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Is "Pay-to-Play" Driving Public Pension Fund Activism In Securities Class Actions?

An Empirical Study

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ABSTRACT

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 paper provides a comprehensive analysis of the securities litigation activity of 111 such funds from the years 2003 through 2006. Three of the paper'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 paper 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 paper 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.

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INTRODUCTION

Every week, the panic over "pay-to-play" in securities class actions continues to grow, with the *Wall Street Journal* running a front page article and two lead editorials on the subject since November 2009,[1] and the U.S. Chamber of Commerce furiously lobbying on several fronts—for securities litigation reform, against a proposed consumer finance protection agency[2]—citing "pay-to-play" concerns. At the core of this frenzy is the substantial role played by public pension funds as lead plaintiffs in these cases. 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 the 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 has previously been viewed as the welcome participation of public pension funds in these cases.

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[1] *See*, *e.g.*, *Pay to Play Torts: Pension middlemen get investigated, lawyers get a pass*, THE WALL STREET JOURNAL, Oct. 31-Nov. 1, 2009 at A18, *available at*: http://online.wsj.com/article/SB10001424052748704107204574473310387443816.html (calling for investigation of purported "pay-to-play" between plaintiffs law firms and public pension funds); Mark Maremont, Tom McGinty, and Nathan Koppel, *Trial Lawyers Contribute, Shareholder Suits Follow*, THE WALL STREET JOURNAL, Feb. 3, 2010 at A1, *available at*: http://online.wsj.com/article/SB10001424052748703837004575013633550087098.html (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: States Begin to shine light on the plaintiffs bar-AG business*, THE WALL STREET JOURNAL, Feb, 12, 2010 at A22, *available at*: http://online.wsj.com/article/SB10001424052748703630404575053460496978800.html (praising reforms designed to reduce purported "pay-to-play") .

[2] United States Chamber Institute for Legal Reform, *Securities Class Action Litigation Reform*, Nov. 6, 2007, at 11-12, *available at* http://www.instituteforlegalreform.com/issues/docload.cfm?docId=1071 (calling for reform of "pay-to-play" in securities class actions; 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 at 33 (April 8, 2008), 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)(competing class counsel argued 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 paper 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.

Prior research has demonstrated that public pension funds have performed admirably in the leadership role, increasing recoveries for the class, procuring corporate governance reforms, improving board independence, and reducing attorneys' fees.[6] This paper 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 are elected by peer beneficiaries to the board)—not politicians. These beneficiary board members are primarily motivated to 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, as sophisticated investors with significant losses at stake, institutional investors 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 enabling these lead plaintiffs to select counsel for the class.[9]

This is the first paper 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 that are controlled by

[6] See discussion *infra* at Section I(B).
[7] S. Rep. No. 104-98, at 10-11 (1995) *reprinted in* 1995 U.S.C.C.A.N. 679, 689-90 ("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"… the Committee permits the lead plaintiff to choose the lead 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 "Institutions with large stakes in class actions have much the same interests as the plaintiff class generally; thus, courts should 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. 104-98, 1995 U.S.C.C.A.N. 679, 690, at n. 34 quoting Elliot Weiss & John 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) (hereinafter "Weiss & Beckerman").
[9] 15 U.S.C.A. § 78u-4(a)(3)(B)(iii)(I)(bb)("(1) 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… (b) in the determination of the court, has the largest financial interest in the relief sought by the class").

politicians versus those controlled by beneficiaries.[10] It also uses the largest sample of public pension among papers 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 comprise 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, the paper 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—negatively correlates with lead plaintiff appointments, whereas the percentage of board seats controlled by beneficiaries—or outright beneficiary control of the board—positively correlates with such appointments. The paper 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; there would be little sense in plaintiffs' lawyers paying politicians who could not deliver the "play". Instead, as is discussed at length below, the funds' 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 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

[10] *Cf.*, Stephen J. Choi, Drew T. Johnson-Skinner, and A.C. Pritchard, "The Price of Pay to Play in Securities Class Actions", University of Michigan Law School, John M. Olin Center for Law and Economics Working Paper No. 09-025, available at http://ssrn.com/abstract=1527047 (January 21, 2010 draft) (focusing on attorneys fees, this paper argues that above-median asset size state public pension funds lower attorneys fees regardless of whether the funds received campaign contributions, although the paper concludes that this advantage disappears when the funds have received a "high contribution." 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 Johnson-Skinner, *Paying-to-Play in Securities Class Actions: A Look At Lawyers' Campaign Contributions*, 84 N.Y.U. L. Rev. 1725 (2009) (noting 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 and not statistically significantly with financial performance); David Hess, *Protecting and Politicizing Public Pension Fund Assets: Empirical Evidence on the Effects of Governance Structures and Practices*, 39 U.C. Davis Law Review 187, 211 (2005) ("member-elected trustees' dedication to their duties also appears to be beneficial to plan financial performance... [such trustees] are motivated, accountable to plan beneficiaries, and independent of political influence".

funds that are already under-resourced, but because they are directly accountable to the fund's beneficiaries and can be voted off the board. They therefore have a greater incentive both to take action to remedy the loss, and to be viewed as zealously guarding and advancing the fund's bottom line. The paper 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 this responsiveness of politicians to business interests, either because of campaign contributions from such interests or because of responsiveness to pro-business constituents generally, as "pay-not-to-play". Finally, the paper examines the impact of other structural features on the funds' litigiousness, including whether financial experts on the board or social investment criteria impact lead plaintiff appointments.

The paper 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 played by beneficiary board members in securities class actions, including the connection between 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. Part VI concludes.

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

[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

substantial Democratic support,[13] the PSLRA fulfilled a political commitment to securities litigation reform enshrined in the Contract With America, a document released six weeks before the November 1994 mid-term election by the Republican Party and signed by all but two of the party's House candidates.[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 originated by Elliott Weiss and John Beckerman 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 usually would appoint as the lead plaintiff whichever plaintiff filed the first lawsuit.[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, or even fractions of shares, in a broad array of companies, and permitted the law firms to file a quick lawsuit on their behalf in the event of an alleged fraud.[19] In some extreme instances, plaintiffs'

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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*, THE NEW YORK 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. The ninth of these bills was entitled, "The Common Sense Legal Reform Act," which included provisions for the reform of securities class actions. See http://www.house.gov/house/Contract/CONTRACT.html and http://www.house.gov/house/Contract/legalrefb.txt.

[15] S. Rep. No. 104-98, at 10-11 (1995) *reprinted in* 1995 U.S.C.C.A.N. 679, 689-90 ("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"… the Committee permits the lead plaintiff to choose the lead counsel. This provision is intended to permit the plaintiff to choose counsel rather than have counsel choose the plaintiff").

[16] Weiss & Beckerman, *supra* note 2 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 2 at 2061.

[18] S. Rep. No. 104-98, at 11 *reprinted in* 1995 U.S.C.C.A.N. 679, 690 ("Courts traditionally appoint the lead plaintiff and lead counsel in class action lawsuits on a 'first come, first serve' basis. Since no deference is given to the most thoroughly researched complaint, the lawyers spend minimal time preparing complaints in securities class actions. The first lawsuit filed also renders the lead plaintiff. The Committee believes that the selection of the lead plaintiff should rest on considerations other than a speedy filing of the complaint.")

[19] S. Rep. No. 104-98, at 9 *reprinted in* 1995 U.S.C.C.A.N. 679, 688 ("A whole stable of 'professional plaintiffs,' who own shares-or sometimes fractions of shares-in many companies, stand ready to lend their names to class action complaints.") *See also*, Weiss & Beckerman, *supra* note 2 at 2060-61 (noting that prior to the PSLRA, plaintiffs' lawyers would maintain "a list of potential plaintiffs and their stockholdings.")

attorneys illegally bribed their lead plaintiffs.[20] The pre-PSLRA process also effectively gave total control over the class action to the lead counsel. 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 by which the presumptive lead plaintiff would be the class member with the largest claimed loss who sought the position. The lead plaintiff provision states that: "(1) 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… (b) 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 in the market more widely, 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 lead 9 of 175 cases.[24] James D. Cox and

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[20] See, e.g., Jonathan D. Glater, "Shareholders' Lawyer Sentenced for Kickbacks Made to Clients," THE NEW YORK TIMES, Jun, 3, 2008, *available at*: http://www.nytimes.com/2008/06/03/business/worldbusiness/03iht-legal.1.13417621.html?scp=3&sq=mel%20weiss%20convicted&st=cse (reporting sentencing of plaintiffs' lawyer Melvyn Weiss to thirty months imprisonment for paying kickbacks to clients who served as lead plaintiffs in his cases); "New York Attorney Sentenced in Kickback Scheme, THE NEW YORK TIMES, Nov. 1, 2008, *available at*: http://www.nytimes.com/2008/02/11/business/worldbusiness/11iht-kickbacks.5.9951917.html?scp=2&sq=lerach%20convicted&st=cse (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.A. § 78u-4(a)(3)(B)(iii)(I)(bb).

[22] 15 U.S.C.A. § 78u-4(a)(3)(B)(v).

[23] S. Rep. 104-98 at , *reprinted in* 1995 U.S.C.C.A.N. 679, 690 ("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"…"). Congress quoted Weiss & Beckerman in adopting the PSLRA, noting that "Institutions with large stakes in class actions have much the same interests as the plaintiff class generally; thus, courts should 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. 104-98, 1995 U.S.C.C.A.N. 679, 690, at n. 34 quoting Weiss & Beckerman, *supra* note 2 at 2060.

[24] Choi, *supra* note 4 at 877, citing Office of the General Counsel, Securities and Exchange Commission, Report to the President and Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995 at 51 (1997), and Elayne Demby, Ducking Lead Plaintiff Status, (May 1999), http:// www.assetpub.com/archive/ps/99-05psmay/may99PS58a.html.

Randall S. Thomas found that an institutional 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] Stephen Choi, Jill Fisch, and A.C. Pritchard reported that institutional investor (and in particular, public pension fund) participation as lead plaintiffs rose modestly from zero percent pre-PSLRA to over ten percent between 1996 and 2000.[26] (In contrast, Choi, Fisch and Pritchard reported that 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. PricewaterhouseCoopers reported that 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 (see discussion 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 sophistication of an institutional lead plaintiff without itself having to bear the (admittedly minimal) burden of serving as lead plaintiff.

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[25] James D. Cox and Randall S. Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 105 Colum. L. Rev. 1587, 1622-23 (2006).
[26] Choi et al., *supra* note 4 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 5 at 33. PricewaterhouseCoopers LLP, 2007 Securities Litigation Study (April 8, 2008) *available at* http://10b5.pwc.com/PDF/2007%20SECURITY%20LIT%20STUDY%20W-LT.PDF.
[29] Stephen J. Choi and Robert B. Thompson, *Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA*, 106 Colum. L. Rev. 1489, 1519 (2006).

Free-riding aside, in many instances, the losses suffered by institutional investors 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 types of 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] Such small recoveries on relatively small losses undoubtedly contributed to at least some institutional investors' lack of enthusiasm for

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[30] Stephen Choi, *Motions for Lead Plaintiff*, NYU Law and Economics Research Paper No. 08-53 at 44 *available at* (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1293926) (reporting that average claimed loss for an institutional investor lead plaintiff in a securities class action is $3.9 million).

[31] See "CalSTRS Corporate Governance Policies" at http://www.calstrs.com/investments/cgpolicies.aspx, July 2003, stating that:

> 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.

[32] John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 Colum. L. Rev. 1534, 1545 (Nov. 2006) citing Elaine Buckberg, Todd Foster & Ronald Miller, *Recent Trends in Shareholder Class Action Litigation: Are WorldCom and Enron the New Standard?* (NERA Economic Consulting 2005) at 6. Note that 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. Stephanie Plancich and Svetlana Starykh, "2008 Trends in Securities Class Actions," NERA Economic Consulting, December 2008, *available at* http://www.nera.com/image/PUB_Recent_Trends_Report_1208.pdf at 14.

[33] Cox, *supra* note 22 at 1621 n.132 (finding 12.7% recovery rate for sample of 388 securities class action settlements).

[34] See CalSTRS Subcommittee on Corporate Governance January 5, 2000 draft of securities litigation policy at 1, at http://www.calstrs.com/about%20calstrs/Teachers%20Retirement%20Board/AGENDAS/bod0100pdf/cg0104.PDF (the average settlement in a securities class action case recovers approximately 10-14% of total damages).

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.[38] These recoveries are often covered by directors and officers insurance, thus undermining their deterrence effect; but in response, some public pension funds have begun insisting that individual defendants make payments out of 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.[39] For example, a recent paper by C.S. Agnes Cheng, Henry He Huang, Yinghua

[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 (2005) (calculating that fewer than 30% 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. Rev. 855 (2002) (citing 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 2 at 2125-26.

[36] Coffee, *supra* note 29 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 more optimal than the current system of enterprise liability for securities class actions. Jennifer H. Arlen and William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. Ill. L. Rev. 692 (1992).

[38] Some scholars have argued that the deterrence effect of securities class actions is reduced by Directors & Officers insurance, which funds most securities class action settlements, thereby immunizing the perpetrators of the purported fraud from the punitive effect of the settlement. See generally, Coffee, *supra* note 29.

[39] C.S. Agnes Cheng, Henry He Huang, Yinghua Li, Gerald Lobo, *Institutional Monitoring Through Shareholder Litigation*, forthcoming in Journal of Financial Economics, January 2009 draft *available at*: http://ssrn.com/abstract=930532 (using database from 1996 to 2005 and controlling for case determinants of having

Li & Gerald Lobo concludes that public pension funds increase monetary recoveries, even controlling for cherry-picking of the best cases, as well as decrease the probability of being dismissed and increasing board independence at the defendant companies.[40] 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.[41] And at least some funds believe 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 it can increase recoveries to 25% of losses when it serves as lead plaintiff.[42] Additional evidence suggests that they reduce attorneys' fees and increase attorney hours worked. The weight of the evidence suggests that they are simply better lead plaintiffs, from which they benefit, as does 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 securities class actions are brought by lead counsel who assume the cost of the litigation and are compensated by contingency fees. At most, the cost to lead plaintiffs is employee time allotted to managing the class action that 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.[43] Weiss and Beckerman themselves predicted that public pension funds would be likely candidates

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an institutional lead plaintiff, this paper finds 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); Cox, *supra* note 22 at 1636-39 (finding that institutional investors increase settlements by 0.04% for every 1% increase in provable losses); and Michael Perino, *Institutional Activism Through Litigation: An Empirical Analysis of Public Pension Funds Participation in Securities Class Actions* , (St. John's Legal Studies Research, Working Paper No. 06-0055, 2006), *available at* http://ssrn.com/abstract=938722 at 24, 30-31. Some scholars have suggested that institutional investors may be "cherry picking" the best cases. Cox, *supra* note 22 at 1636-39 (noting that higher settlements by institutional investors in securities class actions may reflect that institutions, "take the better cases"); Choi et al., *supra* note 4 at 870, 892 (reporting some evidence consistent with "cherry-picking" theory).

[40] Cheng et al., *supra* note 36 (using database from 1996 to 2005 and controlling for case determinants of having an institutional lead plaintiff, this paper finds 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).

[41] 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).

[42] See CalSTRS Subcommittee on Corporate Governance January 5, 2000 draft of securities litigation policy at 1-2 http://www.calstrs.com/about%20calstrs/Teachers%20Retirement%20Board/AGENDAS/bod0100pdf/cg0104.PDF, (anticipating in hypothetical that CalSTRS can increase recovery to 25% of total damages through its "active participation" in securities class action).

[43] 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. Moreover, lead plaintiffs frequently must sue the underwriters and possibly the accountants, with whom they may have ongoing business relationships.

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.[44]

Others have argued that the emergence of public pension funds as lead plaintiffs is attributable to 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 the *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. At the time (1999), this was a record recovery for investors, purportedly recovering 40% of investor losses.[45] 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 the *In re Cendant Corporation Securities Litigation.*[46] In *Cendant*, competing class counsel argued 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.'"[47] The *Cendant* court dismissed the allegation as "speculative" and not violative of any law.[48] Since *Cendant*, some scholars have questioned the "pay-to-play" theory. James Cox and Randall Thomas have noted

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[44] Weiss and Beckermann, *supra* note 2 at 2111 (predicting that public pension funds would be likely candidates for lead plaintiff appointments because such funds were already disproportionately active in corporate governance reform efforts).

[45] Bernstein Litowitz Berger & Grossmann LLP, *Significant Recoveries*, http://www.blbglaw.com/our_record_results/significant_recoveries (stating that *In re Cendant Corporation Securities Litigation* settled for $3.2 billion or approximately 40% of damages) (last visited Sep. 2, 2009).

[46] Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. Ill. L. Rev. 913, 966 n.277 (noting that "[t]here have been allegations in some cases that attorneys have engaged in 'pay-to-play' schemes whereby they contribute to the campaigns of officials that control public pension funds in exchange for an agreement that the funds will select the attorneys as lead counsel in securities class actions"). *See also*, Cox, *supra* note 22 at 1610-15 (discussing theory and noting that the 'pay-to-play' allegedly engaged in by plaintiffs' securities class action firms "appears to be just part of a larger tapestry of 'pay-to-play' practices by law firms generally.")

[47] *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).

[48] *Id.*

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.”[49] 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.[50] 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.[51]

“Pay-to-play” allegations—in particular, the allegation that public pension funds bring securities class actions in exchange for campaign contributions--have re-emerged recently. 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, which have little to do with campaign contributions.[52] and have lead to calls for further reform to securities class actions. For example, in its October 31-November 1, 2009 edition, the *Wall Street Journal* prominently re-aired “pay-to-play” allegations in its 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.” More recently, the *Wall Street Journal* ran a front-page article entitled “Trial Lawyers Contribute, Shareholder Suits Follow,” 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 paper’s dataset) and had collected significant contributions from plaintiffs lawyers.[53] The article also identified out-of-state campaign contributions made

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[49] Cox, *supra* note 22 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” caused by “play-to-play” allegations. Cox and Thomas suggest either a total bar on selection by lead plaintiff funds of lead counsel who have made political contributions to a government official with influence over the fund, or the placement of 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.

[50] Choi & Fisch, *supra* note 38 at 346 (questioning ‘pay-to-play’ theory in light of evidence that there is no correlation (as opposed to positive or negative correlation) between involvement of public officials and higher levels of public pension fund litigation activism.) *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 how much weight should be given to the Choi and Fisch study because of survey methodology and low response rate).

[51] *Id.* 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. Stephen J. Choi, Drew T. Johnson-Skinner, and A.C. Pritchard, “The Price of Pay to Play in Securities Class Actions”, University of Michigan Law School, John M. Olin Center for Law and Economics Working Paper No. 09-025, available at http://ssrn.com/abstract=1527047.

[52] Craig Karmin and Peter Lattman, *‘Pay to Play’ Probe Ensnares Another*, Wall St. J., May 12, 2009 at C1.

[53] Mark Maremont, Tom McGinty, and Nathan Koppel, “Trial Lawyers Contribute, Shareholder Suits Follow,” THE WALL STREET JOURNAL, Feb. 3, 2010 at A1, available at: http://online.wsj.com/article/SB10001424052748703837004575013633550087098.html.

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] A view of public pension fund participation in securities class actions as fundamentally driven by "pay-to-play" has spurred calls for comprehensive reform, such as a proposal to eliminate by the Institute of 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, the Securities Litigation Attorney Accountability and Transparency Act, introduced in the House of 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 an outright ban on representation of public pension funds by plaintiffs' law firms that 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]

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[54] *Id.*

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

[56] RiskMetrics Group Blog Team, December 08, 2008, What Can Investors Expect in 2009?, http://blog.riskmetrics.com/, submitted by Ted Allen, Publications.

[57] "Cornyn Introduces Bill To Strengthen Transparency & Accountability In Securities Class-Action Litigation," Monday May 19, 2008, at http://cornyn.senate.gov/public/index.cfm?FuseAction=ForPress.NewsReleases&ContentRecord_id=02923533-802a-23ad-4e94-a4a2109dfca5

[58] http://www.deseretnews.com/article/705315425/Bennett-seeks-pay-to-play-probe-of-lawyers.html.

[59] 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).

II
METHODOLOGY

This paper tests a number of hypotheses related to public pension fund activism in securities litigation, notably the following two: (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 *Pension and Investments* magazine.[60] Following Congress's reasoning in 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 public pension fund 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

[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 and Capital Stewardship Project of the Harvard Labor and Worklife Program at Harvard Law School. Kendra Strauss, Gordon L. Clark, Tessa Hebb & Lisa Haberman, *U.S. Public Sector Pension Funds and Urban Revitalization: An Overview of Policy and Programs* (2004), (on file with author) *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. In the rare circumstance where data was missing or incomplete, I obtained 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, Vol. 32 Issue 2, 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 could be controlled by a politician regardless of its composition. Under this view, "starstruck" beneficiary board members simply defer to the politician on major

funds' (7) asset size and (8) board size.[63] Using a dataset of securities class actions provided to me by Securities Class Action Services ("SCAS Dataset"), a division of Riskmetrics Group, 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, consisting of seventy-eight funds (the "Litigating Funds").[64] 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.[65] In a few instances where the information was not available on the internet, I obtained it either through telephone or email interviews.[66] 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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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* § 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, 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 conducted by the author with pension fund board members and lawyers practicing in the field. Such interviews reveal a view of the relationship between politicians and beneficiaries as an employer-employee relationship. The politicians/employers sit on the board to oversee the state/county/municipality's contributions to the fund, in part because the politicians/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 paid into the pension fund by the government entity are part of the beneficiaries' compensation and therefore the employer/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.

[64] 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.

[65] All of the information in this paper 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 obtained financial data from the year 2003-04, to match the data I gathered from the Oxford database.

[66] I could not obtain sufficient structural information for two funds, so I excluded them from the sample, reducing my sample size from 81 to 78 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,[67] with total assets of $1.96 trillion under management.[68] The fifty-three Largest Funds held $1.8 trillion[69] 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,[70] 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.[71] Table 1 reports basic statistics on the Largest Funds.

[67] JUN PENG, STATE AND LOCAL PENSION FUND MANAGEMENT 13 (CRC Press 2008).
[68] *Available at*: http://www.wilshire.com/Company/2004_State_Retirement_Funding_Report.pdf.
[69] Unless otherwise noted, all dollar figures used in this paper are from 2003-04.
[70] *The Top 200 Pension Funds/Sponsors*, PENSIONS & INVESTMENTS, January 26, 2004, Vol. 32, Issue 2, at 16.
[71] 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[72]
N=53

Variable	Mean	StDev	Minimum	Median	Maximum
Asset Size ($million)[73]	$33,896	$29,031	$9,051	$24,710	$148,840
Bd Size	9	3.69	1	9	18
Politicians	1.189	1.594	0	1	7
Political Apps	3.708	2.619	0	4	10
Beneficiaries	3.858	3.27	0	4	14
# Appointers	2.17	1.566	0	2	8
Fin 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 $33.9 billion (median is $24.7 billion). The mean (and median) board size for the Largest Funds is nine members. The median number of politicians is one, political appointees ("Political Apps") is four and beneficiaries is also 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; 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—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

[72] "Asset size" is reported in millions of dollars. For consistency, all dollar figures discussed in this paper are from the year 2003-04 unless otherwise noted.
[73] *Supra* note 54 at 16-19.
[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 an appointee, and half a beneficiary. For the remaining thirty-nine Largest Funds, the categories of political appointee and beneficiary were mutually exclusive. Interestingly, my data suggests that beneficiary appointees behave more like political appointees than like beneficiaries. See *infra* at IIIB.

number of different social initiatives I have seen across all funds. Note that 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. If one counts co-lead plaintiff appointments, public pension funds obtained 187 lead plaintiff in these 127 cases.[77] Just 49 of the 187 lead plaintiff and co-lead plaintiff appointments were obtained by Largest Funds,[78] 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

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

least large enough to make them attractive as co-applicants for a lead plaintiff appointment with other 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.[79] 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.[80]

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" is true, one would expect that the coefficients for politicians and their appointees would correlate statistically significantly with lead plaintiff appointments.

[79] 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 38 at 331.

[80] 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 (2008). 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*, BUSINESSWEEK, Feb, 27, 2006 at 31. The WorldCom opt out actions were settled in 2005. Coffee, *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 that case, Lerach persuaded ninety-three state public pension funds to opt-out. Wollert, *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 paper, 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 38 at 331. These results may be explained by the WorldCom and AOL Time Warner opt outs.

Table 3

Largest Funds

Regressions of Board Attributes Against Lead Plaintiff Appointments

	Model 1	Model 2	Model 3	Model 4	Mod. 5	Model 6	Model 7	Model 8
Bd Size	0.09183 (0.214)	0.00358 (0.964)	0.1062 (0.160)	0.02808 (0.725)	0.04002 (0.605)	-0.00660 (0.928)	-0.07961 (0.362)	0.06791 (0.321)
Loge Assets	0.1634 (0.643)	0.3801 (0.243)	-0.059 (0.88)	0.1188 (0.744)	-0.1702 (0.655)	-0.0298 (0.933)	-0.1026 (0.774)	0.0227 (0.947)
% Polit.	-0.503 (0.657)		-0.923 (0.430)					
% Pol. Apps	-1.3593 (0.165)		-1.445 (0.161)					
Polit. Maj.					-0.9208* (0.098)			
% Bens		2.552** (0.034)		2.58** (0.033)			3.677*** (0.003)	
Benef. Maj.						1.8398*** (0.003)		
# Elect. Offs					0.3513* (0.063)	0.4049** (0.021)	0.4406** (0.015)	0.2851* (0.100)
Fin. Experts			0.416 (0.754)	0.289 (0.810)	0.0983 (0.544)	0.0378 (0.797)	0.1287 (0.395)	
Social Invest			0.2498 (0.139)	0.244 (0.121)	0.2062 (0.201)	0.0949 (0.535)	0.1868 (0.217)	
R^2	10.2%	14.6%	14.5%	19.0%	18.8%	29.7%	28.9%	11.3%

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

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 & 3, though 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 & 4, and at the 1% confidence level in Models 6 & 7. The coefficient for boards with a majority of beneficiary board members is both positive and significant at the 1% confidence level (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 & 7, and the 10% confidence level in Models 5 & 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.

These regressions show that the presence of politicians and their appointees correlates negatively and statistically significantly with lead plaintiff appointments when they constitute a board majority; the number of beneficiaries correlates positively with lead plaintiff appointments, statistically significantly 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. 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 indicate the possibility of a new theory that has not before been discussed in the literature, a theory I will call "pay-not-to-play." Just as politicians can, and do, receive significant campaign contributions from plaintiffs' lawyers, or are otherwise influenced by them, 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 the litigation activism of public pension funds that they influence or control, or they may discourage such activism, depending on their political ideology, the identity of their donors, and to what political pressures they are subject. I will further discuss both "pay-to-play" and "pay-not-to-play"[81] below, in light of additional data.

The correlation between the number of politicians 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 the 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

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[81] 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, but rather 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.

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 is motivating 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.[82] (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; 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 beneficiaries.[83] Similarly, of the seventy-eight Litigating Funds discussed below, only four contained at least one board member who was an appointed 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.

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

[83] 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 and not statistically significantly with financial performance).

C. Who Controls the Litigating Funds?

As noted above, I report results for 78 funds that obtained at least 1 lead-plaintiff appointment from 2003-2006.[84] 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 9 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 8 appointments in the same time period, second only to Detroit P&F.85 Table 4 contains descriptive statistics for the Litigating Funds.

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[84] In fact, 81 public pension funds obtained lead plaintiff appointments from 2003-2006. I excluded Ontario because it is based in Canada, and I excluded two other funds because I could not find sufficient data for them.

[85] 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) (2000). 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 the House of Representatives Conference Report No. 104-396 of the 104th Congress at 35 (1999): "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." *See also, In re Critical Path, Inc. Securities Litigation*, 156 F.Supp.2d 1102, 1112 (N.D.Cal. 2001)(selecting institutional investor as lead plaintiff even though the institution was simultaneously serving as lead plaintiff in six cases). 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.*, Cox, *supra* note 22 at 1638 (advocating that courts dispense with the "professional plaintiff" restriction where an institutional investor has proved itself to be a diligent monitor in securities class actions).

Table 4
Litigating Funds Descriptive Statistics
(N=78)

	Mean	StDev	Minimum	Median	Maximum
Asset Size ($mill)	$11,724	$23,249	$28	$2,029	$148,840
Bd Size	9.141	4.330	1	9	27
Politicians	1.385	1.789	0	1	12
Polit Apps	3.032	2.502	0	2.75	13
Beneficiaries	4.340	3.157	0	4	15.5
Num ElecOff	1.974	1.377	0	2	8
Fin Exp.	0.385	1.416	0	0	10
Soc/Pol Agenda	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. Thus, the funds obtaining lead plaintiff appointments are significantly smaller than the ones Congress expected to 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 often than CalPERS, which is 2,902 times larger and was only appointed twice. While Deerfield Beach is an extreme example (as is CalPERS), Largest Funds comprise 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 5 politicians/political appointees versus 4 beneficiaries; the median Litigating Funds board contains 4 beneficiaries to 3.75 politicians, with between 1 and 2 unaffiliated board seats. Table 5 compares the board orientation of the Largest Funds to the Litigating Funds.

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 Beneficiaries	12	23
Majority Neither[86]	9	22
Chi-Square Test P-Value		0.116

A chi-square test (two-way table) 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 noted earlier, 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.[87] Table 6 contains the same model regressions for the Litigating Funds that appear in Table 3 for the Largest Funds.

[86] 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.

[87] 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.

Table 6
Litigating Funds
Regressions of Board Attributes Against Lead Plaintiff Appointments

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
Board Size	-0.07028 (0.181)	-0.09362* (0.073)	-0.07375 (0.168)	-0.09653* (0.069)	-0.09615 (0.112)	-0.14712** (0.015)	-0.15288** (0.011)	-0.09429 (0.114)
Asset Size (loge)	0.0803 (0.425)	0.05259 (0.580)	0.0326 (0.760)	0.0033 (0.975)	-0.0201 (0.852)	-0.0706 (0.494)	-0.0272 (0.788)	0.0411 (0.701)
Polit (%)	-2.423* (0.052)		-2.641** (0.038)					
Political Apps (%)	-1.977* (0.060)		-2.183** (0.050)					
Political Maj					-0.5448 (0.221)			
Benefs. (%)		3.211*** (0.003)		3.402*** (0.003)			3.725*** (0.001)	
Benef. Maj.						1.5074*** (0.002)		
# Elected Offs					0.3534* (0.95)	0.3496* (0.074)	0.3637* (0.061)	0.3697* (0.052)
Financial Ex (%)			0.0908 (0.559)	1.135 (0.518)	-0.0063 (0.967)	0.0234 (0.870)	0.1137 (0.440)	
Soc Invest Criteria			0.2375 (0.204)	0.2145 (0.235)	0.075 (0.717)	0.0508 (0.796)	0.0594 (0.760)	
R^2	6.9%	11.9%	9.2%	13.9%	3.5%	16.9%	18.6%	7.0%

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 negatively correlates with such appointments, statistically significantly so in Models 1 & 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. Pearson correlation 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 accounted for.

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 from 2003-2006. The regressions below measure the chances of (a) becoming (b) and (c), and of (a) and (b) becoming (c).

Table 7
Litigating Funds
Ordinal Logistic Regressions of Board Attributes Against Lead Plaintiff Appointments

	Model 1	Model 2	Model 3	Model 4	Mod. 5	Model 6	Model 7	Model 8
Board Size	-0.13514* (0.070)	-0.17909** (0.035)	-0.151462* (0.058)	-0.21038** (0.025)	-0.1417* (0.075)	-0.263*** (0.009)	-0.1529** (0.011)	-0.1388** (0.049)
(Ln) Assets	0.17697 (0.154)	0.14275 (0.225)	0.08032 (0.548)	0.038775 (0.763)	-0.0252 (0.836)	-0.0508 (0.689)	-0.0272 (0.788)	0.000176 (0.999)
Polit %	-3.8934** (0.020)		-4.8178*** (0.010)					
Polit Apps %	-2.06988* (0.089)		-2.5502* (0.055)					
Polit Maj					-0.4819 (0.332)			
Bens %		4.0797*** (0.005)		4.8761*** (0.003)			3.725*** (0.001)	
Ben Maj						1.928*** (0.002)		
NumElec Off					0.35202 (0.133)	0.4426* (0.066)	0.3637* (0.061)	0.4231** (0.037)
Fin Ex %			1.8031 (0.391)	2.9682 (0.175)	0.37116 (0.846)	1.1421 (0.558)	0.1137 (0.440)	
Soc Invest			0.54424** (0.012)	0.50016** (0.020)	0.32722 (0.142)	0.3014 (0.190)	0.0594 (0.760)	

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 paper 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 section III(F).

E. The Never-Appointed Funds

Thirty-three of the 53 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 to the Largest Funds that obtained lead plaintiff appointments (the "Largest Appointed Funds").

Table 8

Board Attribute	**Largest Funds That Did Not Obtain Lead Plaintiff Appointment (LP=0)**	**Largest Funds That Obtained Lead Plaintiff Appointment(s) (LP>0)**	**P Value+**
Assets ($mill) (mean/median)	31,082/20,272	38,540/26,995	0.370
Board Size (mean)	8.364	10.050	0.107
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
Beneficiaries % (mean)	34.4% (3.273)	41.1% (4.825)	0.352
Fin Ex % (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 to 58.2% of Largest Appointed Funds boards. The distribution of that domination differs slightly, as 15.3% of the Never-Appointed Funds boards are comprised of politicians themselves, compared to 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 vs. 2.8), and a smaller percentage of beneficiaries (34.4% vs. 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 to 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 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 their 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's voice is more muted, or is counterbalanced by organized labor, for example. The "pay-not-to-play" concept is discussed in further detail below, at Section 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 demonstrating that formal financial expertise of board members does not correlate with fund performance.)[88] 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. 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.

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[88] Romano, *supra* note 75 at 841.

I hypothesize that financial experts would negatively correlate with lead plaintiff appointments, if at all, for the following reasons: First, many financial experts are political appointees, and one would expect them to follow their appointers' lead in resisting lead plaintiff appointments. 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 *supra* at section 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 question of the fund taking action to recover funds 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 absolutely, and not the individual or entity that lost the most money relative to its own asset size, Congress and the PSLRA itself emphasize raw losses in terms of dollars, rather than in terms of the relative financial "pain" caused to the victim. 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 is 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 recognizes that corporate responsibility and societal concerns are valid parts of investment decisions…[that] considers both the investor's financial needs and an investment's impact on society… [and that] encourage[s] corporations to improve their practices on environmental, social, and governance issues."[89] Social investment criteria take different forms. They may involve "screening" investment portfolios to include performers deemed socially responsible[90]

[89] *Socially Responsible Investing Facts*, http://www.socialinvest.org/resources/sriguide/srifacts.cfm (last visited on August 27, 2009).
[90] *Id.* (noting that socially responsible performers 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").

and exclude performers deemed not to be.[91] They may also involve community or local investing, or shareholder advocacy.[92] The Uniform Management of Public Employee Retirement Systems Act ("UMPERS") requires that the prudent person standard be met by trustees selecting investments, but that as long as this standard is attained, the trustees may consider social investments.[93]

There is an ongoing debate about whether such investments harm the funds that adopt them. As Meir Statman described it, the debate is whether social investment criteria are about "doing good while doing well" or "doing good but not well."[94] A recent paper, co-authored by Statman, concludes that social investors incur a return disadvantage relative to conventional investors entirely on account of screening out "stocks of companies associated with tobacco, alcohol, gambling, firearms, military, and nuclear operations."[95] Investors who tilt their portfolios towards companies with high social responsibility scores—without screening out the low scoring companies—actually outperform conventional investors.[96] 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,[97] while still other studies support the conclusion that social investing has no effect on fund performance.[98] Some critics of social investing argue that such criteria reflect the degree of political interference in the fund; funds that maintain such criteria do so at the behest of politicians who are interested in using the

[91] *Socially Responsible Mutual Funds Charts: Screening & Advocacy*, http://www.socialinvest.org/resources/mfpc/screening.cfm (last visited on Aug. 27, 2009)(noting exclusion of investments in tobacco companies as a form of screening).

[92] *Socially Responsible Investing Facts*, http://www.socialinvest.org/resources/sriguide/srifacts.cfm (last visited on August 27, 2009).

[93] The Uniform Management of Public Employee Retirement Systems Act, § 8(a)(5) ("(a) In investing and managing assets of a retirement system… a trustee with authority to invest and manage assets… (5) 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.") *Available at*: http://www.law.upenn.edu/bll/archives/ulc/mopepf/retirsy2.pdf (last visited June 29, 2009)

[94] Meir Statman, *Socially Responsible Investments* 10-11 (June 2007) *available at*: http://ssrn.com/abstract=995271. *See also*, Romano, *supra* note 75 at 798 (concluding that for public pension funds there is an inverse relation between return on investments and policies favoring social investing).

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

[96] *Id.*

[97] The Social Investment Forum, *Performance and Socially Responsible Investments*, http://www.socialinvest.org/resources/performance.cfm (last visited June 29, 2009) ("A growing number of academic studies have demonstrated that S[ocially] R[esponsible] I[nvestment] mutual funds perform competitively with non-SRI funds over time... The longest-running SRI index, the Domini 400, was started in 1990. Since that time, it has continued to perform competitively — the S&P 500 with 10.33% total returns, versus the 10.83% return of the Domini 400.")

[98] David Hess, *Protecting and Politicizing Public Pension Fund Assets: Empirical Evidence on the Effects of Governance Structures and Practices*, 39 U.C. Davis Law Review 187, 211 (2005) (finding no effect of social investment criteria on fund performance); *see also*, Alicia H. Munnell & Annika Sunden, *Investment Practices of State and Local Pension Funds: Implications for Social Security Reform*, PENSIONS IN THE PUBLIC SECTOR 153, 174 (Olivia S. Mitchell & Edwin C. Hustead eds., 2001) (same).

fund's resources to please assorted constituents at the expense of maximizing returns for beneficiaries.[99] The funds that maintain such criteria claim altruistic motives for them.[100]

I found a dozen varieties of social investment criteria across the 111 funds in my Largest Funds and Litigating Funds samples. These criteria included 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;[101] (7) environmentally-friendly businesses; (8) affordable housing/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 criteria once widely adopted by public pension funds[102]—presumably because the funds now believe such a policy to be obsolete. Naturally, there is some overlap between 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 & 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, 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 that hypothesis. However, because the results

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[99] *See, e.g.*, Romano, *supra* note 75 at 801-02.

[100] 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." http://www.ceres.org/Page.aspx?pid=415. Also, Jorge Torres, Special Assistant to the Administrator of the Puerto Rican Government Employees' Retirement System told me that while the fund did not have social investment criteria, it was aware that other funds maintained such criteria and was looking into adopting 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 (December 5, 2008).

[101] 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 CFR 2509.94-1, *available at:* http://www.dol.gov/dol/allcfr/title_29/Part_2509/29CFR2509.94-1.htm.

[102] Romano, *supra* note 75 at 809 (identifying eighteen state public pension funds with restrictions on investing in South Africa).

are not very robust, I am reluctant to conclude that such a connection clearly exists. Perhaps further research will affirm or reject this small evidence of a 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 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, statistically significantly 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?

Some context for answering why beneficiary board members may seek lead plaintiff appointments is provided by previous research comparing beneficiary and politician board members, albeit in a different context. 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."[103] 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 is positively correlated with the proportion of equity owned by management. Michael Hess similarly compared beneficiary board members to independent, outside directors of a corporation, noting that the lack of political interference in their selection allows them to focus on shareholder interests and monitor the politically-affiliated trustees.[104] Romano found that the number of beneficiaries on a public pension fund board—and the fewer politicians and their appointees—the higher the fund's returns,[105] 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."[106] Hess, on the other hand, found beneficiary-elected trustees had an inverted U-shape relationship with fund performance, that is, beneficiary-elected trustees improved fund performance up until they constituted about half of the board, but that performance dropped as beneficiary-elected trustees came to dominate the board.[107] Still, Hess concludes that "member-elected trustees' dedication to their duties also appears to be beneficial to plan financial performance."[108] Such trustees "are motivated, accountable to plan beneficiaries, and independent of political influence."[109] Both Romano and Hess recommend increasing the number of elected beneficiary board members to reduce the politicization of public pension funds.[110]

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—in making decisions for the fund, the

[103] *Id.* at 821.
[104] Hess, *supra* note 90 at 198.
[105] Romano, *supra* note 75 at 825.
[106] *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 funds' resources to state and local investments and towards their constituencies. *Id.* at 801-11.
[107] Hess, *supra* note 90 at 213-14.
[108] *Id.* at 217.
[109] *Id.* at 216.
[110] *Id.* at 799-800, 843-44.

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, whether these losses are large or small. 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, [111] 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 passively allow some other institution or individual to lead the class and select class counsel. 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 have other constituencies to report to, beneficiary trustees are elected by the beneficiaries alone. All of the fund beneficiaries in the sample are public employees. They are police officers, firefighters, teachers, and other middle class and working class people. As public employees, they are modestly compensated, for the most part. 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 support the pursuit of cases against corporate officials and corporations that commit fraud, and the opportunity to demand corporate governance reform that is often presented in the context of securities litigation. The fact that some funds proudly tout their involvement in securities litigation to their membership provides at least some support for this theory.[112] 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 on the whole that they are effective in their jobs, and that they are doing something on behalf of the members. They provide a way for board members to build a record of achievement during their tenures in office.

Another explanation may be that public pension fund participation in securities class actions is a function of union influence and control over the funds. Some anecdotal evidence

[111] As noted above, institutional investors 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.*, Cox, *supra* note 22 at 1601 n.51 (citing Mar. 10, 2003 letter from Keith Johnson, Chief Legal Counsel, State of Wis. Inv. Bd. to Cox and Thomas stating that pension funds vastly increase their recovery by taking lead plaintiff role).

[112] *See., e.g.,* Your Pension Matters, Pompano Beach Police & Fire Retirement System, Fiscal Year 2006, First Quarter Ended December 31, 2006 (touting firm's role as lead plaintiff in four separate securities fraud class actions).

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 a four-month long strike against Safeway by the UFCWU, Harrigan and CalPERS led a proxy campaign against Safeway President Doug Burd, seeking Burd's resignation. Harrigan was accused of utilizing CalPERS's position as a Safeway shareholder to further the UFCWU agenda.[113] Regardless of whether this is true, it demonstrates the possibility that unions may be using such class actions either to further their own agendas, or to engage in coalition building with political partners, such as environmentalists, via various forms of shareholder activism.[114] Moreover, thirty-six percent of public employees in the United States are unionized,[115] 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[116] demonstrates that unions are interested in bringing such cases.

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

i. 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.[117] 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.

[113] Iman Anabtawi and Lynn Stout, *Fiduciary Duties for Activist Investors*, 60 Stan. L. Rev. 1255, 1286 (2009).

[114] Ivan Osorio, *Union Pension Funds May Go Green: But It's Not the Color of Money*, Labor Watch, September 2008, *http://www.capitalresearch.org/pubs/pdf/v1219863905.pdf*; *see also*, *Making Green Waves*, Progressive Policy Initiative, May 14, 2004, *available at*: http://www.ppionline.org/ppi_ci.cfm?knlgAreaID=116&subsecID=900039&contentID=252635.

[115] Bureau of Labor Statistics, *Pct of emp, Government wag & sal wrkrs, Members of unions*, Series ID: LUU0204922700, *available at*: http://data.bls.gov/cgi-bin/surveymost?lu. (last visited on May 20, 2009).

[116] Choi, *supra* note 27 (finding that union pension funds constituted 16.5% of lead plaintiff appointments, and public pension funds constituted 13.4% of such appointments).

[117] I obtained this data from a database assembled by Barry T. Hirsch and David A. Macpherson at www.unionstats.com. For a description of this database, see Barry T. Hirsch and David A. Macpherson, *Union Membership and Coverage Database from the Current Population Survey: Note*, Industrial and Labor Relations Review, Vol. 56, No. 2, January 2003, pp. 349-54 *available at* www.unionstats.com.

ii. 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. (Today, in the aftermath of the financial crisis, the percentage of underfunded funds has certainly increased). 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. As noted in a recent *Washington Post* article, underfunding forces funds to "Either slash retirement benefits or pursue high-return investments that come with high risk."[118] For example, underfunding of state pensions in New Jersey has prompted its recently-elected Governor 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.[119]

There is a great degree of variation in public pension underfunding; a few pensions are even overfunded. The hypothesis is 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 more susceptible to challenges from other board members for their seat on the board. Whereas politicians report to a broad constituency, beneficiary board members are responsible solely to the peer beneficiaries who elected them. A securities class action could be a means for beneficiary board members to signal to other beneficiaries that they are active stewards for the fund's finances, taking a lead plaintiff role to maximize recovery, ensure the future soundness of the investment through corporate governance reform, and deter future wrongdoing by the defendant or other entities in whom the fund is invested.

To assess whether the degree of underfunding could affect a fund's pursuit of lead plaintiff appointments, I utilized 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 (the "UAAL variable"). (The Governmental Accounting Standards Board requires public employee retirement plans to disclose this ratio). I

[118] David Cho, *Steep Losses Pose Crisis for Pensions,"* THE WASHINGTON POST, Oct. 11, 2009 available at http://www.washingtonpost.com/wp-dyn/content/article/2009/10/10/AR2009101002360.html (noting that underfunded pension funds face difficult choice between cutting benefits or investing in riskier assets to close funding gaps).

[119] Claire Heininger, *N.J. Gov. Christie, lawmakers propose sweeping pension, health care changes for public employees*, THE STAR LEDGER, Feb. 8, 2010 *available at* http://www.nj.com/news/index.ssf/2010/02/wide-reaching_pension_and_bene.html.

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 data supports the notion that underfunding drives lead plaintiff appointments when beneficiaries control the fund, but has little influence when politicians control the fund.

V
THE INFLUENCE OF POLITICIANS ON PENSION FUND LITIGATION ACTIVISM

This paper finds a negative correlation between 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, it may also be the case that in certain instances, a politician may effectively control a board she does not actually control through majority vote, perhaps on account of her ability to 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 public pension funds' 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 is not what is driving public pension funds to bring securities class actions. Moreover, my data suggest that business interests may be influencing 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 (the "Chamber Survey"), [120] and an annual survey of "The Best States for Business" by Forbes Magazine (the "Forbes Survey"). The Chamber Survey focuses on how senior attorneys at companies with annual revenues of at least $100 million view the litigation environment in each of the fifty states. 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.[121] 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.[122]

[120] *See* Humphrey Taylor, David Krane & Diana L. Gravitch, "2004 U.S. Chamber of Commerce State Liability Systems Ranking Study," conducted for U.S. Chamber Institute for Legal Reform, March 3, 2004, at 15, 18 *available at*: http://www.supreme.state.az.us/ajc/Publications/2004%20Chamber%20Report.pdf. For state public pension funds, I used the rankings at Table 3 ("Overall Ranking of State Liability Systems") of the Chamber Survey. 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"). All four jurisdictions for the five city pension funds in the Largest Funds sample appeared in Table 5.

[121] *See*, "Table: 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.

[122] The state-by-state election data for the 2004 election was obtained from http://www.cnn.com/ELECTION/2004/.

Table 10
Largest Funds
Regressions of Indices of Business Influence Against Lead Plaintiff Appointments

Attribute	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7
Loge Asset Size	0.2972 (0.361)	0.3091 (0.326)	0.2193 (0.539)	0.2546 (0.464)	0.3323 (0.305)	0.4175 (0.186)	0.3732 (0.229)
Board Size	0.09944 (0.125)	0.09451 (0.132)	0.05697 (0.350)	0.05539 (0.350)	0.05091 (0.371)	-0.00419 (0.945)	0.01956 (0.721)
% Polit.			-0.344 (0.765)	-0.300 (0.784)			
% Pol. Apps			-1.00 (0.338)	-0.8216 (0.411)			
Polit. Maj.					-0.3043 (0.560)		
% Bens						2.24** (0.049)	
Benef. Maj.							1.2738** (0.038)
# Elect. Offs							
Chamber Rank	-0.02971* (0.089)		-0.02297 (0.225)				
Forbes Rank		-0.04013** (0.016)		-0.03578** (0.044)	-0.03779** (0.029)	-0.03376** (0.041)	-0.0294* (0.081)
R2	11.4%	16.8%	11.8%	16.6%	15.8%	21.9%	22.6%

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

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 & 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. Thus, some political opposition is the product of sensitivity to business opposition to these cases. 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 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 deemed hostile by big business 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.[123] 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 Safeway CEO Steven Burd.[124] A regional executive for the United Food and Commercial Workers Union,[125] Harrigan had been viewed as a powerful advocate for corporate governance reform,[126] although he was also criticized by some members of the corporate governance movement for his aggressive tactics.[127] His reappointment to the CalPERS Board was refused by the State Personnel Board, a five-member board overseeing the state's civil service system.[128] 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.[129] Harrigan's removal was particularly controversial in light of the

[123] Marc Lifsher, *State Pension Chief Expects to Be Axed*, LOS ANGELES TIMES, November 30, 2004 at A-1 (noting 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*, LOS ANGELES TIMES, Dec. 2, 2004 at A-1 (noting that California Republican Party and "business groups" denied lobbying for Harrigan's ouster).
[124] Lifsher, *supra*, n. 112.
[125] *Id.*
[126] Petruno, supra note 112 at A-1
[127] Sundeep Tucker, *Few Mourn Belligerent President's Departure*, FINANCIAL TIMES, Dec. 2, 2004, *available at* http://www.ft.com/cms/s/0/3084fc50-43d0-11d9-af06-00000e2511c8,_i_email=y.html (describing Harrigan's public tirade against International Corporate Governance Network Chairman over 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.)
[128] Lifsher, *supra*, n. 112.
[129] *Id.*

fact that in the year 2003, under his leadership, CalPERS earned a 23.3% return on investment.[130]

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.[131] 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.[132] And while this particular episode 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.[133] The press release announcing the reforms prominently noted the participation of the Kentucky Chamber of Commerce, and quoted its president and CEO, who

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[130] *Id.*

[131] Lucius Lomax, *Texas v. Iran: About the order banning public pension fund investments*, NEWSPAPER TREE: EL PASO'S ONLINE NEWSPAPER, Aug. 22, 2008, *available at*: http://newspapertree.com/opinion/2770 (last visited on January 21, 2009)(estimating that the Texas Teachers Retirement System and Employees Retirement System have in excess of $1 billion invested in effected companies); *see also*, *Texas: Governor Seeks Divestment From Companies In Iran*, N.Y. TIMES, Jul. 19, 2007, *available at*: http://query.nytimes.com/gst/fullpage.html?res=9806E4DF1431F93AA25754C0A9619C8B63 (noting 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 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 (same).

[132] Jim Wasserman, *Corporate America Pushes Back: After Years of Concentrated Attacks By Public Pension Funds and Politicians, Companies and Allies Say 'Enough'*, THE ASSOCIATED PRESS, Jan. 3, 2005, *available at*: http://seattletimes.nwsource.com/html/businesstechnology/2002137398_pensionpayback01.html (citing report by the Center for Security Policy raising questions about role of public pension funds in indirectly supporting terrorism); *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 (same).

[133] Press Release, Governor Steve Beshear's Communications Office, Gov. Beshear Calls on Pension Systems to Reform Investment Practices (Nov. 20, 2008) *available at*: http://governor.ky.gov/pressrelease.htm?PostingGUID=%7BB18C3139-6834-48C4-9D70-E0073289D862%7D (citing role of Kentucky Chamber of Commerce in reform of state's major public pension fund investment practices).

stated, "We support the changes embodied in this proposal and applaud the governor's leadership on this issue."[134] 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 be reducing public pension fund participation in securities class actions, particularly by politically dominated funds, and particularly in those states deemed to be highly sensitive to such interests, or insensitive to countervailing interests.[135] The U.S. Chamber of Commerce, consistently 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.

[134] *Id.*

[135] It may be argued that pay-to-play explains why the Largest Funds list and the Filer 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 Filer 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 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. Stephen J. Choi, Drew T. Johnson-Skinner, and A.C. Pritchard, The Price of Pay to Play in Securities Class Actions, http://ssrn.com/abstract=1527047 at 22-23. But even if one were to accept the argument that the difference between the Largest Funds and the Filer 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 Filer Funds samples.

VI
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 on the funds' boards receive plaintiffs' lawyer campaign contributions. "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 motivated to take the lead in a class action to remedy the loss. This paper 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 having less success, 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" is not what is driving 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.