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Original Paper

Developments from the PSLRA: Beyond the Lead Plaintiff Provision in Financial Research

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Abstract

Since the passage of the Private Securities Litigation Reform Act in 1995, a robust literature has analyzed the impact of the lead plaintiff provision, which made it more likely for institutional investors to take on the role of lead plaintiff. Recently, less investigated provisions in the PSLRA have had an increasingly relevant role in shareholder litigation, corporate governance, and how firms choose to go public. In this article, we review the law, finance, accounting, and economics literature to show how these other provisions have evolved over time, affecting the incentives for corporate disclosure, how firms go public, and corporate governance.

Keywords

event driven litigation, Federal Forum Provisions, PSLRA, SLUSA

1. Introduction

Under the Securities Act of 1933, and the Securities Exchange Act of 1934, investors have the right to sue firms through private litigation when they believe that they have purchased securities based on misleading or omitted information. Such a claim generally arises when a security was purchased at an inflated price due to that information or lack of disclosure, and after the true information is revealed, the price declines and causes a loss to the investor.

As prior studies have theorized, any lawsuit has a potential option value if there is the possibility it could be settled in order to avoid the expense of litigation and use of managerial time and focus (Huang, 2004; Grundfest & Huang, 2006). Thus, there is an incentive for a lawsuit to be filed following any stock price decline based on the value of a potential settlement. In response to a perception that many of these lawsuits were frivolous, Congress passed the Private Securities Litigation Reform Act (PSLRA) in 1995. Among many changes in the PSLRA (Note 1), Congress focused on several reforms they believed would make it more difficult for low value litigation to proceed, and also lower the incentives attorneys had in rushing to the courts to file litigation following a drop in the price of a security. Since the passage of the PSLRA, research into its impact and effectiveness has generally been focused on two main aspects of the Act. The first examines the provisions related to the selection of lead plaintiffs in the class actions, and how that has impacted case outcomes and the willingness of institutional investors to step into that role. A second track has looked at the safe harbor provisions offered by the PSLRA to management when presenting forward looking projections and whether it has been effective in increasing the amount and quality of such guidance from management.

However, over the past two decades other aspects of the reforms have come to the forefront in the legal literature. As market participants have adjusted their behavior in response to the PSLRA, additional litigation and legislation has created incentives for firms to change how their shares are issued in public markets, and to adopt provisions in their corporate charters ensuring that securities litigation occurs in the federal court system under the shelter of the PSLRA. Not surprisingly, the legal profession has also adapted to restrictions in the reforms, changing the nature and severity of securities class actions. And although these topics are currently being litigated and have been the subject of debate in regulatory and legal circles, only recently has research emerged looking at these topics in accounting, finance and management journals.

In this paper, we seek to help introduce these issues to a broader audience and also offer potential researchers a convenient summary of the current state of research in these topics. By doing so, we hope to invite more perspectives to the ongoing debate; particularly from the practitioner's perspective, as regulators consider changes to the legal environment created by lesser known aspects of the PSLRA.

This review will proceed as follows. Section 1 will introduce the PSLRA, as well as offer a brief review of the literature related to the plaintiff selection provisions and changes in management disclosure following the adoption of safe harbor provisions for forward looking statements at the passage of the PSLRA. This will not be an exhaustive review, as a robust literature exists for both of these topics and they are not the main focus of this paper. In Section 2, we detail the follow up litigation and legislation caused by less researched reforms within the PSLRA that have made it more desirable for plaintiffs to pursue securities litigation in state courts rather than the federal court system. Section 3 then introduces two current, and controversial topics that are the result of this preference for state litigation, as securities issuers attempt to keep litigation in the federal system, and plaintiffs seek out tactics to overcome hurdles set within the PSLRA if the case must be litigated in the federal courts. Section 4 then discusses how the safe harbor provisions in the PSLRA has contributed to the current increase in firms using SPACs to go public versus the traditional IPO path and current empirical evidence contributing to the debate on how to regulate these types of transactions. Section 5 concludes.

2. Introducing the Private Securities Litigation Reform Act of 1995

The history of securities regulation is a story of policy makers walking a tightrope between encouraging increased disclosure by firms to benefit informed, skilled investors, while also trying to protect less informed retail investors from omitted or false information that would lead them into making bad investments. Leading up to the passage of the PSLRA, regulators had attempted many changes to disclosure rules in an attempt to encourage managers to disclose more information to the public (Note 2). These rules often proved ineffective as investors would use this increased information as the basis for private lawsuits. As the number of securities lawsuits increased, and with a common perception that many of them were of low merit and merely attempts to extort a settlement, Congress stepped into the arena with the passage of the Private Securities Litigation Reform Act of 1995 (PSLRA). This amendment to the two foundational acts governing U.S. markets and the issuance of securities, the Securities Act of 1933 and the Securities Exchange Act of 1934, not only took steps to encourage increased disclosure but to also fundamentally change many of the rules relating to the procedures in private securities litigation.

Many of the changes in the PSLRA were created to reduce potential damages being claimed, which is often used in bargaining over settlement amounts. For example, one change removed securities fraud from the purview of the Racketeer Influenced and Corrupt Organizations statutes that could result in treble damages. Another section created specific rules on how damages were to be measured, as well as defining the period of time over which the "real" price would be measured following the revelation of information correcting a misstatement or omission on which the lawsuit is based.

Procedurally, the PSLRA created several rules on who could be named as lead plaintiff in a securities class action. This lead plaintiff represents all claimants in the class and is expected to choose and monitor the attorneys representing the class. The PSLRA requires that any lead plaintiff certify that they have not served as lead plaintiff in more than five lawsuits in the previous three years, that they did not purchase securities on the advice of legal counsel to participate in a private lawsuit, and that they would receive no extra compensation beyond their pro rata share of the recovery without court approval. But the most significant change affecting the incentives of plaintiffs and their attorneys was creating an explicit preference for the investor with the largest potential claims against the defendant firm to act as the lead plaintiff. It was thought that this change would lead to more sophisticated and increased oversight of the attorneys, resulting in higher payouts to class members with less going to the attorneys representing them. It was also suggested that this would eliminate the race to the courthouse to be first to file in order to be named as lead plaintiff as was common prior to its passage. Because the majority of shares in the U.S. are owned by large institutions, this change was often described as an attempt to encourage institutions to take on this role.

Since the passage of the PSLRA, many papers have examined the impact and effectiveness of this change. Perino (2003) finds that the law did not lead to a significant decline in lawsuits against companies in high-risk industries, nor did it increase the time between a large drop in stock price and the filing of litigation. Yet it is clear that it successfully increased the number of institutional lead plaintiffs. Fisch (2001), Choi, Pritchard and Fisch (2005) and Cox and Thomas (2006) all document an increase in the number of institutional lead plaintiffs and find that larger settlement amounts are associated with having an institution as a lead plaintiff. While this could be attributed to institutions selectively choosing the most lucrative potential suits, Baker, Perino and Silver (2013) also show that attorney fees and rewards are lower following passage of the PSLRA and Choi, Erickson and Pritchard (2020) find that increased scrutiny on attorney efforts have led to attorneys billing more hours to justify their payments from the settlements. One could certainly ask whether this is beneficial for the shareholders, and several papers such as Ferris, Jandik, Lawless and Makhija (2007) or Cheng, Huang, Li and Lobo (2010) have found evidence that there is improved corporate governance following the settlement of a shareholder lawsuit, and that the improvements are greater when an institution serves as lead plaintiff. They also find that lawsuits with institutions as lead plaintiff are more likely to have higher settlements and a greater likelihood of surviving the motion to dismiss.

Another major aspect of the PSLRA was the creation of a “safe harbor” from liability for forward looking statements by management when the statement is immaterial to the valuation of the firm, or accompanied by additional statements identifying it as a forward-looking statement with cautionary language identifying factors that could cause actual outcomes to be materially different from what was forecast. This was intended to make it safer for management to disclose uncertain information or projections to investors, or to more openly disclose bad news without fear the resulting price drop would become the basis for a securities lawsuit. In the aftermath of the reforms, empirical research emerged to examine whether this reform was successful. Early research proposed that firms would increase disclosure to preempt bad news and avoid large negative earnings surprises (Skinner, 1994). Since the passage of PSLRA, this has been supported by papers (Field, Lowry, & Shu, 2005; Donelson, McInnis, Mergenthaler, & Young, 2012) showing that increased disclosure does deter litigation, as well as research by Johnson, Kasznik and Nelson (2000) who find increased voluntary disclosure following the PSLRA by firms with higher litigation risk. On the other hand, it isn’t clear that the reforms succeeded in reducing litigation based on these forward-looking statements. Grundfest and Perino (1997) found that there was a decrease in securities lawsuits claiming fraud in forward looking statements in federal courts after passage of the PSLRA, but an increase of lawsuits related to fraudulent forward-looking statements in state courts. This result provides an early indication of the evolution of securities litigation since the passage of PSLRA as plaintiffs and attorneys work to circumvent the reforms.

While these changes have received the vast majority of empirical analysis, there are other changes that have had a major impact on corporate management today. The first of these relate to the requirement that charges made against the defendant firm be done with particularity, or very specific accusations of misconduct, and with specific allegations and facts that give rise to an inference that the defendant acted with the required state of mind necessary for a private suit leading to monetary damages. The PSLRA also states that the plaintiff has the burden to prove loss causation from the misconduct, and if they can’t meet both of those requirements, it is required that the suit be dismissed. Certainly, these heightened pleading standards have made it more difficult to file litigation that will not be dismissed. But in much of the legal literature, the biggest hurdle is a mandatory stay on discovery related to the alleged fraud until after the motion to dismiss is decided. Because of these changes, plaintiffs were no longer able to file a lawsuit with the hope that they would be able to discover evidence that the statements leading to the lawsuit were known to be inaccurate or incomplete at the time by management as the litigation progressed.

3. Evolution of Securities Laws and Litigation Following the PSLRA

Because there were multiple reforms as part of the PSLRA, it is difficult to disentangle the impact of these heightened pleading standards on the quality of observed lawsuits over time. Compared to the impact of the safe harbor provision or a preference for institutional plaintiffs, there is little empirical evidence examining the impact of these changes. But it was these provisions that immediately led plaintiffs to move their filings to state courts, where they would not be governed by the more stringent rules imposed by the PSLRA. In a paper examining the jurisdiction of state courts in securities class actions, Torabi (2021) points to a statement in the Securities Act of 1933, Section 22(a) that states “no case…brought in any State court of competent jurisdiction shall be removed to any court of the United States”. This rule allows for securities litigation under the 1933 Act in either state or federal courts. Most lawsuits filed under the 1933 act is based on Section 11 of the act that creates strict liability for false, misleading, or omitted statements in the registration statements filed with the SEC during the issuance of a security. It is this section, coupled with Section 12(a)(2) which provides purchasers of securities the right for rescission of their investment for misstatements or omissions of material facts in the prospectus or oral communication, that is the basis for most securities class actions under the Securities Act. Under the Securities Exchange Act of 1934, Rule 10(b)(5) makes it illegal to defraud or deceive someone through the misrepresentation of material information for any security. Because these two Acts were viewed as a common framework for regulating securities markets, courts also allowed claims in state courts under the 1934 act as well. Alternatively, claims could also be made in state courts based on the laws of the state governing the issuance and trade of securities, providing an additional avenue for securities litigation.

Table 1. Summary of Key Legislation and Litigation

Laws Related to Private Securities Litigation	
Securities Act of 1933	
Section 11	Makes issuers liable for any false statements or omitted information in their registration statements at the time of issuance.
Section 12	Similar to Section 11, but relates to prospectus and oral communication, and makes issuer liable for rescission of funds or damages to purchaser.
Securities Exchange Act of 1934	
Section 10	Prohibits use of manipulative or deceptive practices in the sale or purchase of a security.
Rule 10(b)5	Defines what is considered to be a manipulative or deceptive act.
Private Securities and Litigation Reform Act	Enacted in 1995 to limit frivolous securities class action litigation.
Securities Litigation Uniform Standards Act	Enacted in 1998, it provides for class actions filed under state laws to be removed to federal courts.
Rulings Related to Private Securities Litigation	
Cyan, Inc. v. Beaver County Employees Retirement Fund	A 2018 Supreme Court decision clarifying that claims based solely on the Securities Act of 1933 could be tried in state courts.
Salzberg, et al. v. Sciabacucchi	A 2020 ruling by the Delaware Supreme court allowing for enforcement of federal forum provisions.

Immediately after the passage of the PSLRA, there was an observed surge in state court filings to avoid the heightened pleading standards and discovery stay in federal courts. This was documented by Grundfest and Perino (1997), who showed that plaintiffs began to file lawsuits related to alleged fraudulent forward-looking statements in state courts immediately after the passage of the PSLRA. In response to what seemed to be a loophole in the reforms, a follow up law was passed in 1998 called the Securities Litigation Uniform Standards Act (SLUSA). This law attempted to restrict securities class actions under either act to federal courts, under the heightened standards of the PSLRA. To do this, Section 22 of the 1933 act was amended to allow removal of state cases to federal courts. This was done by barring the pursuit of claims based on state laws prohibiting securities fraud in state or federal courts, or if the class represents more than 50 claimants against the defendant firm. By precluding claims filed under state law, it was thought that class action claims would be filed under the provisions of federal law instead.

However, this didn't eliminate the opportunity for forum shopping by plaintiffs. While SLUSA carved out exceptions that retained state court jurisdiction over class actions based on the state law where the issuer was incorporated, or lawsuits by state regulators or pension plans, other unanticipated gaps also existed. First, SLUSA did not expressly rule out state jurisdiction of lawsuits under the Securities Act of 1933, only state jurisdiction over similar claims based on state law. Soon the federal districts came to differing conclusions as to whether SLUSA moved all claims under the 1933 Act to federal jurisdiction. Several federal districts took the view that SLUSA removed from the state courts all jurisdiction over cases involving claims under the 1933 Act, while other districts viewed the rights of state courts to exercise jurisdiction as being unaffected. This split was made more acute by the two most popular venues for securities litigation, the Northern District of California and the Southern District of New York, being on opposite sides of this divide. The Southern District of New York took the view that all claims under the Securities Act were under the jurisdiction of the federal system, and unsurprisingly, case filings in the Northern District of California increased rapidly. In 2018, the Supreme Court of the United States finally stepped in to resolve this conflict. In Cyan v. Beaver County Employees Retirement Fund (Cyan, 2018), a unanimous decision was handed down by the Supreme Court in favor of the interpretation that SLUSA did not strip from state courts jurisdiction over claims made purely under the Securities Act of 1933. While it does prohibit jurisdiction over mixed claims (claims made under state and federal laws), it does allow plaintiffs who only assert claims under the 1933 Act to have their cases heard in state courts under potentially lessened pleading standards and a lack of discovery stay. For a summary regarding the Legislation and legal cases, see Table 1.

4. Current Innovations in Securities Litigation

With plaintiffs and their attorneys attempting to keep lawsuits in the state courts and defendant firms attempting to litigate under the protection of the PSLRA's heightened pleading standards and discovery stay, new innovations have been developed by both sides to gain an advantage. Perhaps the most significant is the increasing adoption of Federal Forum Provisions (FFP) in the initial charters and bylaws of corporations. Following the Cyan decision, plaintiffs were able to file similar litigation based on claims under the Securities Act in state courts, and also 10(b)(5) claims under the Securities Exchange Act that must be adjudicated in federal court. These "parallel" cases had multiple benefits for the plaintiffs. First, it forced management to deal with two separate cases at a cost of time and resources. Second, because many states did not enforce the mandatory stay to discovery based on the logic used in the Cyan decision, a plaintiff could look for evidence in the state procedure that would help overcome the heightened pleading standards in the federal court. One solution for potential defendants was to require that all Securities Act claims be filed in federal court, where they could be consolidated into one case under the protections of the PSLRA.

There is nothing new about forum provisions, as they are a common clause in contracts to specify where and under what set of laws disputes will be resolved. Whether the forum provision requires binding arbitration or specifies in which country or state the litigation will occur, these forums are widely accepted, commonly used, and nearly universally enforced with general agreement regarding the circumstances under which they can be set aside. As such, requiring that cases be adjudicated in federal courts seems a natural extension of a common practice. However, plaintiffs have argued that such a provision accomplishes what the Supreme Court refused to endorse in the Cyan decision; the removal of Securities Act litigation from state courts. In addition, the enforcement of contract rules is left to the states, and there is a possibility that some state courts may see this as an intrusion on their rights.

In the last three years, this question has been litigated on a state-by-state basis. And no state is more important than Delaware, where a large portion of U.S. firms choose to incorporate. In the case of Salzberg v Sciabacucchi, a stockholder brought suit against three Delaware incorporated firms, Blue Apron, Roku, and Stitch Fix, arguing that the Federal Foreign Provisions (FFP) in their corporate charters were invalid. The Delaware Court of Chancery agreed, ruling that they were unenforceable because the claims involved were outside the scope of Delaware corporate law, which involved itself only with claims related to the internal affairs of the firm, such as derivative lawsuits against management. However, the Delaware Supreme Court overturned that decision in early 2020 (Sciabacucchi v. Salzberg, 2018), setting off a chain of similar judgements in other states. Since that time, multiple courts in California, New York, New Jersey and Utah have all judged that FFP are enforceable.

This sets up an interesting option for defendant firms as they can choose to have the FFP enforced and the case removed to a federal court, or they could choose to waive the FFP as part of a negotiated settlement if the rules governing the settlement are less restrictive than those under the PSLRA. Empirically, there is little evidence on the number and type of firms who have adopted FFP, and how investors feel about these provisions. Aggarwal, Choi and Eldar (2020) studied a set of firms that had adopted these provisions to analyze factors leading firms to include FFP in their charters. They find that firms in industries at higher risk of claims under the Securities Act are more likely to adopt them, as well as firms that have better governance based on commonly accepted aspects of governance. Adoption of FFP by firms in their sample increased more rapidly following the Cyan decision. More directly, they found that the share price reaction to the announcement of the initial decision in Sciabacucchi invalidating the FFP was significantly negative for the firms in their sample. However, because only claims filed based on the Securities Act are allowed to be litigated in state courts, it could be expected that adoption of FFP may end up being focused in firms expecting their securities to be publicly traded for the first time.

Currently, there are no other published works looking at this topic, creating an opportunity for further examination. But there is evidence providing strong motivation for further investigation. The differences between securities cases filed in state and federal courts is significant. Grundfest (2019) finds that for cases filed in state court between 2011 and 2018 asserting Section 11 or Section 12 claims, only 19% were dismissed, and the likelihood of reaching a settlement was higher. For similar claims in federal courts, 42% of cases were dismissed. Overall, the size of the settlements was similar. But if weaker cases were allowed in state courts, similar settlement amounts could represent the ability of weaker cases to attract similar settlements compared to stronger cases in federal courts. Furthermore, over that same time frame, premiums for D&O insurance issued at the initial securities offering has increased by multiples of 8-10 times what they were in 2011. These costs must be borne by all firms issuing securities, and not just by those firms that end up being sued in Section 11 litigation. Whether these costs will be lower for firms with FFP remains an open question as well.

As defendant firms take steps to force litigation into federal courts, plaintiff attorneys have increasingly adopted strategies to overcome the heightened pleading standards in federal courts. A growing trend in securities litigation is the filing of “event driven” securities litigation (EDSL). While usually filed as 10(b)(5) claims, these alleged claims are based on the non-disclosure of corporate events that lead to a stock price drop at their announcement. For example, an FDA investigation into the safety of a firm’s product becomes a lawsuit when the FDA announces conclusions that negatively affect the viability of that product in the market. These piggyback lawsuits often take advantage of the investigative work done by outside agencies and regulators to provide the specific claims needed under the PSLRA, allowing plaintiffs to overcome the discovery stay that would make it more difficult to get past the motion to dismiss. Furthermore, the use of confidential witnesses, people inside the firm who can demonstrate knowledge of contrary facts by management when making actionable statements, have become a common feature of this type of litigation to get past the discovery stay.

Over the last decade, there has been a significant decline in litigation related to restatements of company’s financial performance, while EDSL have become more prominent. In a study examining the growing trend of event driven securities litigation, Mark (2021) finds that by 2020, only 5% of core securities lawsuits (those filed under Section 10(b)(5) of the Securities Exchange Act or Sections 11 or 12 of the Securities Act) were related to announced restatements to firm financials, down from 19% in 2014. In comparison, 34 EDSL represented 25% of core cases in 2018, and that number had increased to 47 by 2020. Mark (2021) also rebuts the perception that these are generally weak cases and shows that the courts have proven to be adept at dismissing weak cases using these claims, while allowing meritorious cases to proceed. This view is supported by Strauss (2022), who examines a sample of event driven cases filed between 2010-2015 and finds that they were 20% less likely to be dismissed and settled for significantly higher amounts. In addition, they were more likely to have attributes associated with stronger claims, such as being filed against larger defendant firms, and having an institution as lead plaintiff.

With the increasing prevalence of event driven securities litigation, legal scholars are asking whether everything has become securities fraud? Even seemingly innocuous statements, such as a firm reassuring customers that their information is secure by claiming state of the art protection, can become the basis of litigation in the wake of a cyber-attack against the firm that results in information being stolen. Plaintiffs have used similar statements to claim that they purchased shares reliant on the incorrect belief that those statements were true as the basis for the 10(b)(5) filing (Note 3). So even though these lawsuits are filed in federal courts, under the protections provided by the PSLRA, we are again seeing securities litigation creating impediments to increased management disclosure and communication. This trend is examined by Langevoort (2019) and Strauss (2022), who consider what type of duty management has to disclose risks relative to potential negative events, and the impact that has on the ability of plaintiffs to establish the requisite knowledge on the part of management to assert litigation claims. Both papers also point out the perverse incentives created by event driven litigation, as shareholders might prefer management to prevent knowledge of these risks from becoming widespread or might encourage management to aggressively take on riskier projects to increase stock price, knowing that they could recover damages based on the very actions they encouraged. Fox and Mitts (2022) suggest that event driven litigation creates the need to reform how damages are estimated in securities litigation, with increased focus on how much the statements used to establish the claim actually inflated stock prices prior to the event. And Mark (2021) explains the common defenses used by defendants to refute claims in EDSL.

From the perspective of future research, how courts treat these claims in future cases will have a major impact on the financial environment of the firm. Pier (2011) found that disclosure has improved following the passage of PSLRA, SLUSA and regulation FD. But as managers deal with increased litigation costs and penalties from EDSL on top of the litigation expenses from the event itself, we may see a reduced willingness to make any statements beyond those required by law. We could also observe more conservative financing policies, as prior studies have associated increased litigation risk with higher cash holdings (Arena & Julio, 2015; McTier &Wald, 2011) and increased costs of financing (Arena, 2018). These topics might be reexamined as future judgements encourage or push back on these types of claims (Note 4).

5. The Safe Harbor Provision and the Rise of Special Purpose Acquisition Companies

While shell corporations have been used for decades as a method to bring small companies to the market without going through the traditional IPO process, they exploded into prominence in the past decade. In 2017, these special purpose acquisition companies (SPAC) represented only 24.3% of the 140 companies going public that year (Note 5). Over the next five years, they grew to 66.3% of the 924 transactions leading to companies listing on public markets

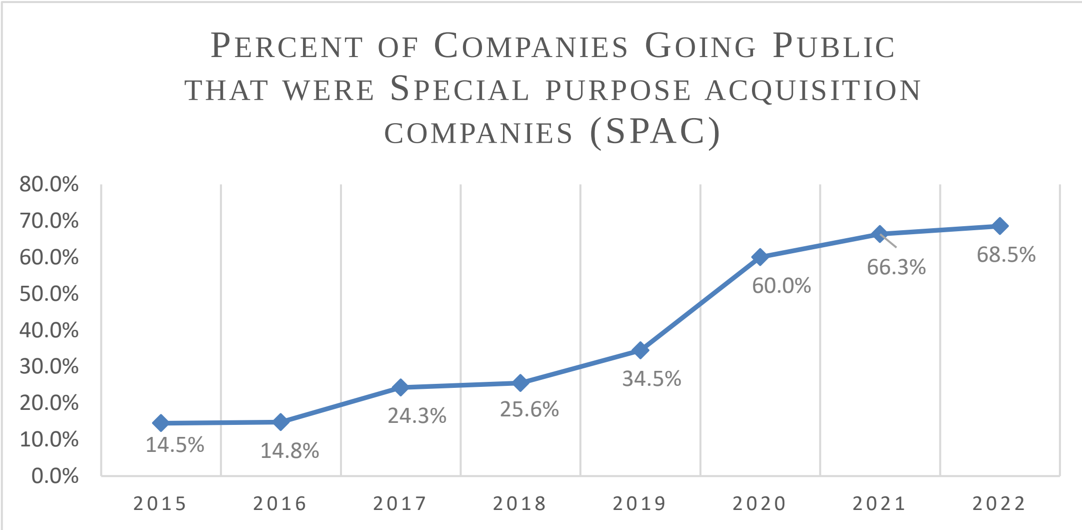

Figure 1. Percent of Companies Going Public Using Special Purpose Acquisition Companies

(See Figure 1). Since 2020, there have been more companies going public through SPAC transactions each year than those choosing the traditional IPO offering, and not surprisingly, litigation filings related to these transactions have grown proportionally. A SPAC is created when a sponsor raises money for the entity through an initial public offering. Ownership is sold to investors in a company that has no operations of its own, and which only exists to find a target for a merger transaction. Because the SPAC has no prior operating history, little information needs to be disclosed at the initial public offering. All money raised in the offering is held in trust, and when the sponsor finds a worthy merger target, all shareholders are allowed to vote on the transaction. If passed, the merger is consummated and the private firm is brought to market based on the previous filing of the SPAC itself. If the SPAC fails to find the target within a set deadline, usually 18-24 months, all money raised at the time of the SPAC IPO gets redeemed to the investors with interest. In fact, one unusual aspect of these "de-SPAC" transactions is that shareholders in the SPAC can redeem their initial investment by selling shares back to management at any point up until the transaction is consummated; even if they voted in favor of the transaction.

While there are many aspects of SPAC mergers that have been criticized and are the subject of current debate within the law and economics literature, one aspect is particularly relevant to this review. Proponents of these transactions suggest that one benefit of SPAC mergers is that it allows small, retail investors access to early-stage investment that has historically only been available to large institutions during the standard IPO transaction. And while this is certainly true, it is also cause for great concern on the part of regulators. The PSLRA offered a safe harbor to forward looking projections in other managerial communications, but Congress specifically chose to not apply the safe harbor to forward looking statements made as part of the IPO process. Although provisions within the PSLRA allowed the SEC to revisit the topic in the future, following a review in 2004-2005, the SEC chose to not extend safe harbor to forward looking statements in IPOs. At the time, they were worried that due to the limited amount of information regarding prior operating history for firms at the time of an IPO, there was little basis for investors to use in evaluating the reasonableness of future projections. Thus, the SEC chose to come down on the side of protecting less sophisticated investors rather than encouraging more information for all investors.

With the explosion in de-SPAC transactions, the debate as to whether this is optimal has become more relevant. Unlike the traditional IPO, the de-SPAC transaction is a merger and market participants have assumed that forward looking projections come under the protection of the safe harbor provision. And historically, forward looking projections were customary or even required by state laws as part of the documentation given to shareholders and management as they evaluate the attractiveness of potential mergers. Rose (2023) shows how this has opened the door to "regulatory arbitrage", or the opportunity for management to safely present information in one type of transaction, which leads to the same outcome as a different transaction where such disclosure could become the basis for private litigation.

Because of the different rules' regimes, it was suggested that de-SPAC transactions may be more likely to attract younger firms, or ones that would have difficulty meeting the greater informational standards required for the traditional IPO process. Early empirical evidence found that SPAC transactions are more expensive than traditional IPO transactions, with high returns going to the SPAC sponsors, and low market adjusted returns to public investors (Klausner, Ohlrogge, & Ruan, 2022; Gahng, Ritter, & Zhang, 2023). Blankespoor, Hendricks, Miller and Stockbridge (2022) examine the accuracy of forecasts used in de-SPAC transactions and find that only 35% of firms end up exceeding their forecasts, and accuracy declined as forecast periods increased. And compared to the growth of benchmark firms, they find that the forecasts are three times higher than actual growth. In response to the growing perception that SPAC investors were being harmed by limits on liability, the SEC proposed many changes to the regulation of SPAC transactions in March of 2022 (Note 6). Among these proposed changes was the removal of safe harbor protections for forward looking projections in a SPAC transaction, and aligning other information disclosure with what would be included in the proxy of a traditional IPO.

Several recent studies have examined whether these proposals related to forward looking statements would be better for investors or needed at all. Rose (2023) examines the exceptions provided in the PSLRA safe harbor provisions in order to analyze what the intent of Congress was when creating the safe harbor, and whether having two different liability standards creates a problem that needs to be solved. Using this framework, she analyzes the cost and benefits of extending the safe harbor protections to IPOs. Orcutt (2022) also suggests that extending the safe harbor protections to IPOs would be a sensible way to go, coupled with extended lockup periods for management equity to prevent management from benefitting from exaggerated forecasts that could damage unsophisticated investors. Nelson (2022) points out that the PSLRA bars plaintiffs from filing private actions enforcing rules against fraudulent disclosure in the courts, but it does not prevent public enforcement by the SEC which can serve as a deterrent to overly optimistic or even fraudulent forecasts. Furthermore, these merger transactions are also subject to state derivative lawsuits by investors for breach of fiduciary duty against the managers and board of directors of the firms involved.

Another recent study has examined the characteristics of SPAC transactions which have led to lawsuits being filed against the company. Strauss (2023) find that there is no significant difference between the age of firm, the post-merger returns, or length of time needed to complete the merger when comparing transactions that resulted in a securities lawsuit and those that did not. Not surprisingly, transactions that were followed by a lawsuit filing were larger and from specific industries. However, she finds a curious result that de-SPAC transactions leading to litigation has significantly lower redemptions by the SPAC shareholders leading up to the transactions. Shareholder redemption is considered as a good measure for investor sentiment regarding the merger, and this result suggests that those transactions seen to be of higher quality are the ones that are more likely to be sued. After considering alternative explanations, she finds that private enforcement might be a poor solution for trying to prevent lower quality transactions compared to public enforcement mechanisms.

Given how quickly this market is evolving, there is great opportunity for new research to inform the current policy debate, as well as to analyze the impact of potential regulatory changes. One such question is the relationship between investors choosing to redeem their shares and the accuracy of forecasts used in de-SPAC transactions. Such a study would examine the ability of retail investors to recognize riskier deals and the extent to which they need protection. Another unexamined aspect is the relationship between litigation risk and the willingness of PIPE investment to fill the gap created by high levels of shareholder redemptions leading up to the merger transaction. Finally, it is still unknown how much the difference in liability created by the PSLRAs safe harbor protections actually contributes to the movement towards SPACs versus IPOs, as opposed to other factors that could explain the growth.

6. Conclusion

Thirty years after the passage of the PSLRA, it continues to have a defining impact on financial management. Whether an ongoing debate overextending its safe harbor provisions to forward looking projections in IPOs versus restricting those same provisions in SPAC offerings, unsettled questions as to whether PSLRA provisions apply to state litigation, or a constant stream of litigation strategies attempting to bypass its restrictions, the PSLRA continues to force market participants to adapt their behavior in preventing or pursuing shareholder litigation. Given the impact it has, savvy market participants need to track how it is being enforced as they evaluate the risk and opportunity presented by potential investments. Better understanding of recent developments allows researchers to predict how management will react and as educators, explain to a wider audience why change is occurring in the approaches management takes to payout policy, financing, or even public communications.

Notes

Note 1. The complete text, summary and legislative history of the PSLRA can be found at: https://www.congress.gov/bill/104th-congress/house-bill/1058

Note 2. Torabi (202) and Orcutt (2022) offer detailed reviews of prior legislative attempts to increase managerial disclosure prior to passage of the PSLRA.

Note 3. In re Solarwinds Corporation Securities Litigation 1:21-CV-138-RP.

Note 4. For a review of the extensive research examining the link between litigation, managerial decision making and corporate value, see Arena and Ferris (2017).

Note 5. Data is obtained from Cornerstone Research. https://www.cornerstone.com/insights/reports/securities-class-action-filings/

Note 6. https://www.sec.gov/news/press-release/2022-56 has links to the text of the proposed changes.

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