Legal Mechanisms for Investors' Protection in the Securities Market of the United State – A Comparative Study, based on Brazilian Legislation

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1. Introduction

The purpose of this article is to draw a picture of how the securities markets in the USA are regulated, and to make Brazilian investors, and their attorneys, more familiar with the remedies available to protect investments in the US securities markets. In this introduction, we will compare briefly the tradition and evolution of both securities markets. Further in the article, we will analyze the relevant US regulations and the legal remedies available to aggrieved investors in the US securities markets, and give a brief description of the correlating statutes in Brazil.

Investments in the United States' financial markets are protected by federal laws that may be enforced by government agencies (principally, the Securities and Exchange Commission, commonly referred to as the "SEC") and/or by private investors. In addition, all of the individual states have laws protecting investors.

During the early development of the US financial markets, investors only could rely upon the laws of the various states for recourse if they were defrauded or deceived by companies trading on the US financial exchanges. However, in the aftermath of the historic US stock market crash of 1929, and the ensuing Great Depression, the United States Congress, which controls legislation nationally, enacted legislation to protect investors from fraud and deceit by those issuing and/or offering securities.

In Brazil, before the 1960's, investors typically focused on real estate, in order to avoid investing in public or private companies. At that time, inflation rates were extremely high and there were rules fixing the maximum interest rate legally acceptable in 12% aa. These factors

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contributed to limit the evolution of the securities markets in Brazil.

Such situation started to change in April 1964, when the federal government launched a program to make deep changes in the national economic system, including the restructuring of the financial markets. In that occasion, many laws were enacted, among others, Law 4.537/64, which created a money correction factor, Law 4.595/64, which restructured the system of financial intermediates and created the Central Bank of Brazil, and, mainly, Law 4.728, dated April 14th, 1965, our first law in securities, which regulated this market and established actions for its development.

The enactment of these Brazilian statutes resulted in structural changes in the stock market, such as the reformulation of the legislation regarding the stock exchanges, the creation of investment banks and the professionalization of brokerage.

The increased investments in the Brazilian securities market, together with various tax benefits granted by the federal government, produced a rapid growth in the demand for stock without a simultaneous growth in the offerings. This caused increased speculation, constantly driving the stock prices up.

By July 1971, sophisticated investors started to sell their shares. This sell-off coincided with new stock offerings. The consequences of the boom were suffered during several years of economic depression, when the shares of many companies proved to be worthless, generating losses to investors and an overall distrust in the market.

Those years of economic depression were followed by the government's several attempts to regulate directly the securities market and to encourage investments by effectuating tax exemption in gains obtained at stock exchanges, deductibility of investments from income tax, and financing lines granted by the National Bank of Economic and Social Development (BNDES).

Since the 1990's, with the opening of the Brazilian economy to foreign markets, the number of foreign investors has increased significantly. In addition, Brazilian companies have started to have access to overseas markets by listing their shares on other stock exchanges, mainly on the New York Stock Exchange, under the format of American Depositary Receipts.

The tradition of securities' regulation has been significantly different in Brazil and

the US. Some very relevant Brazilian acts mirror the US regulations, but some factors, such as the government's intervention in the market and the notorious slowness in the Brazilian judicial system, make both markets operate differently.

2. Laws relating to investments

The US laws relating to investments in securities are well-developed and complex. They are based upon a philosophy of disclosure: that it protects the integrity of the financial markets to require issuers of stock and offerors of stock to disclose fully all material information that reasonable shareholders would need in order to make up their minds about their investments.

On the federal level, the Securities Act of 1933[1], (the "Securities Act") and the Securities Exchange Act of 1934[2], (the "Exchange Act") are the most potent laws protecting US investors from fraud, misrepresentation, false and misleading statements, and/or the failure to disclose material information[3]. Public companies raise billions of dollars annually by issuing securities in the primary market. The Securities Act regulates these original issues, also known as "initial public offerings" or "IPO's", as well as subsequent securities offerings. The Exchange Act largely regulates the secondary trading of those securities in the stock markets, such as trades that retail investors execute for their investor clients through brokerage firms or over stock exchanges.

The Securities Act effectuates its disclosure policy by requiring that any offer or sale of securities be registered with the SEC. In general, registration forms call for a description of the company's properties and business, a description of the security to be offered for sale, information about the management of the company, and financial statements certified by independent accountants.

While the SEC requires that the information provided be accurate, it does

[1] 15 USC. § 77a, et seq.
[2] 15 USC. § 78a, et seq.
[3] There are other laws which also may come into play. For example, the Investment Company Act of 1940 regulates the organization of companies, including mutual funds, the Investment Advisers Act of 1940, regulates investment advisers. The Sarbanes-Oxley Act of 2002 mandated a number of reforms to enhance corporate responsibility, enhance financial disclosures, and combat corporate and accounting fraud. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, a result of the recent turmoil in the US financial markets, sets out to reshape the US regulatory system in a number of areas, among them credit ratings, regulation of financial products, corporate governance, disclosure, and transparency.

not guarantee it. Investors who purchase securities and suffer losses have recovery rights against the companies issuing their shares (and other persons or entities involved in the offerings) if they can prove that there was incomplete or inaccurate disclosure of important information.

The Exchange Act, too, is designed to force companies to disclose public information that investors would find important to making investment decisions. The Exchange Act's mandatory disclosure system requires publicly traded companies to report both periodically (annually and quarterly) and to report certain critical points (for example, proxy materials, tender offers, and other current events[4]). The Exchange Act prohibits fraud and establishes penalties for those who defraud investors, as well as those who engage in insider trading. ("Insider trading" is where corporate insiders use information most investors do not have to trade profitably for their own benefit.).

The Exchange Act empowers investors by providing them with a right to bring a private lawsuit against persons and companies who have defrauded them. The Exchange Act antifraud provision is used against all kinds of behavior, including false and misleading statements in company filings and documents, to insider trading, to market manipulation cases. In a private lawsuit under the Exchange Act, investors can recover the inflation in the stock price due to the false or misleading statement or the failure to disclose material information. Under the Securities Laws in the US, the SEC can sanction, fine, and otherwise discipline market participants - both organizations and associated individuals - who violate federal securities laws.[5]

[4] The full breaths and extent of the federal securities laws n the US and the required disclosure filings under them are beyond the scope of this article. For a comprehensive description of the various laws and forms, including their detailed texts, see the website of the SEC, www.sec.gov, or contact Wolf Popper LLP.

[5] In 2010, the U.S. Supreme Court issued an opinion which limited the extent of the application of the U.S. federal securities statutes. In *Morrison v. National Australia Bank LTD.*, __ U.S. __, 130 S. Ct. 2869 (2010), the court held that a claim brought by foreign investors against a foreign company based on securities transactions in foreign countries (this is referred to as a "F-cubed" or "foreign cubed" case), could not be litigated in the United States under the antifraud provision of the Exchange Act. Morrison reiterated the "longstanding principle that legislation of [the U.S.] Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States." The court reasoned that the focus of the Exchange Act is "upon the purchase and sales of securities in the United States." 130 S. Ct. at 2877. The scope of that decision is still being developed in the lower federal courts. *See, e.g., Absolute Activist Value Master Fund Ltd. v. Ficeto,* 2012 U.S. App. LEXIS 4258 (2d Cir. Mar. 1, 2012). It should be emphasized, however, that the *Morrison* decision does not necessarily preclude foreign investors from suing in the courts of the United States, particularly when the securities are those of a

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Unlike the civil law system in Brazil, the United States is a common law jurisdiction. There are statutes and codes, but not all the laws are written, or fully explained, in them. Most US laws are developed through opinions written by courts. (This is called "case law".) Even where a statute exists, usually there are many court opinions that clarify what the law means and how it is applied in different situations.

A few examples of types of cases brought under the Exchange Act, and the types of defendants involved, are the following: A state public pension fund brought a securities fraud action against Motorola, Inc. and three of its former senior officers, *In re Motorola Securities Litigation*, Case No. 03 C 00287 (N.D. Ill.). The case involved alleged false statements and omissions by defendants in Motorola's filings with the SEC about Motorola's vendor financing to Telsim, a Turkish wireless telecommunications start-up. Following comprehensive trial preparation over almost four years, the litigation was settled for $190 million three business days before the start of trial in April 2007.

company listed and purchased on a stock exchange in the U.S.

Investors in the largest complex of Bernard Madoff "feeder funds" – those marketed by the Fairfield Greenwich Group (FGG), are currently prosecuting an action against FGG to recover for the well-publicized fraud perpetrated by the now infamous Bernard Madoff, *Pacific West Health v. Fairfield Greenwich Grp*, 09-cv-0118(VM) (S.D.N.Y.).

The court has already issued an opinion sustaining most of the claims asserted by plaintiffs against FGG, the FGG corporate and partnership entities, the individual executives and partners of FGG, the Citco entities, and the Canadian and Dutch offices of the accounting firm of PricewaterhouseCoopers, including claims for securities fraud, common law fraud, breach of fiduciary duty, gross negligence, negligent misrepresentation, third party beneficiary breach of contract, unjust enrichment, and aiding and abetting fraud and breach of fiduciary duty.

Several years ago two cases were prosecuted against Mattel, Inc. (the manufacturer of perhaps some of the most widely recognized toy products in the world) primarily in connection with statements made regarding Mattel's financial condition and its acquisition of a company named The Learning Company, Inc. One case was prosecuted under the

proxy provision of the Exchange Act (§14(a)), in which it was alleged that the proxy sent to shareholders of Mattel seeking approval of the merger of The Learning Company into Mattel contained false and misleading statements and omitted material information important to investors, *Dusek v. Mattel, Inc.*, CV-99-10864-MRP (C.D. Cal.). The second case was prosecuted under the antifraud provision of the Exchange Act (§10(b)). Following extremely hard-fought litigation, both cases entered into a settlement for the aggregate sum of $122 million, half of which was attributed to each case (the $61 million allocated for the Dusek §14(a) claims is believed to be the then largest settlement of a §14(a) case).

As a different type of securities fraud case, an action was brought in Florida involving Sunbeam Corporation, 98 8258-CIV Middlebrooks (S.D. Fl.). Although Sunbeam itself was bankrupt, the plaintiffs in the case succeeded in recovering $110 million from the accounting firm that certified Sunbeam's financial statements, Arthur Andersen, one of the largest settlements ever with an accounting firm, and $31 million from the remaining defendants.

In connection with a company merger or acquisition, investors sometimes believe they have been offered inadequate compensation for their stock. Also, directors and managers frequently have conflicts of interest which prevent them from maximizing shareholder value. In these instances, shareholders may bring actions to obtain, among other things, a fair price for their stock or to stop the unfair transaction from occurring. These types of claims are controlled by the laws of the various states not, generally, federal law (unless a false and misleading proxy is issued in connection with a vote on the transaction and then the investor may opt to bring an action in federal court alleging violations of the proxy provisions of the Exchange Act).

Also controlled by states' laws are actions against stock brokers by their customer/investors who have been harmed by their brokers conduct, such as violations of professional duties of fair dealing, or breaches of fiduciary duties. These types of cases are usually governed by the agreements which individual investors sign with a brokerage firm, which typically require that disputes be resolved by arbitration proceedings.

Different types of cases may be brought in court by investors against their brokerage, bank, or other advisor firm, depending on the nature of the claim as well as the

nature of the relationship between the investors and the brokerage bank or other advisor firm. For example, many large investors such as public pension funds are currently prosecuting cases against BNY Mellon and State Street Bank which executed foreign exchange transactions for them. The lawsuits generally claim that the banks priced the transactions to their clients at the worst rates at which the currencies had traded during the day rather than at the market rate at the time of the trade – and then the banks pocketed the difference. The complaints allege that this conduct breaches the fiduciary duties owed by the banks to their customers, and breaches the contracts between the customers and the banks.

Cases under state law involving mergers or acquisitions are often brought on an expedited basis. That is, in a merger or acquisition there is a date by which the transaction is scheduled to close (usually in a matter or weeks or a few months).

Plaintiffs often attempt to enjoin the transaction from closing pending a change in the terms of the transaction -- such as an increase in an offer price or the reduction of benefits to insiders -- and/or the disclosure of additional material information to shareholders voting on such transactions so that they can make an informed decision whether to vote in favor of the transaction or against (or whether, for example, to seek an appraisal of the value of their shares, if applicable). If the shareholders are unsuccessful in enjoining the transaction, in various states the lawsuit may still proceed with the plaintiffs' attempting to prove that the defendants breached their fiduciary duties, such as by unfairly structuring the transaction. Under such circumstances, the lawsuits will take longer than when they are prosecuted on an expedited basis.

A couple of simple examples of this type of litigation are the following: In the *Aramark Corporation Shareholders Litigation*, Consolidated C.A. No. 2117-N (Del. Ch.), in which a public pension fund challenged a transaction in which Aramark's Chief Executive Officer/Chairman of the Board of Directors, along with other members of management who controlled approximately 40% of the total voting power of the Company and various financial sponsors, sought to buy out Aramark's public shareholders.

As a result of the litigation, the initial buyout proposal was increased by an aggregate financial benefit to Aramark's public shareholders of $222 million, and members of the management buyout group agreed to reduce their voting power

to one-tenth of what they were otherwise entitled to, thus giving the public shareholders the unfettered power to veto the buyout transaction if they so desired. In *Rice v. Lafarge North America, Inc.*, Civil No. 268974-V (Consolidated) (Circuit Court, Md.), a trust fund challenged a $3 billion Tender Offer made in 2006 by the majority shareholder of Lafarge North America, Inc. ("LNA") at $75 per share as being grossly inadequate to LNA's minority public shareholders. After litigating their claims, Plaintiffs ultimately settled the case after LNA's majority shareholder increased its Tender Offer to $85.50 per share, a $383 million aggregate increase to Class members from the initial Tender Offer price challenged by the litigation.

In Brazil, for a long time, the capital markets could not grow in importance due to the lack of protection to the public shareholders and the instability of the financial regulations. In addition, lack of transparency in the management and the absence of adequate corporate mechanisms to supervise the offer of shares contributed to the distrust in this type of investment and impacted the risk perception of investors.

In the last decade, we have witnessed some institutional and governmental initiatives aiming at the improvement in the corporate governance practice of Brazilian rules. In this context, it is worth mentioning the enactment of Law 10.303/01 and the creation of the so-called New Market, which classifies the listed companies into different categories depending on the level of corporate governance each of them practices. However, in terms of information disclosure, the securities regulations in Brazil are still far from ideal.

A crucial reason for that is that the financial market in Brazil is relatively recent and not as mature as the US market. In this regard, most of the agents simply lack experience and expertise in the matter.

3. Procedure of Lawsuits

Federal securities cases in the US prosecuted by private investors are often initially brought as class actions. In a class action, known as a collective action in Brazil, one aggrieved party can bring a lawsuit purportedly representing all others parties with the same problem. Through a procedure during the litigation known as "class certification," the named plaintiff (or plaintiffs) seeks to establish that many others have been similarly defrauded by the defendant company, and that the moving party is able to represent the

interests of all other shareholders similarly situated with respect to the claim at issue.

Investors may also prosecute securities actions as individual actions, but because of the complexity of these lawsuits, such investors (whether private investors or public pension funds) usually have very significant losses to make the effort of a case worthwhile. Such non-class actions are often litigated concurrently with any class action involving the same defendants.

The Private Securities Litigation Reform Act of 1995[6], (the "PSLRA") significantly changed the way private federal securities actions in the US are prosecuted. The PSLRA adopts a procedure that is designed to give investors, particularly those with a greater financial interest, i.e., losses, greater control over the conduct of the class action litigation.

The legislation creates a procedure for a Court to appoint as a "lead plaintiff" the member or members of the purported plaintiff class that the court determines to be most capable of representing the interests of the class. The act requires that a plaintiff filing a class action complaint bringing claims under the Securities Act or the Exchange Act must publish a notice, within 20 days of the filing of the complaint, advising members of the purported class that any class member has 60 days in which to ask the Court to serve as lead plaintiff.

The bill creates a presumption that the class member that has the "largest financial interest in the relief sought by the class" is the most adequate plaintiff to represent the class.

There is no exact length of time that it may take to prosecute a case under the U.S. securities laws from start to finish (whether that finish is by settlement or a judgment after trial). Some cases take 2-3 years while others take 4 or more years. It depends on many things, including the nature of the case, the facts, the particular court and judge, and the litigation strategies of the attorneys and their clients.

A case is commenced by the filing of a complaint. As indicated above, under the PSLRA, the notice must be published within 20 days of the filing of the complaint and class members have 60 days to file a motion seeking to be appointed to serve as the lead plaintiff. Courts usually rule promptly on such motions.

[6] 15 USC. § 78u-4, *et seq.*

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Thereafter, it is often the procedure to file a consolidated complaint. Defendants usually file motions to dismiss the complaints. The papers filed by the attorneys on such motions are often filed within several weeks or a few months. There is no set time period for the courts to issue a ruling on such motions; sometimes rulings are issued in a matter of days or weeks and sometimes not for many months.[7]

If the complaint is sustained (in whole or part), the case usually proceeds to the next stage, which involves discovery of the facts, including review of documents and the taking of depositions of witnesses. If the case is brought as a class action, then at some point (usually pursuant to a negotiated schedule), the plaintiff will file a motion with the court seeking to have the court officially certify the action to proceed as a class action (i.e., put its "stamp of approval" on the case that it is a proper class action).

As part of this class certification process, the plaintiff usually produces documents regarding its transactions in the securities of the company at issue, as well as other documents that defendants might seek or be entitled to. Defendants also often take the deposition, that is, ask questions in person under oath, of the plaintiff or, if the plaintiff is some form of business entity, the appropriate representative of the business entity. Once the court rules on the class certification motion, under recent revisions to the laws and procedures in the U.S., the losing party might try to seek appellate review of that decision.

Once discovery has begun, the case generally proceeds through the litigation process until it is resolved, by motion, settlement, or trial (sometimes the losing party might appeal the loss to the appellate court). Accordingly, it is difficult to predict how long a case might take to work its way through the judicial system.

Securities cases in the U.S., particularly class actions, are generally handled on a contingent fee basis, that is, the plaintiff incurs no attorneys' fees unless and until there is a resolution of the case to the benefit of the plaintiffs and the fees come from the recovery (or, if applicable, are otherwise paid by defendants or their insurers).

[7] If the complaint is upheld in whole or in part, the losing party may try to have the ruling reversed by an appellate court. If the complaint is dismissed, sometimes permission is granted to file an amended complaint and the motions to dismiss begin anew. If permission to file an amended complaint is not granted, the plaintiff may decide to take an appeal of the dismissal. Appeals to appellate federal courts in the U.S. can take several months to a year or more, depending on the court.

Similarly, unless prohibited by a particular state, costs in a case (typically out of pocket expenses such as photocopying, travel expenses, costs of depositions, etc.) are advanced by the plaintiffs' attorneys and also generally handled on a contingent basis. Like their fees, plaintiffs' attorneys are re-paid for costs only if the lawsuit is successful.

4. Conclusion

As opposed to the Brazilian legal regulations on securities, the US laws are extremely complex and detailed, and a deep knowledge and precise legal support from in the sector are essential to the success of an investor's claim.

US courts are more familiar with this type of sophisticated claim, which motivates the party who suffered the damages to pursue fair compensation. As seen above, proceedings and costs involved in US actions are significantly different from those involved in a similar claim in Brazil. As a result of the well-developed laws relating to the securities investments and the familiarity of the US courts with complex actions, distressed investor should be encouraged to pursue fair compensation in the US for losses related to their investments there.