4.758)	58.2% (5.125)	0.431
# Appointers (mean)	(1.788)	(2.8)	0.230
% Benefs (mean)	34.4% (3.273)	41.1% (4.825)	0.352
% Finan. Exp. (mean)	9.5% (0.727)	6.3% (0.550)	0.582
Soc./Pol. (mean)	(0.788)	(1.45)	0.185
N	33	20	

*=P value from two sided t-test of difference in means.

To some extent, the Never-Appointed Funds mirror the Largest Appointed Funds in terms of political domination: on average, politicians and their appointees make up 59.2% of Never-Appointed Funds boards, compared with 58.2% of Largest Appointed Funds boards. The distribution of that domination differs slightly, as 15.3% of the Never-Appointed Funds boards are composed of politicians themselves, compared with 21.3% of Largest Appointed Funds boards, with Never-Appointed Funds having 1 politician, and Largest Appointed Funds 1.5, on average. On the other hand, as expected, the Never-Appointed Funds contain fewer appointers to the board (1.788 versus 2.8) and a smaller percentage of beneficiaries (34.4% versus 41.1%). Thus, the higher number of beneficiaries on the Largest Appointed Funds boards, combined with a greater dispersal of elected official influence, may help tip the balance in favor of lead plaintiff appointments when compared with the Never-Appointed Funds boards. Moreover, the smaller absolute and relative number of politicians on Never-Appointed Funds boards may also play a role in keeping these funds on the sidelines of securities litigation. With one politician on average controlling the Never-Appointed Funds, compared to one

and a half for the Largest Appointed Funds, the lone politician can more easily exert control over her board. But these are at best tentative suggestions, as the structural differences between the Never-Appointed Funds and the Largest Appointed Funds are relatively small and not statistically significant.

One factor that may explain the difference between Never-Appointed Funds and Largest Appointed Funds is "pay-not-to-play," as discussed in Part V below. It may be that the Never-Appointed Funds are primarily located in states or cities in which the business community plays an unusually large and active role, making the politicians on these boards disproportionately reluctant to act against that community's interests. Conversely, Largest Appointed Funds boards may find themselves in states or cities in which the business community is either more muted or counterbalanced by some other interest group, organized labor, for example. The pay-not-to-play concept is discussed in further detail below, at Part V.

F. *Financial Experts on Pension Fund Boards*

While almost all funds will provide some financial training to their board members, only a small minority of funds require that at least one board member have prior experience in the financial industry. The relative dearth of financial experts on pension fund boards may be explained, in part, by prior research that demonstrates that board members' formal financial expertise does not correlate with fund performance.[92] The small percentage of funds that are required to have at least one financial expert on the board does not mean that most boards have no access to financial expertise.[93] Many funds require their board members to undergo at least some financial training. Moreover, all funds employ, either directly, or through outside consulting and advisory relationships, financial experts who are not board members. And just because the fund is not required to have at least one board member with prior experience in the financial industry does not mean that politicians or beneficiaries cannot select someone with such experience.

I hypothesize that financial experts would negatively correlate with lead plaintiff appointments, if at all, for three reasons. First, many financial experts are political appointees, and one would expect them to resist lead plaintiff appointments as their appointers do. Second, compared to other board members, financial experts may be more likely to view the potential for a securities class action in purely financial terms. As discussed above in Part I.B., the financial stakes for public pension funds are relatively low in any given securities class action, both in terms of the fund's losses relative to its asset size, and the likelihood of a small recovery. Financial experts may be less inclined to view a securities class action in moral or deterrent terms, as a

[92] Romano, *supra* note 11, at 840.

[93] *See, e.g.*, *id.* at 841 (stating that some states have established advisory councils of individuals with investment expertise who submit recommendations to the boards concerning investment strategy).

question of the fund taking action to recover assets of which it had been defrauded and punishing the wrongdoers, regardless of the relative size of the loss. Indeed, by making the presumptive lead plaintiff the individual or entity that lost the most money in absolute terms, and not the individual or entity that lost the most money relative to its own asset size, Congress and the PSLRA emphasize raw losses in terms of dollars, rather than in terms of the relative financial "pain" the victim suffers. Financial experts may take the view that the pain is often slight, unlikely to be wholly remedied, and simply not worth the costs, low as those costs may be.

Third, people with prior experience in the financial services industry may be less inclined to view conduct in the industry as fraudulent. They may have more sympathy for potential defendants, and they may take a more skeptical view of plaintiffs' lawyers and the benefits of litigation than people who have not worked in the industry.

The data on financial experts and lead plaintiff appointments are inconclusive. None of the results are statistically significant, and thus I can neither prove nor disprove the hypotheses regarding the role of financial experts on public pension fund boards.

G. *Social Investment Criteria and Litigation Activism*

The Social Investment Forum defines "socially responsible investing" as investing that (1) recognizes that corporate responsibility and societal concerns are valid parts of investment decisions; (2) considers both the investor's financial needs and an investment's impact on society; and (3) encourages corporations to improve their practices on environmental, social, and governance issues.[94] Social investment criteria take different forms. They may involve "screening" investment portfolios to include performers deemed socially responsible[95] and excluding performers deemed not to be.[96] Socially responsible investing may also involve community or local investing, or

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[94] *Socially Responsible Investing Facts*, SOCIAL INVESTMENT FORUM, http://www.socialinvest.org/resources/sriguide/srifacts.cfm (last visited on May 18, 2010).

> Socially Responsible Investing (SRI) is a broad-based approach to investing that now encompasses an estimated $2.71 trillion out of $25.1 trillion in the U.S. investment marketplace today. SRI recognizes that corporate responsibility and societal concerns are valid parts of investment decisions. SRI considers both the investor's financial needs and an investment's impact on society. SRI investors encourage corporations to improve their practice on environmental, social, and governance issues.

Id.

[95] *Id.* (stating that socially responsible performers may include those with "good employer-employee relations, strong environmental practices, products that are safe and useful, and operations that respect human rights around the world").

[96] *Socially Responsible Mutual Funds Charts: Screening & Advocacy*, SOCIAL INVESTMENT FORUM, http://www.socialinvest.org/resources/mfpc/screening.cfm (last visited on May 18, 2010) (including as a form of screening the exclusion of investments in tobacco companies).

shareholder advocacy.[97] The Uniform Management of Public Employee Retirement Systems Act (UMPERS) allows investors to consider social investments as long as such investments are themselves prudent, irrespective of their collateral social benefits.[98]

There is an ongoing debate about whether such investments harm the funds that adopt them. As Meir Statman described it, the debate concerns whether social investment criteria are about "doing well while doing good" or "doing good but not well."[99] A recent paper, co-authored by Statman, concludes that social investors incur a return disadvantage relative to conventional investors because they screen out "stocks of companies associated with tobacco, alcohol, gambling, firearms, military, and nuclear operations."[100] Investors who tilt their portfolios toward companies with high social responsibility scores – without screening out the low-scoring companies – actually outperform conventional investors.[101] Some advocates of social investment criteria have claimed that such investments can be structured to offer rates of return that are equivalent to those made purely to maximize profits,[102] while still other studies support the conclusion that social investing has no effect on fund performance.[103] Some critics of social investing assert that social investment criteria reflect the degree of political interference in the fund, arguing that funds that maintain such criteria do so at the behest of politicians who are

[97] *See Socially Responsible Investing Facts*, *supra* note 94.

[98] UNIF. MGMT. OF PUB. EMP. RET. SYS. ACT, § 8(a)(5) (amended 1997), 7A U.L.A. 63-64 (2004) ("In investing and managing assets of a retirement system . . . a trustee with authority to invest and manage assets . . . may consider benefits created by an investment in addition to investment return only if the trustee determines that the investment providing these collateral benefits would be prudent even without the collateral benefits.").

[99] Meir Statman, *Socially Responsible Investments* 1, 10, 11 (June 2007), *available at* http://ssrn.com/abstract=995271 (describing the two hypotheses); *see also* Romano, *supra* note 11, at 798 (concluding that there is an inverse relation between return on investments and policies favoring social investing for public pension funds).

[100] Meir Statman & Denys Glushkov, *The Wages of Social Responsibility* 1 (December 2008), http://www.socialinvest.org/resources/research/documents/2008WinningPrize-Moskowitz.pdf.

[101] *Id.*

[102] *Performance and Socially Responsible Investments*, SOCIAL INVESTMENT FORUM, http://www.socialinvest.org/resources/performance.cfm (last visited Sept. 17, 2010) ("A growing number of academic studies have demonstrated that [Socially Responsible Investment] mutual funds perform competitively with non-SRI funds over time . . . . The longest-running SRI index, the FTSE KLD 400, was started in 1990. Since that time, it has continued to perform competitively – with 9.51 percent total returns through December 31, 2009, compared with 8.66 percent for the S&P 500 over the same period.").

[103] Hess, *supra* note 11, at 211; *see also* Alicia H. Munnell & Annika Sundén, *Investment Practices of State and Local Pension Funds: Implications for Social Security Reform*, *in* PENSIONS IN THE PUBLIC SECTOR 153, 173-74 (Olivia S. Mitchell & Edwin C. Hustead eds., 2001).

interested in using the fund's resources to please assorted constituents at the expense of maximizing returns for beneficiaries.[104] The funds that maintain such criteria claim altruistic motives for them.[105]

I found a dozen varieties of social investment criteria across the 111 funds in my Largest Funds and Litigating Funds samples. These criteria include investments in: (1) women-owned businesses; (2) minority-owned businesses; (3) disabled-owned businesses; (4) urban renewal; (5) rural reinvestment; (6) "economically targeted investments," usually defined as investments to improve the local or national economy;[106] (7) environmentally-friendly businesses; (8) affordable housing or home loans; (9) businesses that maintain "responsible contractor" policies that pay "fair wages," often by hiring union labor; (10) the city or state in which the fund is domiciled; and divestment from (11) tobacco companies and (12) companies that do business in Northern Ireland and tolerate discrimination on the basis of religion (the "MacBride Principles"). I found no funds that maintained a policy of divestment from South Africa (known as the "Sullivan Principles") – a social investment criterion once widely adopted by public pension funds[107] – presumably because the funds now believe such a policy to be obsolete. Naturally, there is some overlap among the social investment categories enumerated above.

Nineteen of the fifty-three Largest Funds (thirty-six percent) and twenty-five of the seventy-eight Litigating Funds (thirty-two percent) maintain social investment criteria of some kind. I hypothesized that social investment criteria would positively correlate with lead plaintiff appointments, reasoning that funds that were activist in managing their investments would also be activist in litigating over investment losses caused by fraud.

In Tables 3 and 6, social investment criteria regressed against lead plaintiff appointments yielded no statistically significant results, although all of the coefficients for social investment criteria were positive. But in Table 7,

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[104] *See, e.g.*, Romano, *supra* note 11, at 801-02.

[105] For example, several public pension funds are members of CERES, "a national network of investors, environmental organizations and other public interest groups working with companies and investors to address sustainability challenges such as global climate change." *About Us*, CERES, http://www.ceres.org/Page.aspx?pid=415 (last visited May 20, 2010). Jorge Torres, Special Assistant to the Administrator of the Puerto Rican Government Employees' Retirement System, told me that the fund did not have social investment criteria. But it was aware that other funds maintained such criteria and that it was looking to adopt some such criteria of its own, "because it is the right thing to do." Telephone Interview with Jorge Torres, Special Assistant to the Administrator of the Puerto Rican Government Employees' Retirement System (Dec. 5, 2008).

[106] In 1994, the U.S. Department of Labor published Interpretive Bulletin 94-1 allowing public pension funds to make "Economically Targeted Investments" which are "investments selected for the economic benefits they create apart from their investment return to the employee benefit plan." 29 C.F.R. § 2509.94-1 (2009).

[107] Romano, *supra* note 11, at 809 (identifying eighteen state public pension funds with restrictions on investing in South Africa).

ordinal logistic regressions did yield two statistically significant results, showing a positive correlation between social investment criteria and lead plaintiff appointments, lending some support to my hypothesis. However, because the results are not very robust, I am reluctant to conclude that such a connection clearly exists. Perhaps further research will affirm or reject this suggested connection, but based on the data presented here, I can neither accept nor reject the hypothesis that social investment criteria correlate with lead plaintiff appointments.

Table 9 reports results from two sample t-tests run on both the Largest Funds and Litigating Funds samples.

Table 9
Two Sample T-Tests of Social Investment

Largest Funds

	N=53	Politicians on Board (mean)	# Appointers (mean)
No Social Investment Criteria	34	0.91	1.85
At Least one Social Investment Criterion	19	1.68	2.74
P-Value		0.091*	0.048**

Litigating Funds

	N=78	Politicians on Board (mean)	# Appointers (mean)
No Social Investment Criteria	53	1.32	1.64
At least one Social Investment Criterion	25	1.52	2.68
P-Value		0.620	0.001***

*=statistically significant at 0.10; **=statistically significant at 0.05; ***=statistically significant at 0.01. P-values are in parentheses.

Table 9 shows that funds that have at least one social investment criterion have more politicians on their boards. This result is statistically significant for the Largest Funds. Table 9 also shows that funds that have at least one social investment criterion have more elected officials on the board or with appointing power to it, which is statistically significant for the Largest Funds at the 5% confidence level and for the Litigating Funds at the 1% confidence

level. No such relationship was found for beneficiaries and social investments. The correlation between social investment criteria and politicians, the lack thereof between such criteria and beneficiaries, and the even higher correlation between social investment criteria and the dispersal of elected official influence, provide some support for the view that social investment criteria are a reflection of political pressure exerted on a fund. This last relationship suggests that social investment criteria are most likely to exist where political accountability is at its lowest and most dispersed. Politicians correlate with such criteria, but politicians who have cover from other politicians correlate most strongly with them.

IV. WHY DO BENEFICIARY BOARD MEMBERS SEEK LEAD PLAINTIFF APPOINTMENTS?

Previous research comparing beneficiary and politician board members provides some insight into why beneficiary board members may seek lead plaintiff appointments. Roberta Romano hypothesized that "board members who are elected by plan participants and are themselves fund beneficiaries are likely to be less susceptible to political influence or pressure because their personal retirement funds are at stake and their positions do not depend on the good graces of state officials."[108] Romano asserts that the correlation between improved pension fund performance and elected beneficiary board members coheres with the corporate finance literature showing that corporate performance correlates positively with the proportion of equity owned by management.[109] Michael Hess similarly compared beneficiary board members to independent, outside directors of a corporation, noting that the lack of political interference in outside directors' selection allows them to focus on shareholder interests and monitor their politically-affiliated counterparts.[110]

Romano found that the higher the number of beneficiaries on a public pension fund board – and the fewer politicians and their appointees – the higher the fund's returns,[111] supporting her hypothesis that "compared to boards with beneficiary-elected members, boards without elected members choose riskier social investments within asset classes, where the increased risk is firm-specific and hence not priced."[112] Hess, on the other hand, found that beneficiary-elected trustees had an inverted U-shape relationship with fund performance: beneficiary-elected trustees improved fund performance up until

[108] *Id.* at 820.

[109] *Id.* at 821.

[110] Hess, *supra* note 11, at 198.

[111] Romano, *supra* note 11, at 825.

[112] *Id.* at 827. These findings and hypotheses also cohere with Romano's view that social investment criteria are a measure not of a fund's altruism but of political meddling by elected officials eager to divert the fund's resources to state and local investments and towards their constituencies. *Id.* at 801-11 (describing examples of investments used for a broader social purpose at the expense of fund beneficiaries).

they constituted about half of the board, but performance dropped as beneficiary-elected trustees came to dominate the board.[113] Still, Hess concludes that "[m]ember-elected trustees' dedication to their duties also appears to be beneficial to plan financial performance."[114] Such trustees "are motivated, accountable to plan beneficiaries, and independent of political influence."[115] Both Romano and Hess recommend increasing the number of elected beneficiary board members to reduce the politicization of public pension funds.[116]

Romano's and Hess's conclusions provide some context for evaluating why beneficiary board members pursue securities fraud class actions. Beneficiary board members have their own money at stake – and those of their peers and co-workers – when making decisions for the fund in the same way that managers do in making decisions for a company in which they have equity. For such board members, alleged frauds and portfolio losses affect them personally, not merely in their roles as fiduciaries. From a fund-wide perspective, there may be little reason why politically-dominated funds should be less motivated to bring class actions than beneficiary-dominated funds. The same considerations of maximizing recoveries,[117] punishing wrongdoing, deterring future frauds, protecting investments, and instituting corporate governance reforms apply equally to both types of funds. But the personal investment of beneficiary board members may make them less inclined to allow some other institution or individual to lead the class and select class counsel. The fact that they can be held directly accountable to the beneficiaries who elect them may make them more likely to obtain a lead plaintiff appointment, rather than respond passively. It may also be that, just as beneficiary board members are associated with higher fund returns, beneficiary board members may actually obtain higher relative recoveries than their political counterparts, or may at least believe that they do.

Moreover, it could be that these cases are simply popular among fund beneficiaries, and that, while elected official board members are committed to other constituencies, beneficiary trustees are elected by the beneficiaries alone. All of the fund beneficiaries in this sample are public employees. They are police officers, firefighters, teachers, and other middle-class and working-class people. As public employees, they are, for the most part, modestly

[113] Hess, *supra* note 11, at 213-14.

[114] *Id.* at 217.

[115] *Id.* at 216.

[116] *Id.* at 217; Romano, *supra* note 11, at 799-800, 843-44.

[117] As noted above, institutional investor lead plaintiffs correlate with higher recoveries, though it remains unknown whether such investors are more effective lead plaintiffs or simply "cherry-pick" the best cases. *See, e.g.*, *Does the Plaintiff Matter?*, *supra* note 25, at 1601 & n.51 (citing Letter from Keith Johnson, Chief Legal Counsel, State of Wis. Inv. Bd., to Cox and Thomas (Mar. 10, 2003) (stating that pension funds vastly increase their recovery by taking the lead plaintiff role)).

compensated. More than a third of them belong to unions. Even if they have little pecuniary interest in the outcome of a case, they may be more likely to be offended by fraud, to want to pursue cases against corporate officials and corporations that commit fraud. Some public pension funds report that they believe serving as a lead plaintiff in a securities class action is simply the right thing to do, morally, for their members, and for the public. Bobby Deal, Chairman of the Board of Trustees of the Jacksonville Police and Fire Pension Fund, described to me some of his fund's motivation in obtaining lead plaintiff appointments: "Half of my guys carry axes, and the other half carry guns. We put bad guys in jail for a living. We are not about to sit back and let someone steal from our members and the investing public. We are going to do something about it."[118] The fact that some funds proudly tout their involvement in securities litigation to their membership provides at least some support for this theory.[119] The financial costs to defendants in litigating and settling such lawsuits, in addition to the potential embarrassment and exposure to those who committed the fraud, may motivate beneficiary board members to pursue such actions, even if the fund may have little to gain financially from the litigation. Such litigations may also give board members an opportunity to demonstrate to beneficiaries that they are doing something on behalf of the members. Securities litigation also provides a way for board members to build a record of achievement during their tenures in office.

Another explanation for public pension fund participation in securities class actions is that unions influence and control the funds. Some anecdotal evidence supports this view. For example, Sean Harrigan, the controversial former President of CalPERS who was forced to resign (see discussion below at Section V), simultaneously served as a senior official in the United Food and Commercial Workers Union (UFCWU). Shortly following UFCWU's four-month long strike against Safeway, Harrigan and CalPERS led a proxy campaign against Safeway President Doug Burd, seeking Burd's resignation. Harrigan was accused of using CalPERS's position as a Safeway shareholder to further the UFCWU agenda.[120] Regardless of whether this is true, it demonstrates the possibility that unions may use class actions to either further their own agendas or engage in coalition building with political partners, such as environmentalists, via various forms of shareholder activism.[121] Moreover,

[118] Conversation with Bobby Deal, Assistant Police Chief and Chairman of the Board of Trustees of the Jacksonville Police and Fire Pension Fund (June 3, 2010).

[119] *See., e.g.*, Paul O'Connell, *Your Pension Matters: Pompano Beach Police & Firefighters' Retirement System*, NEWSLETTER (Dec. 31, 2006), http://pbpfrs.org/newsletter.htm (touting the firm's role as lead plaintiff in four separate securities fraud class actions).

[120] Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Investors*, 60 STAN. L. REV. 1255, 1286 (2009).

[121] Ivan Osorio, *Union Pension Funds Go Green: But It's Not the Color of Money*, LABOR WATCH, Sept. 2008, at 1-5, http://www.capitalresearch.org/pubs/pdf/v1219863905.pdf; *see also* Progressive Policy Institute, *Making Green Waves* (May 14, 2004), *available*

thirty-six percent of public employees in the United States are unionized,[122] compared to just twelve percent of private sector employees. The fact that labor union funds are even more active in securities litigation than are public pension funds[123] demonstrates that unions are interested in bringing such cases.

A. *Hypothesis Testing for Beneficiary Board Member Pursuit of Lead Plaintiff Appointments*

1. Beneficiary Litigation Activism and Unions

To test the possibility that public pension fund participation in securities class actions may be driven by their degree of unionization, I analyzed state-by-state data on the percentage of public employees that were unionized in 2004.[124] I hypothesized that the state-by-state percent unionization of public employees would correlate with lead plaintiff appointments obtained by statewide public pension funds within the state, the percentage of beneficiary board members serving on the boards of those public pension funds, and beneficiary control of those boards. I found no correlation between percent unionization of public employees and either the number of lead plaintiff appointments or board composition. This finding undermines but does not eliminate the notion that public pension fund lead plaintiff appointments are driven by unions.

2. Beneficiary Pursuit of Lead Plaintiff Appointments and Pension Fund Underfunding

Underfunding is a chronic and widespread problem for public pension funds. In 2004, 73% of public pension funds were underfunded.[125] While the consequences of underfunding may pose political problems for members of a pension fund board who are elected officials, beneficiary board members, like other beneficiaries, are personally impacted by underfunding. An article in the

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at http://www.ppionline.org/ppi_ci.cfm?knlgAreaID=116&subsecID=900039&contentID=252635.

[122] Bureau of Labor Statistics, *Percent of employed, Government wage and salary workers, Members of unions*, U.S. DEP'T OF LABOR, http://data.bls.gov/cgi-bin/surveymost?lu (check the box for Series ID: LUU0204922700; then select "Retrieve Data") (last visited Oct. 1, 2010).

[123] *Motions for Lead Plaintiff*, *supra* note 30, at 42 (finding that union pension funds constituted 16.5% of lead plaintiff appointments, and public pension funds constituted 13.4% of such appointments).

[124] I obtained this data from a database assembled by Barry T. Hirsch and David A. Macpherson, at http://www.unionstats.com. For a description of this database, see Barry T. Hirsch & David A. Macpherson, *Union Membership and Coverage Database from the Current Population Survey: Note*, 56 INDUST. & LABOR REL. REV. 349, 349 (Jan. 2003), *available at* http://unionstats.gsu.edu/UnionStats.pdf.

[125] In the aftermath of the financial crisis, the percentage of underfunded funds has certainly increased.

Washington Post noted that underfunding forces funds to "[e]ither slash retirement benefits or pursue high-return investments that come with high risk."[126] For example, the underfunding of state pensions in New Jersey prompted its newly-elected Governor Chris Christie to propose capping sick leave payouts, mandating longer work weeks to qualify for benefits, and requiring beneficiaries to assume a greater share of their healthcare costs.[127]

There is great variation in public pension underfunding, and a few pensions are even overfunded. I hypothesize that the degree of a pension fund's underfunding correlates with lead plaintiff appointments. Board members of underfunded funds – especially beneficiary board members – may be particularly concerned about the financial condition of the fund. The fund's vulnerability could potentially affect their own retirement funds, and those of their co-workers and, perhaps, family members. Moreover, underfunding may make beneficiary board members' seats more vulnerable to challenges from other board members. Whereas politicians report to a broad constituency, beneficiary board members are responsible solely to the peer beneficiaries who elected them. Taking a lead plaintiff role to maximize recovery, ensuring the future soundness of the investment through corporate governance reform, and deterring future wrongdoing by the defendant or other entities in whom the fund is invested could be a means for beneficiary board members to signal to other beneficiaries that they are active stewards for the fund's finances.

To assess whether the degree of underfunding could affect a fund's pursuit of lead plaintiff appointments, I used a standard measure of a plan's ability to pay its unfunded actuarial liability: the ratio of unfunded actuarial accrued liability (UAAL) to annual covered payroll as of the actuarial valuation date (UAAL variable). The Governmental Accounting Standards Board requires public employee retirement plans to disclose this ratio. I also used the simple funding ratio for each fund, which is the actuarial value of assets as a percentage of the actuarial accrued liability, although this measure is considered less reliable than the UAAL variable because of differences in actuarial assumptions, amortization periods, and valuation methods across funds. I obtained these figures for the Largest Funds, when available. I found that the higher a fund's ratio of UAAL to annual covered payroll, the more lead plaintiff appointments the fund obtained, statistically significant at the 5% confidence level (p-value 0.032). When the UAAL variable is interacted with beneficiary control of the board, the statistical significance increases (p-value 0.021); when it is interacted with political control of the board, the significance disappears. This supports the notion that underfunding drives lead plaintiff appointments when beneficiaries control the fund, but has little influence when politicians control the fund.

[126] David Cho, *Steep Losses Pose Crisis for Pensions*, WASH. POST, Oct. 11, 2009, at A1.

[127] Claire Heininger, *State to Seek Pension, Benefits Overhaul*, STAR-LEDGER (Newark, N.J.), Feb. 8, 2010, at 1.

V. THE INFLUENCE OF POLITICIANS ON PENSION FUND LITIGATION ACTIVISM

This Article finds a negative correlation among politicians, their appointees, and lead plaintiff appointments. This finding cannot be said to rule out either form of pay-to-play: campaign contributions from plaintiffs' lawyers to politicians with control over public pension funds may spur funds that would otherwise not seek a lead plaintiff appointment to obtain one, and to select the contributing lawyers as lead counsel. Moreover, in certain instances, a politician may effectively control a board she does not actually control through majority vote, perhaps because she can find other ways to punish or reward board members she does not directly control. But overall, the finding suggests that "pay-to-play," to the extent it exists, is not driving most public pension fund litigation activism. If pay-to-play were a significant factor in a public pension fund's decision to become active in securities litigation, one would expect that politician board members would positively and highly correlate with lead plaintiff appointments. That the correlation is negative both for the Largest Funds and the Litigating Funds, coupled with the fact that the category of funds that has the highest degree of political control is the Never-Appointed Funds, suggests that while pay-to-play may indeed be occurring in certain instances, overall, it does not drive public pension funds to bring securities class actions. Moreover, my data suggest that business interests may influence elected officials to discourage lead plaintiff appointments, even where their funds would be well-positioned to obtain them.

To reiterate, I define pay-not-to-play not as the opposite of "pay-to-play," but as something broader. It is unlikely that anyone would contribute to a politician with the specific hope that the politician would restrain her public pension fund from pursuing a lead plaintiff appointment against the contributor or the contributor's allies, since some other party will likely bring the lawsuit anyway. pay-not-to-play simply suggests that politicians who are either themselves pro-business, who receive campaign contributions from business interests, or who are subject to other forms of pressure from business interests, are likely to avoid lead plaintiff appointments.

To empirically test if pay-not-to-play may be impacting the funds' pursuit of lead plaintiff appointments, I relied on a few metrics, including an annual survey of U.S. state liability systems conducted by the U.S. Chamber of Commerce Institute for Legal Reform (Chamber Survey), [128] and an annual survey of "The Best States for Business" by *Forbes Magazine* (Forbes Survey). The Chamber Survey focuses on how senior attorneys at companies

[128] HUMPHREY TAYLOR, DAVID KRANE & DIANA L. GRAVITCH, 2004 U.S. CHAMBER OF COMMERCE STATE LIABILITY SYSTEMS RANKING STUDY: FINAL REPORT. For state public pension funds, I used the rankings at Table 3 ("Overall Ranking of State Liability Systems") of the Chamber Survey. *Id.* at 15. For the five city public pension funds in the Largest Funds sample, I used Table 5 ("Local Jurisdictions with the Least Fair and Reasonable Litigation Environment"). *Id.* at 18. All four jurisdictions for the five city pension funds in the Largest Funds sample appeared in Table 5. *Id.*

with annual revenues of at least $100 million view the litigation environment in each of the fifty states.[129] The Forbes Survey ranks states' business-friendliness by several metrics, including business costs, the labor pool, regulatory environment, economic climate, growth prospects, and quality of life.[130] I utilize the Chamber Survey and the Forbes Survey as rough measures of how much influence big business has with state politicians, and, by extension, how much impact it has on the public pension funds within each state. I hypothesize that a state's ranking in the Chamber Survey and the Forbes Survey will negatively correlate with lead plaintiff appointments obtained by public pension funds in the state. Table 10 contains regression results for Chamber Rank and Forbes Rank.[131]

[129] *Id.*

[130] *See The Best States for Business*, FORBES, July 11, 2007, *available at* http://www.forbes.com/2007/07/10/washington-virginia-utah-biz-cz_kb_0711bizstates-table.html. The Forbes Survey began in 2006.

[131] The state-by-state election data for the 2004 election was obtained from *America Votes 2004*, CNN, http://www.cnn.com/ELECTION/2004 (click on menu "Pick state" and select state) (last visited Sept. 17, 2010).

As predicted, both variables are negative and statistically significant. The Chamber Rank variable loses its significance when included alongside variables of board control regressed in Table 3, but the Forbes Rank variable remains negative and statistically significant in all models. Note that in Models 6 and 7, the variables for beneficiary board members remain positive and statistically significant at the five percent confidence level. In contrast, the political control variable which was negative and marginally statistically significant in Table 3 loses its significance when regressed with the Forbes Rank variable here. This suggests that at least some of the resistance to lead plaintiff appointments by politicians is a product of their sensitivity to business interests. Once those business interests are accounted for, political resistance to lead plaintiff appointments flags. In contrast, business influence has effectively no impact on the correlation between beneficiary board members and lead plaintiff appointments. This evidence supports the proposition that public pension funds in business-friendly states tend to avoid lead plaintiff appointments or seek comparatively few such appointments. The Chamber and Forbes Survey results provide some support for the pay-not-to-play theory, demonstrating that politicians are sensitive to their constituencies and the special interests that act upon them, and, further, that where those constituents and special interests tend to lean in favor of business interests, lead plaintiff appointments do not follow. Campaign contributions from plaintiffs' lawyers, assuming they exist in such jurisdictions, may simply not be enough to tip the balance towards lead plaintiff appointments among politicians in states that are particularly sensitive to big business concerns. In addition, plaintiffs' lawyers, well aware of the pro-business orientation of the politician or of his state, might even avoid "wasting" campaign contributions there. Conversely, those states big business considers hostile have public pension funds that obtain more lead plaintiff appointments.

Several recent examples of business interests influencing public pension fund policies and decision-making provide indirect illustrations of how pay-not-to-play could operate in practice. For example, in late 2004, CalPERS President Sean Harrigan was ousted from the CalPERS Board, a coup attributed to the influence of the California Chamber of Commerce and the California Business Roundtable.[132] As noted earlier, Harrigan, an outspoken advocate for shareholder rights and corporate governance reforms, had led calls for the ouster of Disney Chief Executive Michael Eisner (who subsequently resigned in 2006) and attempted to force the resignation of

[132] Marc Lifsher, *State Pension Chief Expects to Be Axed*, L.A. TIMES, Nov. 30, 2004, at A1 (mentioning accusations of improper conduct leveled at Harrigan by the California Chamber of Commerce and the California Business Roundtable, and Harrigan's own attribution of his ouster to these entities, other business interests, and the administration of California Governor Arnold Schwarzenegger). *But see* Tom Petruno, *Business Applauds Shake-Up at CalPERS*, L.A. TIMES, Dec. 2, 2004, at A1 (stating that the California Republican Party and "business groups" denied lobbying for Harrigan's ouster).

Safeway CEO Steven Burd.[133] A regional executive for the United Food and Commercial Workers Union,[134] Harrigan had been viewed as a powerful advocate for corporate governance reform,[135] although some members of the corporate governance movement also criticized him for his aggressive tactics.[136] The State Personnel Board, a five-member board overseeing the state's civil service system, refused Harrigan's reappointment to the CalPERS Board.[137] Three of the State Personnel Board's members – two Republicans appointed by California Governors Arnold Schwarzenegger and Pete Wilson, and one Democrat – chose to support another candidate.[138] Harrigan's removal was particularly controversial in light of the fact that in the year 2003, under his leadership, CalPERS earned a 23.3% return on investment.[139]

Likewise, in response to pressure from the American Enterprise Institute, among others, Republican Governor Rick Perry of Texas ordered the state's public pension funds to divest from companies doing business with Iran, requiring the liquidation of positions the funds held in international energy conglomerates such as France's Total and Great Britain's Royal Dutch Shell.[140] The Texas funds' divestment was a reaction to a broader campaign by AEI and the U.S. Chamber of Commerce to highlight public pension funds' purported indirect financing of terrorism.[141] And while this particular episode

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[133] Lifsher, *supra* note 132 ("[Harrigan] said corporate and political interests – including Walt Disney Co. and supermarket giant Safeway Inc. – were 'trying to take out one of the most outspoken advocates on behalf of corporate governance in the country.'").

[134] *Id.*

[135] Petruno, *supra* note 132, at A1.

[136] Sundeep Tucker, *'Ideological Puritan' Who Alienated by Belligerence*, FIN. TIMES, Dec. 2, 2004, at 27 (describing Harrigan's public tirade against the International Corporate Governance Network Chairman over the Chairman's decision to appoint a corporate member to the Network's Board and noting that corporate governance community may have welcomed his departure as much as the business community did).

[137] Lifsher, *supra* note 132.

[138] *Id.*

[139] *Id.*

[140] Lucius Lomax, *Texas v. Iran: About the Order Banning Public Pension Fund Investments*, NEWSPAPER TREE, (Aug. 22, 2008) http://newspapertree.com/opinion/2770 (estimating that the Texas Teachers Retirement System and Employees Retirement System have in excess of $1 billion invested in affected companies); *see also Texas: Governor Seeks Divestment from Companies in Iran*, N.Y. TIMES, Jul. 19, 2007, at A21 (mentioning Governor Rick Perry's exploration of whether he has the authority to order state public pension funds to divest from companies doing business with Iran, and observing that he had already ordered divestment from companies doing business in Sudan because of the atrocities in Darfur); *Texas Governor Seeks Divestment from Companies Dealing with Iran*, HAARETZ, Jul. 19, 2007, *available at* http://www.haaretz.com/hasen/spages/883892.html.

[141] Jim Wasserman, *Corporate American Pushes Back: After Years of Concentrated Attacks by Public Pension Funds and Politicians, Companies and Allies Say 'Enough'*, ASSOCIATED PRESS, Jan. 3, 2005, *available at* http://www.commondreams.org /headlines05/

of business interests exercising influence over public pension funds postdates the timeframe of my lead plaintiff sample, I note that of the four Texas public pension funds that appear on my Largest Funds list – the Teachers' Retirement System of Texas ($77.8 billion in assets), the Employees' Retirement System of Texas ($18.8 billion in assets), the Texas County and District Retirement System ($10.0 billion in assets), and the Texas Municipal Retirement System ($10.3 billion in assets) – none obtained a lead plaintiff appointment between 2003 and 2006. More recently, Democratic Governor Steve Beshear of Kentucky invited the Kentucky Chamber of Commerce to participate in reforming the investment practices of the state's two major public pension funds, the Kentucky Teachers' Retirement System and the Kentucky Retirement Systems, including adding majorities of investment experts to the investment committees and reforming the allocation of assets in the investment portfolio.[142] The press release announcing the reforms prominently noted the participation of the Kentucky Chamber of Commerce, and further quoted its president and CEO, who stated, "[w]e support the changes embodied in this proposal and applaud the governor's leadership on this issue."[143] The Kentucky Teachers' Retirement System and the Kentucky Retirement Systems are both Largest Funds with $12.1 billion and $12.4 billion in assets, respectively. As with the Texas funds, the Kentucky funds obtained no lead plaintiff appointments from 2003-2006.

Setting aside the merits of this intervention by business interests in both the leadership and the investment decisions of public pension funds, the examples above illustrate the susceptibility of public pension funds to influence by business interests. Politicians who serve on public pension fund boards are just as exposed to political pressure – including campaign contributions – from business interests as they are from plaintiffs' lawyers. Strong opposition to securities class actions by business interests may reduce public pension fund participation in securities class actions, particularly by politically dominated funds, and particularly in states highly sensitive to such interests, or insensitive to countervailing interests.[144] The U.S. Chamber of Commerce, consistently

0103-23.htm.; *see also US Pension Funds Indirectly Support Terror: Report*, REUTERS, Aug. 14, 2004, *available at* http://www.financialexpress.com/news/us-pension-funds-indirectly-support-terror-report/112380/0.

[142] Press Release, Governor Steve Beshear, Gov. Beshear Calls on Pension Systems to Reform Investment Practices (Nov. 20, 2008), http://governor.ky.gov/pressrelease.htm?PostingGUID=%7BB18C3139-6834-48C4-9D70-E0073289D862%7D.

[143] *Id.*

[144] It may be argued that pay-to-play explains why the Largest Funds list and the Litigating Funds List are not more similar, or even identical, to one another. Most of the Largest Funds are statewide funds or funds from major cities. In contrast, most of the Litigating Funds are local municipal funds from small to midsized cities or counties. Campaign contributions to politicians serving on such fund boards are more difficult to track than contributions to politicians serving on statewide or large urban fund boards. Therefore, according to this reasoning, campaign contributions to these smaller funds will

one of the nation's largest campaign contributors, may take some comfort from this data that its contributions and lobbying efforts are having some effect in preventing public pension funds from leading shareholder lawsuits against the Chamber's members.

CONCLUSION

The data presented here demonstrate that politicians and political control negatively correlate with lead plaintiff appointments in securities class actions. This fact challenges the belief that the primary driver of public pension fund activism in securities class actions is "pay-to-play," the theory that the funds participate in securities class actions because politicians who serve on the funds' boards of trustees seek lead plaintiff appointments in exchange for campaign contributions from plaintiffs' lawyers. pay-to-play may be taking place in certain instances, and plaintiffs' lawyers undoubtedly contribute substantial sums of money to politicians with control over public pension funds (and to politicians with no control over the funds). But if pay-to-play were driving pension fund participation overall, politicians and political control would correlate positively, and not negatively, with lead plaintiff appointments. The data also provide some support for "pay-not-to-play;" to the extent that public pension funds are susceptible to political pressure, through campaign contributions and otherwise, that pressure tends to decrease the funds' participation in securities litigation, not increase it. Business interests appear to be successful in using political pressure to reduce lead plaintiff appointments. This may explain why the very largest public pension funds participate in securities class actions less frequently than one would predict.

Conversely, beneficiaries on public pension fund boards strongly and positively correlate with lead plaintiff appointments. Such funds may be pursuing lead plaintiff appointments because the beneficiary board members personally incur losses in securities frauds, and thereby are more highly

flow unnoticed; lawyers would rather make such contributions and politicians would rather receive them, since there is little chance for the public to discover such contributions, unlike politicians on Largest Funds boards. The counterargument to this is that local politicians at the small city or county level are hardly in need of campaign contributions, as they are not making significant purchases of advertising, for example. Such elections are much more likely decided by local manpower and local political machines than they are by elaborate political campaigns funded by significant campaign contributions. Moreover, a recent study suggests that large local public pension funds correlate with lower attorneys' fees for the class, which cuts against the suggestion that there is more pay-to-play at the local level. The *Price of Pay to Play, supra* note 10, at 22-24. But even if one were to accept the argument that the difference between the Largest Funds and the Litigating Funds is explained by plaintiffs' lawyers' preference to make (and politicians preference to receive) campaign contributions that will likely go unnoticed, this still does not explain why beneficiaries positively correlate with – and politicians negatively correlate with – lead plaintiff appointments for both the Largest Funds and the Litigating Funds samples.

motivated to take the lead in a class action to remedy the loss. This Article furnishes empirical support for this theory, showing that underfunded public pension funds are more likely to obtain lead plaintiff appointments, particularly when they are controlled by beneficiaries. Beneficiary board members may also pursue these cases because they are accountable to the narrow constituency of their peer beneficiaries who elect them, unlike politicians who serve a broader constituency. Moreover, as beneficiary board members are relatively immune to political pressures, business interests may be less successful, or may not even attempt, to reduce securities litigation activity among beneficiary-dominated funds.

While these facts do not rule out the possibility that pay-to-play is taking place in certain instances, they suggest that pay-to-play does not drive public pension activism in securities litigation. Overall, beneficiary board members – not politicians – drive these cases for reasons having to do with the financial soundness of the fund. These conclusions have potentially significant public policy implications. First, when considered with prior research demonstrating the efficacy of public pension funds as lead plaintiffs, and the skill of beneficiary board members as fund fiduciaries, this evidence supports the contention that the PSLRA's lead plaintiff provision is working as intended, and that, from the point of view of shareholders, public pension funds are desirable lead plaintiffs. Other jurisdictions that have begun to follow the PSLRA structure of lead plaintiff selection, such as Delaware, may take comfort that they have taken the correct approach. Moreover, courts faced with pay-to-play allegations may wish to use these findings to evaluate the board structure of the pension fund in question. If a politician on the board of trustees, or with appointing power to it, received a campaign contribution from a plaintiffs' law firm, but the board overall is actually controlled by beneficiaries or at least has substantial beneficiary representation, the court should be less concerned that the fund has been unduly drafted into a securities class action that is not in the interests of its beneficiaries, or shareholders overall. Finally, the fact that pay-to-play is not driving the bulk of public pension fund participation in securities class actions suggests that the numerous proposed legislative and administrative solutions to "pay-to-play," even if enacted, will be unlikely to have much impact on the rate of public pension fund participation in securities class actions.